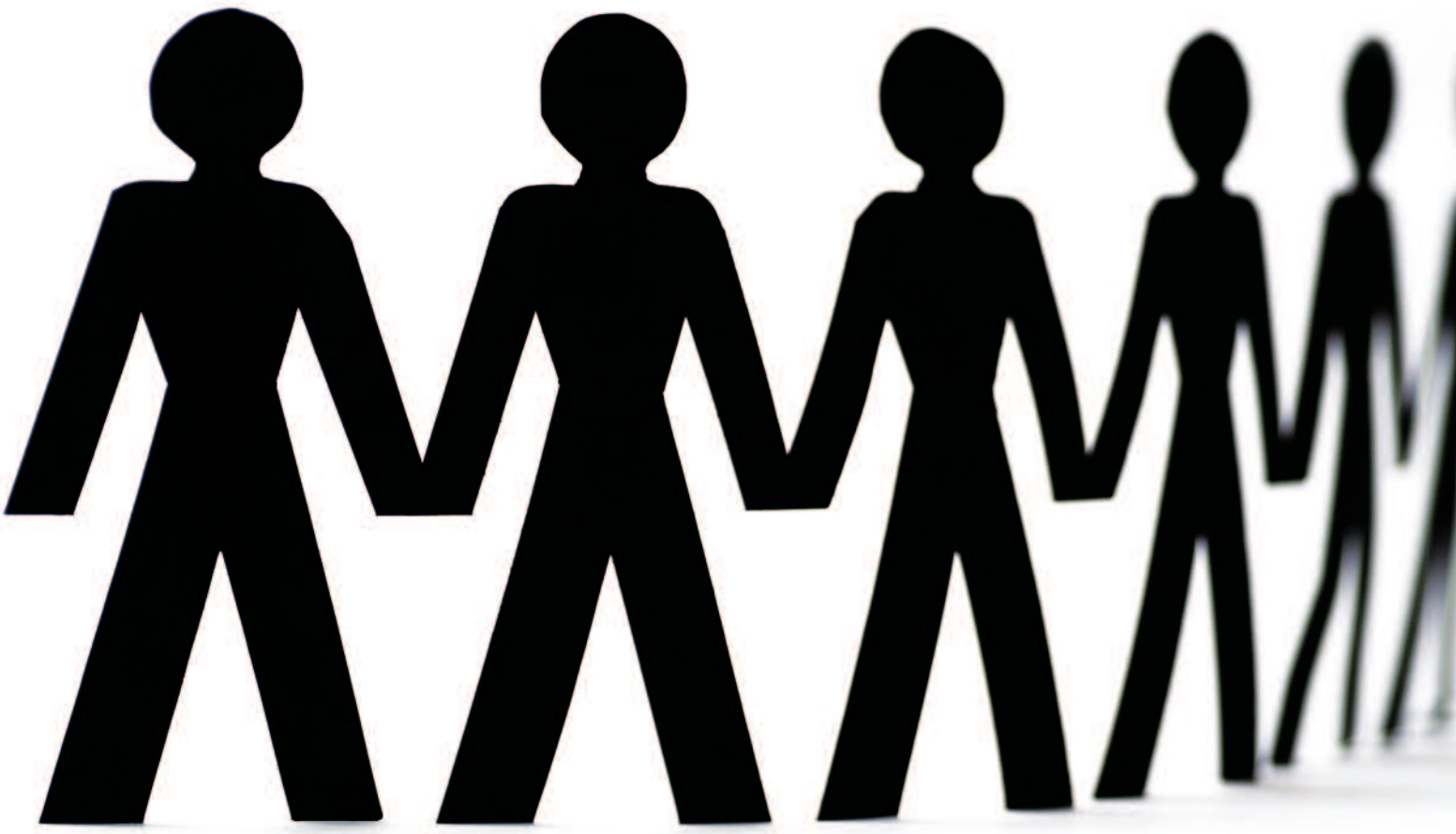
Controlling Public Spending

Policy Exchange

Pay, Staffing and Conditions in the Public Sector

Ed Holmes and Andrew Lilico



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About the Authors

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He is a member of the IEA/Sunday Times Shadow Monetary Policy Committee, is one of Europe's top experts on the economics of financial regulation (having led the teams assessing for the European Parliament the impact of the AIFM Directive, the Financial Services Action Plan, led one of the two large projects for the European Commission on the FSAP, and led the project for the Financial Services Authority on the impact of the Markets in Financial Instruments Directive) and is a leading UK authority on cost of capital analysis (advising Ofwat on the cost of capital for the water industry, the CAA on the costs of capital for the London Airports, and Ofcom regarding BT, Sky Digital, and others).

His first degree was from St John's College, Oxford, and his doctorate was from University College London (where he has also lectured in Money and Banking, Macroeconomics, and Corporate Finance). He also has a Masters degree in Philosophy from the University of London (where he currently teaches Epistemology and Metaphysics).

Published by
Policy Exchange, Clutha House, 10 Storey's Gate, London SW1P 3AY
www.policyexchange.org.uk

ISBN: 978-1-906097-80-6

Printed by Heron, Dawson and Sawyer
Designed by SoapBox, www.soapboxcommunications.co.uk

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Acknowledgements

With special thanks to the Rosenkranz Foundation for funding this study and the generous support of Theodore Agnew, James Barty, Robin Edwards, Don Hanson, Andrew Law, Philip Richards and Robert Rosenkranz.

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Executive Summary

Part one: a summary of findings from our analysis

Pay

- On any measure, public sector workers are now, on average, better paid than private sector workers. The median salary in the public sector is 12% higher, or 30% higher on an hourly basis.
- This pay advantage is not evenly distributed. It is higher in lower grades, with the bottom 10% of public sector workers now 25% better paid than their private sector equivalents. This is a post 1997 phenomenon – they were 4% less well paid in 1997.
- We do not believe that the public sector premium can be explained away by differing qualifications or age (although no-one has suggested it can be fully explained away). Paper qualifications are used in the public sector where informal CV experience tends to be used in the private sector. Using previously unpublished ONS data, we find that in two thirds of cases where people are doing the same job in both sectors, public sector workers are substantially better paid. This might be thought surprising in the case of private nurses or teachers, given the high cost of private healthcare or education.
- National pay setting means the same wage everywhere in the country, despite huge differences in costs in different areas. "London weighting" and other fixes are not enough to offset this, so the public sector wage premium is small in the south east and London. It is higher in Scotland, Wales, the North East and North West, where public sector workers enjoy a 17-20% premium.
- National pay setting results in wasteful overpayment in some areas, and underpayment and staff shortages in others.
- Public sector wage growth has been higher than the private sector across the overwhelming majority of occupations. In three quarters of categories where there are equivalents, public sector wages have grown faster. However, wage growth has been *particularly* high in some sectors, such as health.
- These factors all combine. A low paid worker in a lower income region, in a sector where the pay premium is higher will enjoy a huge premium over his or her peers in the private sector.
- Wage drift is an important part of public sector pay growth, adding 30-40% to the "headline" increase in a normal year. We should expect that wage drift would accelerate if a freeze in the headline rate is announced, and some other countries have announced promotion freezes to counteract this.
- The Labour government set in train a real terms cut in public sector wages by capping nominal increases at 1%. This would lead to a 4% real terms cut in the absence of wage drift. Any political argument is not, therefore, about the principle of whether there should be real pay cuts in the public sector, but about the magnitude of such reductions.

Headcount

- Outsourcing and the Private Finance Initiative have further blurred the already unclear boundary between the public and private sector and may have masked the rising numbers of people working for the government to some extent. On the narrow ONS definition, the number of people working in the public sector has increased by 692,000 (or 13%) since 1997, bringing the total to 5.9 million. But on the ONS Labour Force Survey definition, based on people's own reports, the total number of people working for the public sector has increased by 1,258,000, or 21%, bringing the total to 7.3 million. Over the period 2002-2009 the number of people working in the public sector increased nearly five times more quickly than numbers in the private sector.
- The number of management positions has increased particularly rapidly in recent years, increasing by over 80% between 2002 and 2009. However, the proportion of people in management in the public sector is still lower than in the private sector.
- The increases in headcount are highly concentrated in certain sectors. A remarkable net 97.7% of the increase in numbers has been in education and the NHS.

The payroll bill

- Because both headcount and pay have grown faster than in the private sector, the paybill has increased very rapidly. Public sector pay costs increased 33.2% in real terms between 2002 and 2009 alone, nearly three times faster than in the private sector.
- Some categories of public sector workers have seen large increases in their numbers, but relatively normal (for the public sector) increases in their pay. The most important example of this is the growth of management roles in the public sector. Social and youth workers are another example of this. Some groups have seen substantial increases in pay, while their numbers remained relatively constant, or even declined. Firefighters and manual roles are examples of this. In a number of categories both numbers and pay have increased sharply. This is particularly true of higher paid roles in health.
- It is important to understand the relative significance of different groups. While there is certainly evidence of an increase in the number of non-core jobs (like marketing, PR, customer service and office managers), these groups are small as a share of the total. Nonetheless, the total spend on these roles has increased by £4 billion as the result of both rapid growth in numbers and rapid pay increases. Those who think these roles unnecessary will see this as a good place to start reducing spending.
- The growth of management is a more serious issue, and accounts for £14 billion of the £67 billion increase in the payroll bill between 2002 and 2009.
- However, the growth of the paybill is, nonetheless, dominated by the growth in the pay and numbers of frontline workers in health and education.
- The most recent attempt to freeze the payroll bill in the UK, back in 1993, led to the majority of the cuts falling on headcount, rather than pay.

Beyond the paybill

- There are several aspects of public sector remuneration (and costs) which are not fully captured in the payroll bill. These include job security, pensions, and time worked. The old idea that public sector workers have "lower salaries but job security and gold-plated pensions" is out of date. Workers in the public sector now enjoy both higher salaries *and* better conditions.

Job security

- Data on job security is limited. Over the last decade the redundancy rate in manufacturing or construction has been seven times higher than in the public sector, roughly defined. During the recession these multiples increased to 16 and 10 times respectively. In a large survey of 60 different public sector organizations coordinated by the Cabinet Office, just 13% of employees disagreed with the statement that their organisation "is too lenient with people who perform poorly here." The Civil Service is the most extreme example of this. Less than 1% of civil servants take voluntary redundancy each year, and compulsory redundancies are even rarer, affecting less than 0.005% of the workforce a year. Job security can be seen as a benefit for the individual worker, which might be worth a certain amount of salary.

Pensions

- Between 1997 and 2008 the proportion of public sector workers without pension provision from their employer fell from 21% to 16%. However, in the private sector the same figure rose from 54% to 63%. While the proportion of public sector workers in more generous defined-benefit schemes largely rose until 2006, the number in the private sector has progressively declined – to just 8% of its workforce compared to 80% in the public sector by 2007. There are various estimates of the value of these more generous pensions, putting the value at between an extra 12% and 15.6% of total salary.
- In the 2009 Pre-Budget Report the government moved to cap its contributions to pensions, saving £1 billion. If we were to go further we could try to close some of the 15% of salary gap which is currently "met" through increasing unfunded liabilities. These liabilities are not captured in the paybill. An Irish style pension levy of 7.5% would close half this gap.

Time worked

- Public sector staff work 23% less hours over their lifetime, thanks to a combination of shorter hours, more time off – and earlier retirement. This is not fully captured in the paybill, and is a benefit to the people who work in the public sector.

International lessons

- Most countries currently undergoing fiscal consolidations are using a mix of wage freezes and cuts (often falling more heavily on the higher paid). Few have explicitly targeted headcount reductions, though many are using partial or total recruitment freezes to drive down headcounts through natural wastage. Ireland is implementing a 10% reduction in pay, three quarters of which takes to form of increased pension contributions. Portugal has also targeted the pension bill, along with a 5% wage cut. In France the public sector is not replacing half of retirees,

using natural wastage to drive down headcount. The Netherlands have introduced a one year wage freeze, and Greece has announced a four year wage freeze. The Spanish government is pursuing a 4% cut in the total pay bill. It has also introduced a "ten out, one in" rule: nearly, but not quite, a total recruitment freeze.

- Less developed European countries like Lithuania and Romania are simply cutting wages by around a quarter. In the US the response is most visible at the state level, where there has been extensive use of unpaid leave, and the municipal level, where towns have declared bankruptcy in order to shed their pay and pensions commitments.

Part two: recommendations

Overall approach

- We should adopt a hybrid approach. Overall we should set a target to reduce the paybill, rather than introduce a single across the board wage freeze. This allows different tradeoffs to be made between headcount reductions and pay reductions in different areas, and would be more efficient. This approach has been tried in the UK before, and is currently being implemented in Spain.
- However, we should also introduce an Irish style levy on public sector pensions. If this can be successfully implemented, the total amount that will need to be found from pay cuts and headcount reductions can be smaller.

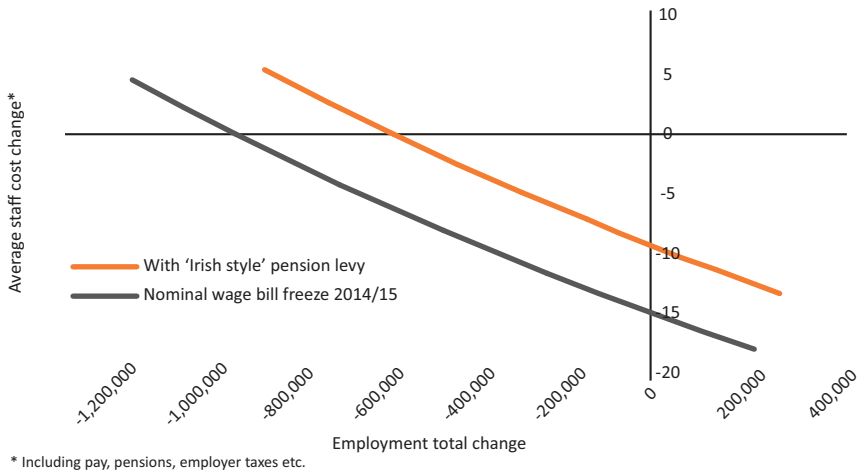
Overall target

- We should freeze the public sector paybill in cash terms until 2014/15.

This is a real terms cut of 14.6%, saving £26 billion per year by the final year.

- It would take the paybill back to where it was in 2003/4 in real terms.
- It is unrealistic to expect the entire burden to be borne by pay decreases alone.
- Unless healthcare is included in the paybill freeze, it is probably not plausible to target the same reduction.

Figure 1: Tradeoff in public sector employment totals, real average salaries for nominal paybill freeze to 2014/15



* Including pay, pensions, employer taxes etc.

- Opposite we see the sort of trade-off that would be involved in freezing the paybill to 2014/15. The lower line shows the various combinations of pay and headcount reductions which would be needed to implement a nominal paybill freeze to 2014/15. If greater savings are found above those already identified in existing spending plans, this proposal would allow the trade-off line to shift up and to the right. This would be the consequence of using the proceeds of an 'Irish style' pension levy to mitigate the effects of a cash freeze – allowing 322,000 fewer layoffs.
- This trade off looks rather stark. But to put these numbers into some context around 400,000 people per year leave the public sector. Not replacing half of staff who leave for three years would reduce headcount by around 600,000.

Longer term reforms

- We should aim to phase out national pay bargaining, and replace it with local wage bargaining. This would be fundamentally more efficient than national pay bargaining.
- We should reduce the cost of redundancies in the public sector, particularly in the civil service.
- We should consider the future role of trade unions in the public sector, particularly in the light of moves to local pay bargaining.

Introduction

Pay is nearly 30% of total public spending, or around half of the total departmental spending bill. This total would be even higher if we included the unfunded pension liabilities the Government is accumulating. Some 6-7 million people work in the public sector (depending on the definition used), around 20% of the total workforce. Measures affecting public sector pay and staffing numbers thus have significant implications for public spending and for the personal circumstances of millions of workers, as well as potential knock-on implications for those making use of public services.

In this report we begin by analysing the current situation, considering issues such as how public sector pay has evolved over time, how public sector pay compares with that in the private sector, how public sector pay varies across regions of the country, and how public sector pay is being affected in other countries during their fiscal consolidation programmes. We then move on to consider how the number of people employed in the public sector has evolved, again considering the question from a number of angles. We examine conditions of employment, like pensions and the amount of time worked. We then bring these different factors together to examine how the total paybill has changed. To conclude our analysis we will look at developments in other countries.

Finally we will consider options for reform, and reflect upon the trade-offs involved – e.g. between pay cuts and cuts to staffing numbers; between cuts of the same magnitude across regions and those focused in particular geographical areas; and between across-the-board cuts and cuts affecting particular departments.

Part One

Analysis of the Current Situation

1
Pay

Overall trends in public and private sector pay

Whereas during the period up to 1997, public and private sector pay rose at very similar rates, between 1997 and 2009 typical pay grew 32% faster in the public sector as in the private sector. Much of the differential arose between 2002 and 2009, when public sector pay increased 86% faster than the private sector. Typical pay in the public sector is now 12.5% higher than in the private sector.[1]

Part of the reason for this growing difference is the relatively stagnant real earnings of the private sector since 2002.[i] Much of the additional public spending since 2002 has been used to pay higher wages rather than hire additional staff. Had pay increases been restricted to the private sector average, significant savings or increased staff levels could have been realised.

Savings had public sector pay growth conformed to private sector levels

Table 1.1

2009 compared to 2002 (nominal)	Doctors	Nurses	Policemen	Firefighters	General government pay costs
Percentage increase in average pay	36.0%	33.5%	29.1%	33.6%	37.6%
Increase in pay costs	£6,836m	£4,467m	£2,716m	£441m	£41,951m
Increase due to additional pay	£3,459m	£3,538m	£2,178m	£441m	£36,424m
Increase due to additional staff	£3,377m	£928m	£538m	£0m	£5,527m
Potential saving in 2009 if pay increases had followed private sector average	£1,700m	£1,607m	£806m	£200m	£18,695m
Additional staff in 2009 which could have been paid for had pay increases followed private sector average	30,600	67,000	22,800	8,500	952,100

Source: Annual Survey of Hours and Earnings supplementary data, United Kingdom National Accounts, 'The Blue Book' 2009, Office for National Statistics. Nominal mean values: health professionals, nurses, police officers (sergeant and below), fire service officers (lead fire officer and below). General government pay costs exclude public corporations and social contributions.

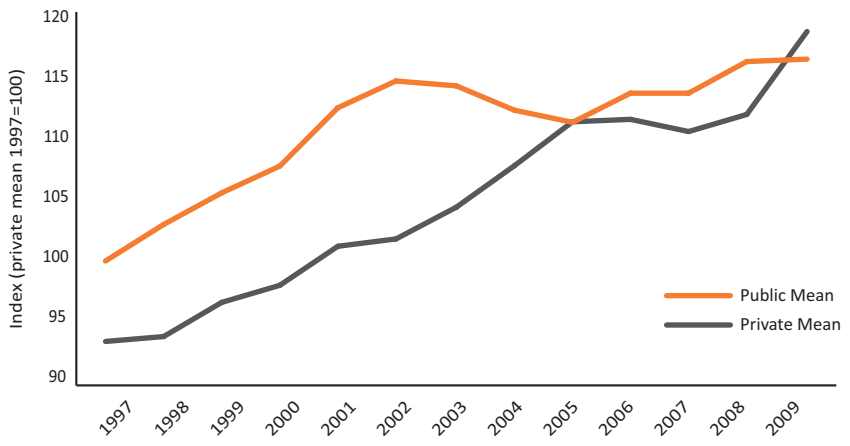
1 Median average pay, ONS, *Annual Survey of Hours and Earnings.*

- Had the public sector headcount remained the same as it was in 2002 but remuneration per head continued to rise at the same rate, then pay costs would have been £8.8 billion per annum lower by 2009.
- If, conversely, headcount had grown as it did, but the pay of public sector workers had conformed to the private sector average growth, then £17.6 billion would have been saved by 2009.
- In other words, excessive pay growth has been a more important reason for rising pay costs than increasing headcounts.
- Combining both pay and staffing, had central and local government headcount remained the same as in 2009 as 2002 *and* average pay increased at the same rate as the private sector average, the salary bill for these workers would have been 18.9% lower in 2009 – a saving of £25.2 billion in that year.

A logical thought might be that pay should be linked to productivity – the more productive you are, the more you are paid.[2] So was the more rapid rise in public sector pay perhaps justified by a more rapid rise in public sector productivity? Alas not. The Office for National Statistics finds that public sector productivity fell by 3.2% in the decade 1998 to 2007, during which period private sector productivity rose by 22.8%.

Why productivity fell in this way is disputed, but causes often cited include: that it was a brute result of large increases in spending that were simply too rapid to be absorbed efficiently; that it was a consequence of high spending levels meaning that incentives to be efficient and productive were blunted by the lack of scarcity; low staff morale; a lack of innovation; a semi-automatic pay and promotion system which often does not significantly reward effort or ability; and extreme difficulties in sacking underperforming workers and rewarding high performers.

Figure 1.1: Index of real basic median salaries in the public and private sectors, 1997-2009



Source: Office for National Statistics – Annual Surveys of Hours and Earnings – Analyses by Public private sector (1997-2009).

2 Formally, economic theory teaches that wages will be efficient when the marginal product of work is equal to the marginal cost (the wage).

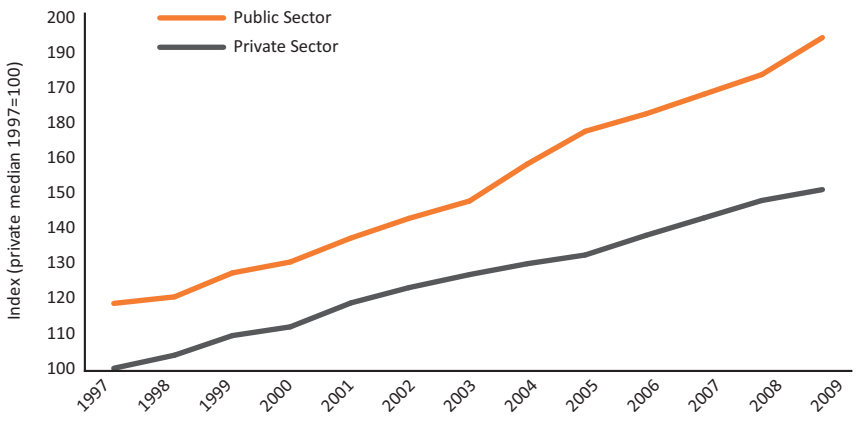
Much commentary appears still to regard public sector workers as low-paid. This may have something to do with high profile media reports of very high remuneration at the top of the private sector pay scale (multi-million pound 'mega-salaries' and bonuses in financial services, for example) and an implicit misunderstanding of job comparability. Because the mean average was dragged up by a small number of very high earners, mean salaries in the private sector were indeed slightly higher than the public sector before the recent recession, largely because of a combination of bonus payments and significantly higher remuneration for the top 10% of private sector employees.

However, when distributions are significantly skewed at the top or the bottom, such that the mean value is largely driven by the extreme outliers, it is often more informative to consider the median – the middle value. The median wage (i.e. the wage that 50% of employees earn less than) is generally accepted as a better indication of a 'normal' wage than a raw mean.[3] Median wages in the public sector, excluding bonuses, have been above those in the private sector since 1997 with the gap widening significantly after 2002 (and indeed dramatically during the recent recession).

Significant divergence occurs subsequent to the large increase in spending from 2002 onwards. In real terms, the public sector enjoyed the strongest growth in 2009. The median public sector salary premium grew from 2.4% in 1997 to 12.5% in 2009.

It is sometimes argued that this premium results from the greater proportion of part-time workers in the public sector.[4] In fact, if we strip out this distortion by looking at hourly rather than annual pay, the public premium is exacerbated.

Figure 1.2: Index of nominal median gross hourly pay in the public and private sectors, 1997-2009



Source: Office for National Statistics – Annual Surveys of Hours and Earnings – Analyses by Public private sector (1998-2009).

The public sector premium grew from 18.8% in 1997 to reach 28.9% in 2009, accounted for relatively flat hourly earnings in the private sector between 2001 and 2005 and large public sector increases between 2003 and 2005 and in 2009.

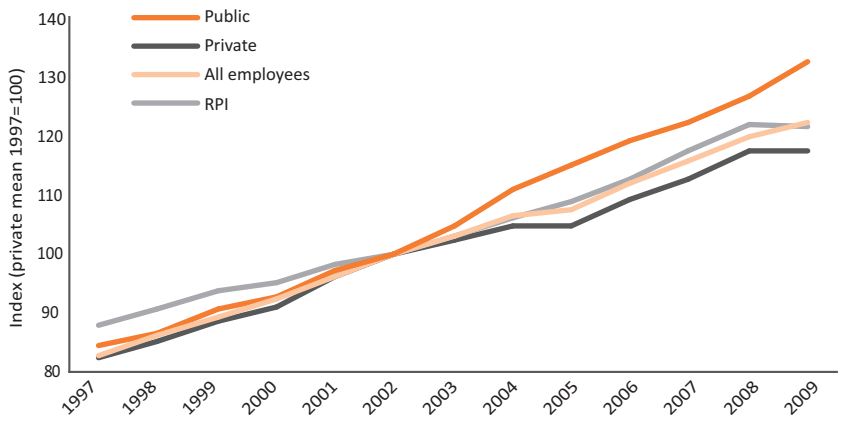
3 [The median is the] 'ONS's preferred measure of average earnings as it is less affected by a relatively small number of very high earners and the skewed distribution of earnings. It therefore gives a better indication of typical pay than the mean'. http://www.statistics.gov.uk/pdfdir/ashe1109.pdf, p. 14.

4 For example, see 'Public sector pay: some unstraight statistics from the Sunday Times', http://www.touchstoneblog.org.uk/2010/01/public-sector-pay-some-unstraight-statistics-from-the-sunday-times/

As discussed above, at the very top of the private sector salary distribution there are some very high salaries – far higher than in the public sector – which drag up the mean. But in 2009 even the *mean* basic salary of public sector workers overtook that of the private sector. Mean public sector salaries are now 1.9% higher than the private sector.

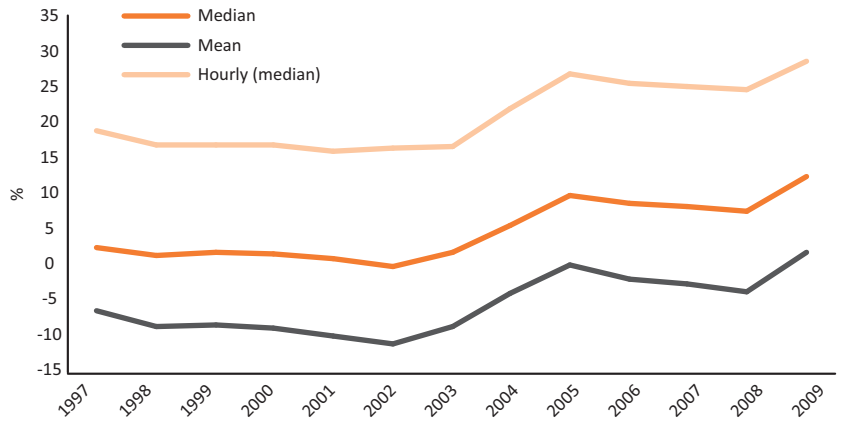
The gap between public and private sectors has widened particularly quickly since major public spending growth began in 2002. The relative stagnancy of real private sector wages, especially between 2002 and 2005, is in stark contrast to the public sector, which consistently grew faster than RPI inflation every year except 2007 and 2008.[5] In total, since 2002, public sector pay has grown twice as fast as private sector pay.

Figure 1.3: Index change in public and private sector gross pay versus RPI inflation, 2002-2009



Source: Annual Survey of Hours and Earnings, Office for National Statistics.

Figure 1.4: Public sector premium, 1997-2009



5 Annual Survey of Hours and Earnings, Office for National Statistics. The ONS' Average Weekly Earnings data shows a similar result but with slightly higher private sector earnings growth. See http://www.statistics.gov.uk/StatBase/Product.asp?vlnk=14015

On any measure, public sector workers now enjoy a significant pay premium. We will return to the subject of time worked later in this report. However, it is worth noting at this point that on an hourly basis the premium enjoyed by public sector workers is even larger – and had grown to a 29% premium by 2009.

Trends in public and private sector pay across the income distribution

Significantly greater divergence emerges when one compares salaries for different income groups. Pay growth in the public sector has been concentrated among lower earners. Pay in the bottom tenth of the public sector grew twice as fast as in the private sector over the whole period 1997-2009.

Figure 1.5: Public sector gross pay growth as percentage of private sector growth by percentile, 1997-2009

Figure 1.6: Public sector gross pay as percentage of private sector by percentile, 1997 and 2009

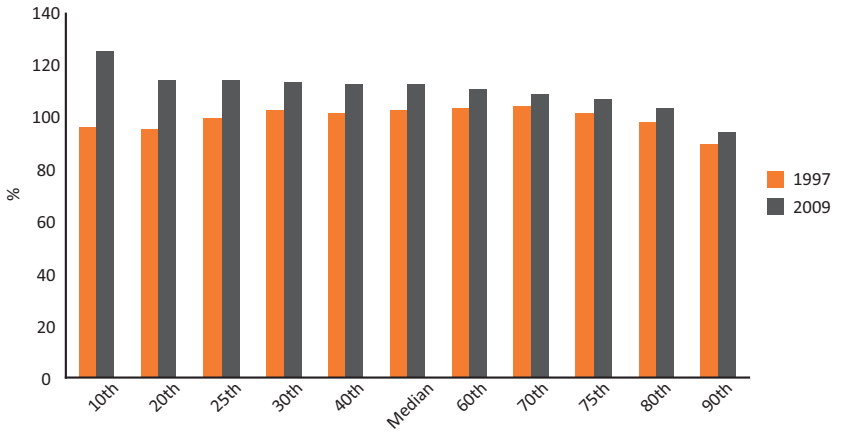
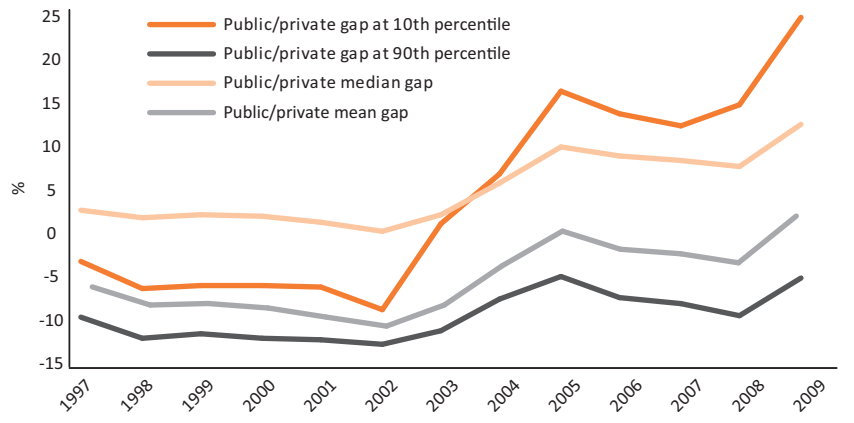


Figure 1.7: Public/private pay gap, 1997-2009



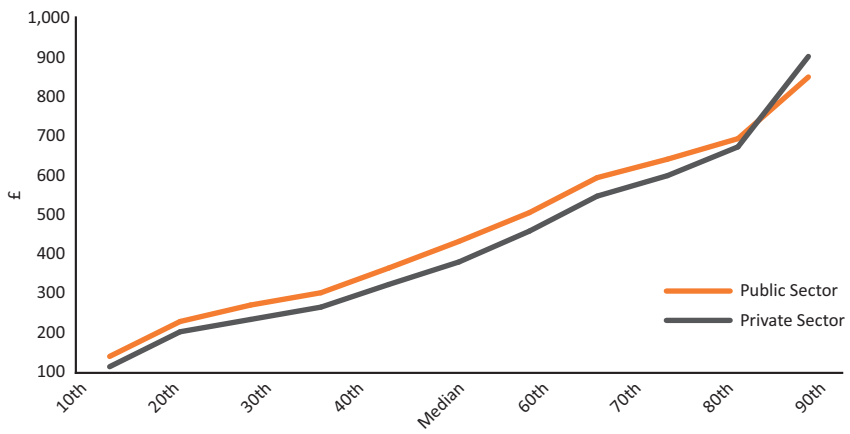
We hence see that public workers at the 10th percentile (i.e. the low paid) enjoyed far greater increases relative to the private sector than those at the 90th percentile (i.e. the highly paid). The most dramatic uplift occurs at the 10th percentile from 2002 to 2005 in the former Government's first spending boom, and then again from 2007 to 2009, during its second. At the 90th percentile (i.e. the salary below which 90% of the total falls) public workers are still paid less than those at the 90th percentile in the private sector (though even here the gap is less than in 1997), whilst at the 10th percentile the change has been dramatic, with incomes growing from almost 4% under private workers' at that level to 25% above them.

The dramatic uplift on all measures of the public sector premium during 2009 was principally due to the implementation of previously agreed pay settlements, which had been negotiated in an inflationary environment. Inflation usually erodes the value of pay settlements – between 1.5% in 1999 to 4.3% in 2007 (RPI). However, since inflation actually became negative in 2009 (0.5%), this has had the effect of making public sector pay settlements extremely generous relative to their long-run average. Since at the same time private sector incomes were stagnant or falling, this had the effect of dramatically widening the public/private pay gap.

The 'chance-for-promotion' effect in the private sector

A great deal of attention has been paid to alleged overpayment of very senior public sector employees covered by the Senior Salaries Review Body, which covers just 8,000 staff out of a total of more than 6 million public workers – a fraction of 1 per cent. However, this section of the public sector workforce is the least well remunerated relative to their private sector counterparts. While there is a consistent pattern of lower median salaries in the private than public sector, the private sector does offer great earning potential at the top end of the scale, significantly outstripping its public sector counterpart at the 90th percentile.

Figure 1.8: Gross weekly pay by percentile, 2009



Source: Annual Survey of Hours and Earnings, Office for National Statistics.

High paid public sector workers have seen their pay grow faster than in the private sector, however. Chief executives of National Health Service foundation trusts, for example saw their average pay rise by 7.6% from 2007 to 2008 – almost four times as fast as their staff. Six-digit salaries are by no means the sole preserve of bankers and chief executives of blue chip companies. The average GP earned £106,000 in 2007/08 (by way of reference, a typical salary for a mid-level finance professional in 2007 was around £120,000 including bonus[ii]) and GPs have enjoyed some of the fastest salary growth in any sector of the economy since the introduction of a new pay contract in 2004 – some 7.5% in that year alone. Some GPs now earn in excess of £300,000. 170 public sector employees, including eighty-eight quango heads, are earning more than £150,000; some positions, such as the Olympic Delivery Authority's Chief Executive (£624,000) or the Chief Executive of Partnership UK (£505,000) earn considerably more.

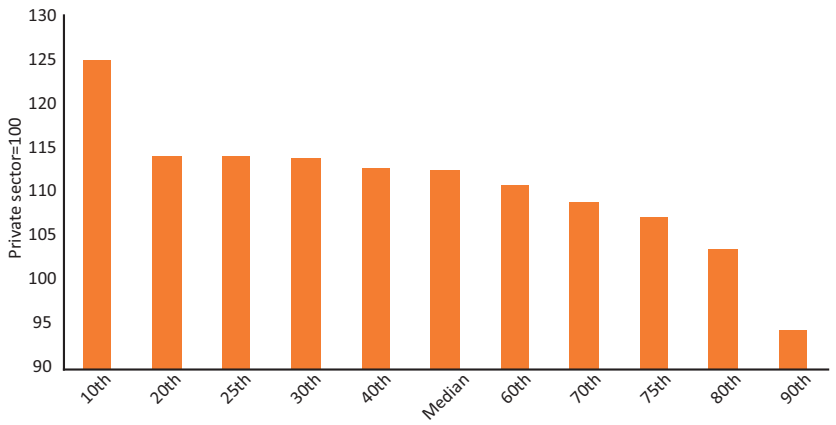
But while top pay in the public sector has rightly attracted a lot of media attention, ironically the very top end is the only part of the pay scale where public sector workers are worse off. High paid public sector workers have seen their pay grow faster than in the private sector, and have closed some of the gap with their equivalents in the private sector. But they have not caught up.

On the other hand, despite the media publicity about "public sector fat cats", most people still think of high salaries being concentrated in the private sector. This is no longer really the case. Only a tiny proportion of the total private sector workforce will ever have the ability to access jobs with higher salaries than would be possible in the public sector.

What should we conclude from all this? On the one hand, a recent poll found that 72% of respondents thought that salaries for those running organisations in the public and private sector should be about the same.[iii] Certain public posts have seen substantial wage increases as a response to rising private sector wages where there is a particular skills shortage – such as in IT or finance. The public sector has deliberately recruited senior staff from the private sector in recent years, often at a higher salary than employees with an equivalent grade coming

from a public sector background.[iv] The breaking down of boundaries between the public and private sectors has sometimes been encouraged by governments in the hope of introducing private sector attitudes and disciplines to the public sector.

Figure 1.9: Public sector pay by percentile, 2009



On the other hand we might hope that we could under-pay public sector officials compared to the private sector, and that an ethos of public service (what Julian Le Grand has called "knightly" motives) would be sufficient to still attract people of the top calibre. We might hope to pay less because some top jobs in the public sector are particularly "interesting". We might think that even within the top decile, the extent of private sector advantage is being exaggerated by a miniscule number of "superstar" wages in sport and financial services.

For "political" reasons, both private and public sector organisations have often chosen to compress top wages by more, in order to show that "we are all in it together". In Westminster, the Coalition government has signalled that it will consider the use of "pay multiples" which constrain top salaries to a multiple of the lowest salaries of twenty.

There is no clear consensus about what to do about top pay. But there is clearly considerable confusion in the public sector about how much to pay high officials. The Normington Report (2008) on senior civil servant pay found that:

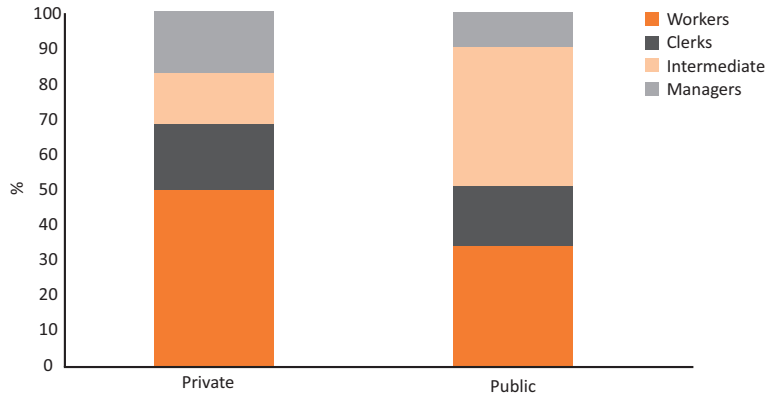
> *'Almost every Department... [showed] little rigour about the market premium that should be paid when recruiting externally'.*

Are public sector employees overpaid in comparison to their qualifications?

It has been argued that the premium in public sector median salaries reflects the different characteristics of public and private sector workers. There is some truth in this point, though as we shall see it is easy to exaggerate its significance and even if it was true it could not explain the whole premium.

Only 8.6% of people in the private sector are classified by the ONS as working at professional grades, compared with the 24.5% of public employees.[v] 35.5% of public sector workers have a degree or postgraduate qualification compared to 24.7% of the private sector; they have had on average 2.3 more years of experience and 1.2 days more training in the previous year; they are also almost 9% more likely to have a vocational qualification.[6]

Figure 1.10: Worker classification, public and private sectors



Source: *Claudio Lucifora, Dominique Meurs*, The Public Sector Pay Gap in France, Great Britain and Italy, Table 1, p. 9. http://cep.lse.ac.uk/piep/papers/meurs_lucifora.pdf

Public sector workers have an average age of 41.7 years compared to 38.2 years in the private sector. Some part of the public pay premium may therefore be explicable because their workers are older and relatively more qualified. The Institute for Fiscal Studies has argued that comparing private and public sector pay averages as a measurement of the public sector pay premium can be quite misleading. Public sector employees, on average, have higher qualifications than those in the private sector, as they provide skill-intensive services in health and education etc.[vi] As a result, raw comparisons between the two sectors will overestimate the public sector pay premium. To obtain an unbiased estimate of the pay premium economists compare like with like, controlling for qualifications, age, experience and other characteristics that affect wages and participation in the public workforce.

Recent research by Disney and Gosling at the IFS suggests that the public sector pay differentials are about 2% for men and 4% for women after controlling for different characteristics of workers, whereas their raw estimates suggested a pay premium of 15% for men and 22% for women in 2006.[7] In their Green Budget Report, the IFS (using less sophisticated econometric analysis than Disney and Gosling) suggest that with the latest data, the public sector wage differential is 19% for men and 26% for women. When controlling just for education this differential falls to 12% and 17% respectively, and when controlling for education, age and qualification the wage differential is just 2% and 7% respectively.[8] However, this measure does not take into account the greatly superior pensions and other benefits available in the public sector, which, the IFS notes, exacerbate the public sector premium by adding an additional 15.6% onto an equivalent private sector wage.

6 Office of Manpower Economics.

7 These estimates are based on ASHE data collected before the financial crisis and may not reflect present differentials. These estimates are based on "within group" panel estimation, regressing log of hourly wages on control variables for the private sector. For more details see Disney, Richard and Amanda Gosling. "Changing Public Sector Pay Differential in the UK" *IFS Working Paper* WP08/02, 2008. http://www.ifs.org.uk/wps/wp0802.pdf

8 These wage differentials are estimated by OLS regression of log hourly wages. See Bozio, Antoine and Paul Johnson, "Chapter 9: Public Sector Pay and Pensions" in *The IFS Green Budget*, February 2010, p. 223.

Even gross salary comparisons can be more a matter of categorisation than direct comparability. Many have criticised the public sector for a 'qualifications culture' in which jobs are given a higher professional status than an equivalent job in the private sector – nurses being redesignated as a graduate-level profession, for example, or the necessity of having a master degree to be an arts therapist in the NHS.[vii]

Furthermore, there is room to question to what extent formal qualifications play the same role in the public and private sectors. For example, one might take the view that in the public sector, because of long management chains and limited surplus motives for managers (intrinsic to their nature as non-profit-making organisations), and because the size of some of these organisations makes it desirable to be able to move internally (versus taking a new job when one moves in the private sector), some aspects of job experience become codified in the public sector that might otherwise take the form of "CV strengths" (e.g. a record of success in sales, management, or innovation) in the private sector. Another possibility might be that qualifications serve as devices to entrench "insider" power versus "outsiders" in a highly unionised environment.

On the other hand, it is also possible that public sector qualifications serve as more concrete training, and thereby improve human capital, whereas in the private sector qualifications often serve merely to signal quality differences but without themselves improving productivity (e.g. someone with a degree in Latin and Greek may not learn new skills that are useful in a job, but instead simply demonstrates that she already has valuable attributes, such as intelligence, self-application, personal organisation, health, an ability to flourish under pressure, and so on). The implication would be that the presence of more qualifications in the public sector would imply increased actual productivity, and hence justify increased salaries. Of course, if that were the case one might hope that it would be reflected in enhanced statistical productivity performance for the public sector – and of course we have seen that precisely the opposite is true.

"Many have criticised the public sector for a 'qualifications culture' in which jobs are given a higher professional status than an equivalent job in the private sector – nurses being redesignated as a graduate-level profession or the necessity of having a master degree to be an arts therapist in the NHS"

Public and private sector workers by occupation

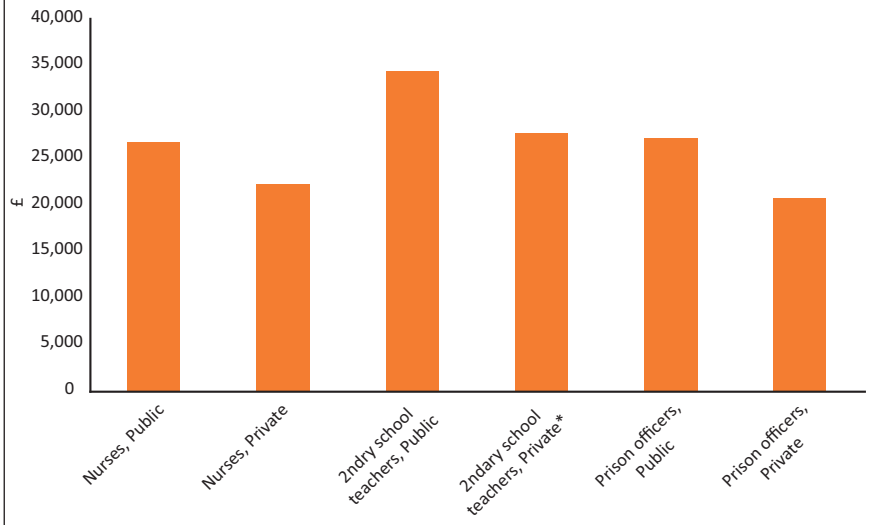
Another way to try and compare whether public sector workers are overpaid would be to look at jobs which are carried out in both public and private sectors. Whether they have different paper qualifications or not, we might expect people doing the same job to be paid the same amount, regardless of which sector they work in.

Obviously, many occupations in both sectors have semi-professional statuses which are very different and defy easy comparability (public sector employees are much more likely to be in the professional, technical, clerical and personal services occupations, whilst the private sector has more

managers, craftsmen, salesmen, and operative-assembly workers, for example). There are occupations like the 525,000 employees of the Civil Service or the 346,000 support staff in English state schools who have relatively few private sector equivalents.

However, there are also many equivalent roles, and it is far from the case that public sector workers are necessarily underpaid even in terms of gross salary:

Figure 1.11: Public and Private Sector Workers' Median Gross Annual Wage, 2009



Source: Annual Survey of Hours and Earnings supplementary data, Office for National Statistics. Category titles have been shortened for reasons of length. Series labelled with an asterisk have one or more cells with coefficient of variation > 10% and <= 20% in ONS data and are indicative only.

Even for nurses and secondary school teachers (who one might *expect* would receive higher remuneration due to the very high cost of private school fees and health insurance) the public sector actually provides a significant premium – even excluding much higher auxiliary benefits such as pensions, holidays and so on.

In fact of the 295 job categories in the 2009 Annual Survey of Hours and Earnings with both public and private sector workers, 192 showed the public sector workers' gross salary higher than its private sector counterpart. In other words two thirds of comparable jobs have higher wages in the public sector. Public sector pay has grown more rapidly in recent years too. Of 231 occupational categories with comparable pay data for 2002 and 2009, 170 (three quarters) showed the public sector worker getting a greater percentage increase of gross salary than the equivalent job in the private sector over the period.

All of the job categories below were paid more than their private sector counterparts in 2009. In some, private sector wage growth was faster than the public sector and there was some 'catch up', such as road sweepers, care and nursing assistants. However, for most other categories, public sector workers enjoyed both higher pay in 2002 and greater increases to 2009, thus increasing their pay premium. This includes not just politically popular occupations such as teachers and nurses but also managers and administrative staff.

Table 1.2: Nominal median gross pay for select occupations, 2002-9

Title sector	% increase, public sector	% increase, private private	Public increase as % sector	2009 annual pay, public sector	2009 annual pay, private private	Public annual pay as %	'Winner', income	'Winner', increase
All occupations	**32.4%**	**17.5%**	**185.5%**	**£22,417**	**£19,932**	**112.5%**	**Public**	**Public**
Sales and retail assistants	73.5%	15.4%	478.0%	£13,671	£7,800	175.3%	Public	Public
Medical secretaries	36.5%	11.2%	325.4%	£18,096	£12,074	149.9%	Public	Public
Nursery nurses	24.6%	30.0%	82.1%	£16,021	£11,372	140.9%	Public	Private
Social workers*	32.4%	21.6%	149.9%	£29,650	£22,578	131.3%	Public	Public
Care assts. and home carers	51.1%	51.9%	98.5%	£15,137	£11,658	129.8%	Public	Private
Teaching Professionals	19.6%	12.1%	161.7%	£32,859	£25,938	126.7%	Public	Public
Security guards occupations	25.3%	24.0%	105.5%	£23,395	£19,484	120.1%	Public	Public
Basic Cleaning Occupations	39.6%	31.5%	125.5%	£7,852	£6,703	117.1%	Public	Public
Financial institution managers	60.2%	16.3%	370.1%	£42,957	£37,003	116.1%	Public	Public
Elementary admin occupations	51.4%	24.0%	214.1%	£9,225	£7,956	115.9%	Public	Public
Agricultural Trades	26.1%	29.1%	89.5%	£18,819	£16,494	114.1%	Public	Private
Nursing auxiliaries, assistants	38.8%	54.5%	71.3%	£15,595	£13,686	113.9%	Public	Private
Database assistants/clerks	38.1%	12.8%	298.3%	£16,910	£15,018	112.6%	Public	Public
Personal assistants, secretaries	31.9%	16.1%	197.5%	£20,550	£18,268	112.5%	Public	Public
IT user support technicians	20.9%	0.6%	3699.7%	£25,428	£23,187	109.7%	Public	Public
Youth and community workers	37.2%	31.6%	117.9%	£21,232	£19,479	109.0%	Public	Public
General Admin Occupations	31.2%	16.4%	190.5%	£16,224	£14,893	108.9%	Public	Public
Personal service occupations	36.8%	44.3%	83.2%	£12,886	£11,846	108.8%	Public	Private
Road sweepers*	20.0%	32.9%	60.8%	£17,274	£16,271	106.2%	Public	Private
Marketing and sales managers	54.3%	18.6%	292.0%	£44,642	£42,266	105.6%	Public	Public
Purchasing managers*	75.2%	24.5%	307.2%	£44,361	£43,087	103.0%	Public	Public
Painters and decorators*	31.3%	22.3%	140.0%	£21,445	£21,003	102.1%	Public	Public

Source: Annual Survey of Hours and Earnings supplementary data, Office for National Statistics. Category titles have been shortened for reasons of length. Series labelled with an asterisk have one or more cells with CV > 10% and <= 20% in ONS data and are indicative only.

How pay is determined in the public sector

National pay bargaining

National pay bargaining remains the norm across the public sector. Salaries are mostly determined at a national level – officially, this is usually done through the relevant Secretary of State, though many public sector employees' salaries are based on the recommendations of independent Pay Review Bodies. The Office of Manpower Economics (which supervises the work of several of these) describes its criteria being determined by the effect 'on recruitment, retention, morale and motivation... and on equality of treatment'.[viii] While analysis undertaken involves extensive qualitative research (visits, oral hearings, negotiations with trade unions and so on), most public sector organisations rarely attempt to develop any rigorous quantitative framework for comparison with the private sector (except for very senior staff) aside from crude 'benchmarking' of salary equivalents.

In reality the process is centrally driven by a political process, and is little affected by regional considerations. National salary scales effectively prevent public sector organisations from reducing wages in bad economic times as effectively as the private sector can. Almost the only 'safety valve' is direct reductions in staffing.

Around 45% of public sector workers' remuneration is evaluated by Pay Review Bodies. A significant proportion of their work involves negotiation with relevant trade unions, excepting a very limited number of occupations excluded from union recognition (Trade Union and Labour Relations (Consolidation) Act 1992). The latter are almost entirely composed of the Police and Armed Forces (as perhaps might be expected as the ultimate guarantors of internal and external security). This does not, however, include other essential services such as nurses, doctors, prison officers or firefighters.

The major exception to the centralised pay review bodies is for local government workers. Their pay is in practice determined by bilateral negotiation by the Local Government Employers (LGE) and Local Government Association (LGA) on the one hand, and trade unions, most notably Unison, on the other. As with other public organisations, this severely limits the scope of local councils to remunerate according to local labour market conditions and the relative cost of living. Council pay rates for equivalent jobs vary by less than 20% between regions and often not at all, while differences in the cost of living are far larger.[ix]

An overview of the pay review bodies, number of employees, main trade unions and most recent pay settlement is given below:

9 01/04/09 – 01/04/10 unless otherwise indicated. Figures are for general base pay (i.e. excluding performance-related bonuses, expense allowances and regional weighting.)

10 2.8% core pay settlement, 0.5% for targeted measures.

11 GPs were awarded 2.29%, dentists 0.21% in total contract payments. However, due to changes in expenses requirements, both are calculated to equate to a 1.5% increase in net income.

12 In the maintained sector. Most LEA schools use local government pay scales.

13 HM Treasury guidelines to departments.

Table 1.3: Organisations involved in public sector pay settlements

Public sector area	Relevant Review Body	Main trade union/s	Spending Department(s)	Summary of 2009/2010 pay round[9]	Number of public sector workers affected
Members of HM Armed Forces (excluding senior officers)	Armed Forces' Pay Review Body	None (various member groups: e.g. British Armed Forces Federation)	Ministry of Defence	3.3%[10]	193,000
NHS doctors and dentists	Review Body on Doctors' and Dentists' Remuneration	HCSA, Unison, MPU-Unite, British Medical Association	Department of Health	1.5%[11]	146,000
All other staff in NHS excluding doctors, dentists and senior management	NHS Pay Review Body	Unison, GMB, Unite, BMA, APAP	Department of Health	2.4%	1,223,000
Prison governors, managers, officers and staff	Prison Service Pay Review Body	Prison Officers	Home Office Association, Prison Service Union	1.5% for managers, 1.8% other staff	44,000
School teachers	School Teachers' Review Body	National Union of Teachers, NASUWT	Department for Children, Schools and Families	(In England and Wales, 01/09/09 – 01/09/10), 2.3%	482,000
School support staff Negotiating Body	School Support Staff	GMB, Unite, Unison	Department for Children, Schools and Families	1.0 - 1.25%[12]	346,000
Civil Servants/ central government employees (excluding senior grades)	Government Departments in compliance with Treasury guidelines (mainly: DWP, HMRC, Justice and Defence).	Public and Commercial Services Union	Various	In the region of 1.5%[13]	522,000

Public sector area	Relevant Review Body	Main trade union/s	Spending Department(s)	Summary of 2009/2010 pay round	Number of public sector workers affected
Senior civil servants, holders of judicial offices, senior officers of HM Armed Forces and other senior public sector positions.	Senior Salaries Review Body	First Division Association	Various	Senior civil servants – 1.5%, Senior officers – 2.8%, Judiciary – 1.5%[14]	8,000
Police officers	Police Negotiating Board	None (various associations: e.g. Police Federation of England and Wales)	Home Office	01/09/09 – 01/09/10, 2.6%	286,000
Firefighters	National Joint Council for Local Authority Fire and Rescue Services	Fire Brigades Union	Department of Communities and Local Government	01/07/09 – 01/07/10, 1.25%	52,000
Local, other government workers	Advisory, Conciliation and Arbitration Service (advisory role)	GMB, Unite, Unison	Department of Communities and Local Government	1.25%	2,913,000
Total[15]					**6,215,000**

Sources: Labour Force Survey, Office for National Statistics, departmental figures.

How national pay bargaining works in practice is opaque and involves highly centralised discussions by a small group of leading stakeholders. For example, the School Support Staff Negotiating Body (SSSNB), established in the Apprenticeships, Skills, Children and Learning Act 2009, negotiates the remuneration of school support staff across England employed by local education authorities and maintained schools. This involves a total of around 300,000 workers, such as caretakers, administrative and classroom assistant staff. It is made up of 15 Union seats: Unison (8), GMB (4), Unite (3) and 14 employer seats: Local Government Employers (8), the Catholic Education Services (2), the Church of England (2) and the Foundation and Aided Schools National Association (FASNA) (2) plus an independent chair.

This composition has led to accusations they are insufficiently impartial to produce appropriate pay settlements – and that they have been relatively more generous than those workers not covered by their deliberations[x]. They have also been criticised for not allowing sufficient scope for response to changing circumstances.For example, despite falling private sector wages and government calls for pay restraint, the GMB and Unite submitted a collective pay claim of 2.5% for 2010. No systematic attempt to justify such an increase was offered. Heather Wakefield, Unison's head of local government, said: 'We believe this claim is both realistic and affordable. Local government workers are playing a vital role in helping communities through the recession'. This is a relatively common theme – simply, that public workers are not responsible for the budgetary deficit, are valuable and so should be paid more. This kind of straightforward political struggle explains more about national pay bargaining than the pretence that is based on a "scientific" analysis of recruitment, retention, morale or motivation.

14 Ministers and Permanent Secretaries pay was frozen for 2009. See http://www.number10.gov.uk/Page18862

15 This figure differs from that of the ONS due to definitional change. It is difficult to quantify precisely how many people are employed in the public sector because of outsourcing, ambiguity and self-misidentification. The ONS includes those banks taken into the public sector (uncounted here), but excludes higher and further education (uncounted) and GPs (counted). Private contractors largely or entirely funded through public funding, such as Tube Lines, Network Rail, private hospital cleaners etc. – are uncounted. This figure should thus be taken as a narrow count of 'traditional' public sector employees; the total number one might include on a broader definition (all those whose salary is mainly financed through public expenditure, for example), would be higher.

Pay bodies are overridden by central control during fiscal problems

Quite apart from problems with national pay bargaining during "normal" periods of growth, they tend to be overridden during period of fiscal stress. The current fiscal crisis has significantly affected the "independence" of public pay review bodies. On October 5th 2009, the then Chief Secretary to the Treasury Liam Byrne wrote to the chairs of the review bodies, stating that 'the Government is proposing awards of up to 1 per cent across the board for workforces not in multiyear deals, with proposals of 0 per cent for senior groups within this'. The 2009 Pre-Budget Report announced an intention to cap *all* public sector pay rises at 1% for two years from 2011 except for the Armed Forces.

Interestingly this was to be coupled with a cap on state pension contributions for teachers, councils, the NHS and civil service (with any liabilities above the limit to be met by employee contributions.) The then government also announced higher contributions to be paid by public workers earning above £100,000 and a cut of £100 million in the senior civil service paybill over 3 years. However, as we have seen, the highest earners are in fact those comparatively least well paid in the public sector. A recent Public Administration Committee report commented, 'it would be particularly damaging if talented managers able to deliver substantial savings left the public sector because of pay reductions that would contribute relatively little to deficit reduction'.[xi]

Treasury figures show a projected saving of around £1 billion a year from the pension cap and £3.4 billion for the salaries cap from 2012/13 as a result of these changes. Even so, this represented only 2.8% of the total public sector wage bill, 4.1% of the total projected borrowing for 2012 and 2013 (£213 billion) or a mere 1.2% of total projected borrowing from 2009/10 to 2013/14 (£8.8 billion of £706.6 billion). Nevertheless, despite the modesty of these proposals, they were widely condemned by trade unions leaders. The General Secretary of the TUC, Brendan Barber, condemned the cap as 'unfair and inefficient'.

Figure 1.12: Public sector pay index projections

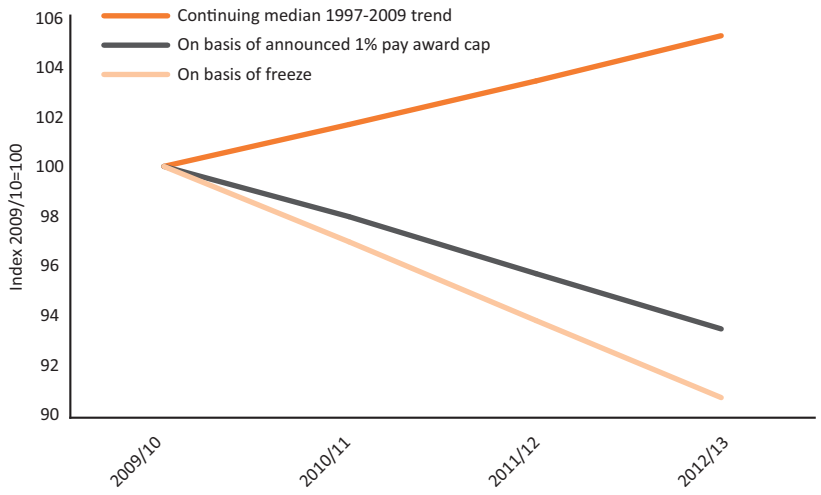


Table 1.4

Year	2010/11	2011/12	2012/13	Implied change to 04/2013
RPI inflation[xii]	3.0%	3.25%	3.25%	
Continuing median 1997-2009 trend	+1.7%	+3.4%	+5.2%	**+5.2%**
On basis of announced 1% pay award cap	-2.0%	-4.3%	-6.5%	**-6.5%**
On basis of freeze	-3.0%	-6.2%	-9.2%	**-9.2%**
Government basic pay award cap	+1.0%[16]	+1.0%[17]	+1.0%	

Even assuming that the basic pay award across the public sector is equal to the declared maximum (this is what happened in 1993 when the then Chancellor Norman Lamont announced a band of 0% to 1.5% on public pay settlements for the coming year in the 1992 Autumn Statement, for example), the former government's projections did already imply real terms cuts in pay. This means the political issue is no longer about *whether* to reduce public sector wages, but how much to reduce them by.

Even with the full 1% cap increase, the basic salaries of public sector workers would be continually eroded due to the effects of inflation (even without the unpredictable pressures of the government's £200 billion asset purchases, which could push inflation much higher). By April 2013, for the 1% cap this totals to a 11.7% difference were the previous trend since 1997 continued, or 14.4% were this extended to a cash freeze.[18]

Two problems with national pay setting

There are two main problems with national pay setting which, together mean that there is no properly functioning labour market in the public sector.

Firstly, national pay setting requires 'pay spines', based on levels of experience. Progression up the pay spine is largely automatic, breaking the link between effort, ability and promotion. Public sector pay tends to reflect length of service rather than individual performance, an approach phased on in the private sector decades ago.

Secondly, setting a single wage for the whole country – when the cost of living and average wages are so different in different parts of the country – inevitably means that people will be overpaid in some areas and underpaid in others.

National pay setting means pay reflects age, not performance

Most pay scales in the public sector are organised in a grading hierarchy according to skill level and knowledge appropriate for each particular grade and 'pay spines' within them, according to experience within that grade. Progression up the pay spine is largely automatic (and, indeed, is often necessitated by contractual obligation) and this can apply equally to promotion to a higher grade. This often means that pay and position are largely determined by length of service.

16 Workforces not in multiyear deals: Government Evidence to the Pay Review Bodies for 2010-11 Pay Awards, 5th October 2009.

17 Announced in 2009 Pre-Budget Report.

18 Compared to the median real public sector increase of 1.7% since 1997 (Annual Surveys of Hours and Earnings, 1997-2009).

The earnings of public sector employees tend to be more tightly compressed, due to these grading and progression structures. Public sector pay as a whole can be characterised as a series of graded pyramid hierarchies, each representing a particular occupation cadre largely negotiated at a national level. A typical example is that of prison officers. Their national minimum starting salary (£17,319) is increased incrementally through length of service up a national 'pay spine' to a maximum of £25,490, followed by additional long service increments up to £26,433 (plus allowances and supplemented by regional weighting). This system of progression based on length of service has the potential to be discriminatory against women as they are more likely to take time out of the labour market.

Pay progression systems often take much greater account of length of service than individual performance: this is routinely cited as a key factor by around 70% of public sector employers compared to less than 20% in private sector services or manufacturing.[xiii]

Many public workers in effect get two pay rises a year – one based on the negotiated settlement and another based on moving up the point scale as a consequence of being in their job for another year. This occurs largely irrespective of performance and critics see this is a key factor in lower public sector productivity.

For example, state school teachers will generally move up to a higher scale point each year. While technically this can be denied for unsatisfactory performance (and promotion by two grades can be granted for exceptional teachers), in practice the overwhelming majority of teachers increase by one grade each year (in Scotland, the progression is fully automatic).[xiv]

Of course, most private sector workers will increase their salaries as they become more experienced and productive. The difference with teachers and many other public workers is the scale of the rise and the fact that it is semi-automatic – indeed, the union NASUWT describes the scales on its website simply as 'six annual increase points'.[xv] This causes all kinds of distortions. Indeed, it has also led to complaints by experienced teachers that they are often overlooked when new jobs become available in favour of newly qualified teachers – as the former are (by definition), cheaper.

National pay rates mean under-payment in some areas and over-payment in others

Despite some research to examine equivalent pay rates in the private sector in different regions, most salaries are determined by nationally-set regional and grading pay bands. The degree of differentiation according to the regional cost of living (outside of London), incomes and the local rate of unemployment is extremely limited or non-existent across much of the public sector. (There are a few other efforts to mitigate this such as 'key worker' housing.) Though the general criteria is that pay awards should 'reflect the individual labour market position of work forces, particularly their recruitment and retention position' these are principally a uniform percentage rise which applies nationally across all pay scales.[xvi]

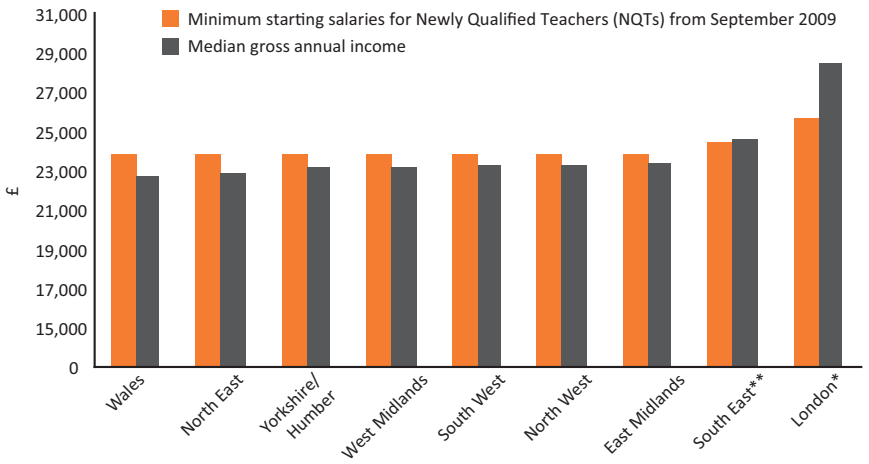
In the private sector, salaries – subject to the national minimum wage – are largely determined by supply and demand. If there is a shortage of welders on

Teesside, for example, pay goes up. This in turn attracts more people to learn the trade, resulting in a levelling off of wages, and so on: the market ensures that workers and pay are kept in equilibrium.

In general, public sector pay is rigidly equal across the UK – with only significant weighting given for London and its surrounding area. This largely eliminates the market mechanism as a means of regulating scarcity in the public labour market. Attempting to give people the same pay in areas with widely varying living costs causes serious disruptions.

To take the example of classroom teachers, virtually all newly qualified teachers in maintained schools will start on point M1 on the pay scale in England and Wales (though it may be higher in light of previous experience or exceptional shortages). The value of these point scales is greater in London and its surrounding area. We can compare its value to regional median incomes.

Figure 1.13: New teachers' minimum starting salaries and average income by region in maintained schools, England and Wales, 2009/10



Source: Annual Survey of Hours and Earnings, 2009.

* Figure given is for Outer London (Inner London is £26,000).

** The salary figure is for the 'Fringe' area around London (e.g. Surrey, Dartford, Crawley etc.) Outlying regions in the South East are paid at the lower rate of £21,102.

Simply, these payments are not enough to stop teachers being relatively underpaid in London and overpaid in less expensive regions. In effect, any new teacher in Wales is guaranteed a minimum starting salary 112% of the regional median, while a new teacher starting in Outer London will be paid just 81.8% of the regional average. This major disparity has been linked to serious labour shortages in high income areas and oversubscription in lower ones. It also makes it more difficult for private firms in low-wage areas to compete with the public sector salaries on offer, increasing their costs.

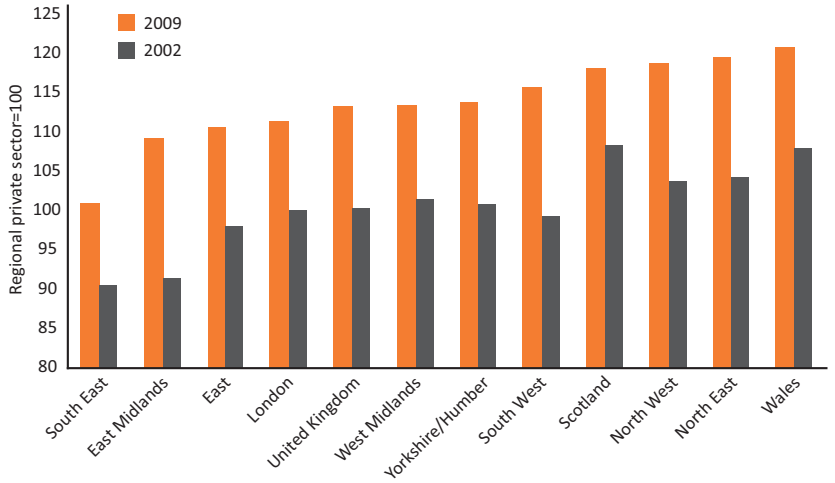
One might defend this system as a means of reducing regional income differentials. However, even were this the goal, the policy does seem extraordinarily arbitrary, with only teachers in and around London enjoying any differentiation. A new teacher in a central London school enjoys an additional £4,898p.a. – presumably to reflect the additional costs associated with a central city location

(travel, housing costs, a higher price level for goods and services, etc.) However, the teacher might work in a cheap part of London; meanwhile a teacher working in a different high cost city such as Leeds, Manchester or Liverpool, will receive nothing. In addition, teachers just outside the zone will not qualify for the bonus while those just within it will cash in – even though there is likely to be little difference in their costs of living. Organisations that sit just outside such boundaries often find difficulties recruiting for the simple reason people are willing to cross the boundary for the additional pay. This system also severely restricts the scope for schools to adjust their salaries according to supply and demand for particular subjects (although certain measures do exist such as the 'golden hello' worth £2,500 or £5,000, these only slightly mitigate supply disparities and do not address the core problem).[xvii]

"The public sector pay premium is dramaticaly higher in regions where private incomes are lower. In Wales the typical public sector worker is 20% better of than the typical private sector worker, compared to an average premium of 12%"

These kinds of problems exist right across the public sector, wherever there is nationally-set pay. The pay premium we have observed for the "average" public sector worker disappears almost entirely in the South East of England – where public sector workers are paid just 0.4% more than people in the private sector. However, the public sector pay premium is dramaticaly higher in regions where private incomes are lower. In Wales the typical public sector worker is 20% better of than the typical private sector worker, compared to an average premium of 12%. These trends are the consequence of national pay bargaining, with public sector workers inadequately or entirely uncompensated for higher private sector incomes and the regional cost of living.

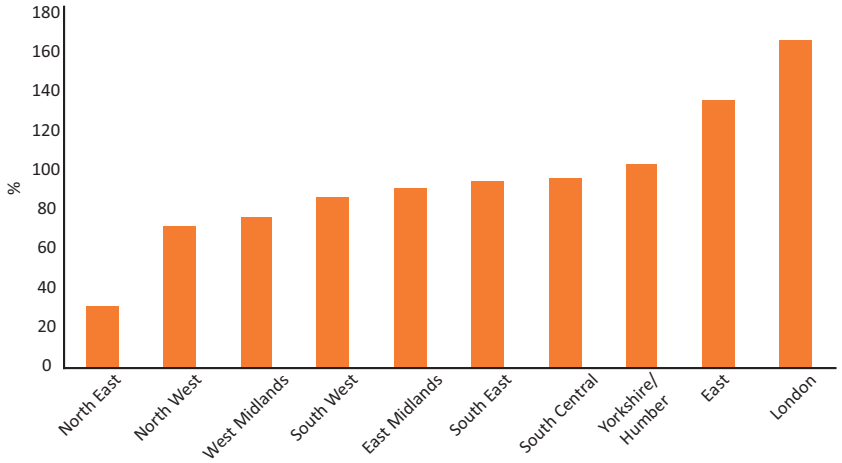
Figure 1.14: Public sector median gross weekly salary by region, 2002 and 2009



Source: Annual Survey of Hours and Earnings supplementary data, Office for National Statistics.

The effect of this is seen most clearly in vacancy rates – in the NHS, these are 63% higher in London than the English average.

Figure 1.15: Vacancy rates for NHS qualified nurses by region relative to England average, 2009

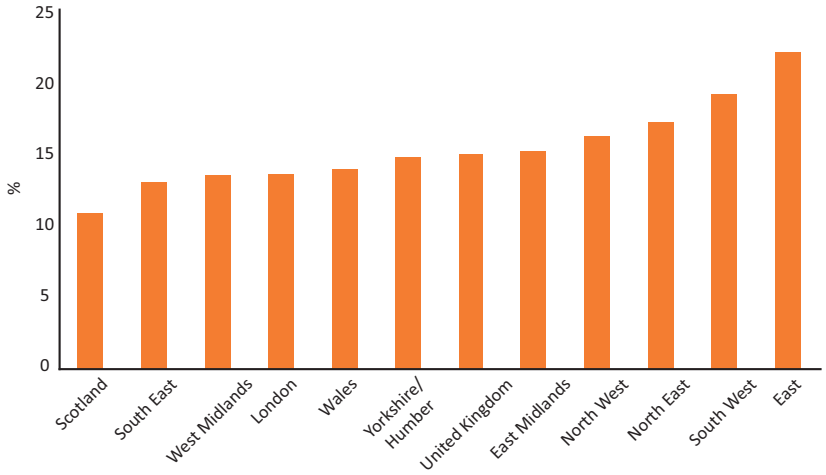


Source: The NHS Information Centre Vacancy Survey, NHS information centre, 2009.

How regional disparities between the public and private sectors have changed

In every region public sector workers have extended their lead over public sector workers' pay. However, the public sector premium has grown unevenly across the country. This is partly because private sector pay has not grown evenly across the country, and partly reflects the different composition of the public sector in different regions.

Figure 1.16: Additional pay growth of public sector over private sector, 2002-2009



Source: The NHS Information Centre Vacancy Survey, NHS information centre, 2009.

Perhaps reflecting the fact that they were already better paid relative to the private sector than people in any other area, public sector workers in Scotland extended their lead by the smallest amount. Public sector wages in Scotland actually grew faster than the national average, but private sector wages grew still faster

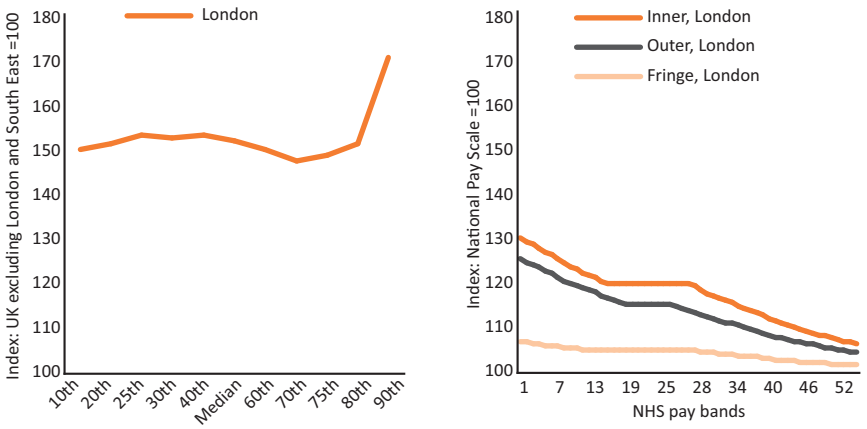
relative to the national average. The areas where the premium increased the most are the East, South West, and North East. In the East private sector wages grew more slowly than the national average while public sector wages grew much more quickly. In the South West and North East private sector wages grew faster than the national average but public sector wages grew even more quickly.

These regional pay disparities conceal deeper disparities at more local levels because each region contains towns which are far above and below the regional average. Yet a typical public sector worker doing the same job in these regions will be given precisely the same base pay, pension arrangements and – with satisfactory performance – salary increases. This limits the ability of organisations with challenging roles – difficult schools or high-crime areas, for example – to attract better staff by offering them additional pay.

London weighting closes the gap for lower paid workers, but not those on higher pay

A still more dramatic trend emerges if we compare public workers at different income points. To take one example, if we compare the premium paid to NHS workers at different pay points in London to the premium paid at different income points for London generally, we see a dramatic difference.

Figure 1.17a: Pay Premium at different NHS Pay Bands, 2009
Figure 1.17b: Annual Gross Income Premium, London v. UK, 2009



While the proportionate income premium relative to the rest of the UK for London and the South East increases for the highest earners generally, the NHS' paybands progressively reduce it. To take the lowest incomes, at the 10th percentile, a London worker is paid around 50% more compared to the rest of the UK, while an NHS employee on the lowest pay scale will be paid 30% more. In contrast, at the top of the income ladder, at the 90th percentile a London worker is paid more than 70% more; in contrast, an NHS employee on the top scale will enjoy a premium of only 4.5%. It should be noted, however that even for the lowest paid workers, this weighting does not reflect the much higher living costs

associated with London: house prices, for example, are 104% higher than the England and Wales average.[xviii]

The general trend in both the NHS and the rest of the public sector is that, while public workers are underpaid relative to their regional counterparts in London and the South East (and this trend is exacerbated by the fact that these payments are generally non-pensionable), this becomes much more pronounced higher up the income scale. Much the same distortion occurs in other high cost areas where even less (usually no) additional pay is awarded. Regional weighting tends to have a minimum and maximum or simply a flat rate, thus rendering it relatively more important for lower paid workers.

Should people be paid the same in different regions?

You might think that the economic output of a nurse is essentially the same in whatever region of the country it is delivered. And there is certainly little reason to suppose that regional differentials in the salaries of public sector workers (if any such are indeed justified) should mirror differentials between average wages in regions. To see why, suppose that in one region of the country most of the employees were finance professionals whilst in another most were agricultural labourers. There would be little economic or social logic in demanding that a nurse receive the average lawyer's salary in the one region and the average agricultural labourer's salary in the other.

And yet, on second thoughts, this same line of reasoning might nonetheless support significant differentials – even if not perhaps as large differentials as those in overall averages. For it is plausible to imagine that the output of public sector workers supports the productivity of other workers. Nurses help keep people healthy and restore them to health, allowing them to work as lawyers, agricultural labourers, etc. Policemen, road workers, and many other public sector workers perform analogous roles. On this analysis, since their key output is the facilitation of the output of others, it is incorrect to say that the value of their output is the same – in narrow economic terms, restoring a lawyer to health (allowing her to work thereafter) is much more valuable than restoring a farm worker. So, since the economic value of the outputs of public sector workers in different regions differs with the average outputs of other workers in those regions (reflected in differences in average salaries of those other workers), it would therefore be economically efficient for public sector workers in materially different regions to receive materially different salaries.

The importance of wage drift, and non-headline growth in pay

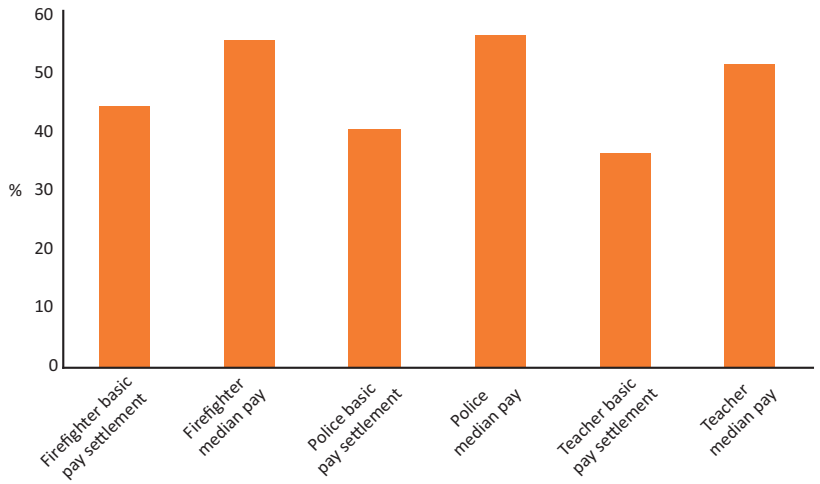
It is perhaps misunderstood that public sector workers, as in the private sector, generally enjoy pay increases not limited to the headline negotiated settlement. Some trade unions have reinforced this perception. To take the example of teachers, Christine Blower, General Secretary of the National Union of Teachers, argued of the 2.3% increase per year negotiated for 2008 to 2011, that 'Teachers' pay went up by less than inflation for four consecutive years, from 2005 to

2008. This pay increase does not reverse the pay losses that teachers have suffered over that period.'[xix] In basic pay settlement terms, this is correct.[19] Using this as justification, despite a 40% increase in inquiries into teacher training and agreeing to a 2008-2011 pay settlement, the NUT demanded a 10% salary increase in April 2009.[xx]

However, this is not the whole story. Some public sector workers may sometimes have had 'pay losses' in terms of their basic pay settlement, but this is not reflected in their actual incomes. This is the phenomenon known as 'wage drift': the tendency of average wages to rise faster than official wage rates.

Wage drift is caused by factors such as grade inflation (people are promoted more rapidly), drift within grades (more people are moved to the top of a salary band), changes in overtime arrangements and other local agreements.

Figure 1.18: Nominal change in basic and median public sector pay, 1997-2008



Source: Departmental figures, Annual Survey of Hours and Earnings, Office for National Statistics.
Full-time, retained firefighters (leading fire officer and below), police federated ranks, sergeant and below, secondary school teaching professionals, England and Wales.

Wage drift is estimated to add 30% to 40% to public sector wage increases in a typical year. In the three examples above, it has added 25%, 40% and 42% to the "headline" increase.

This phenomena is extremely important to understand if government is considering any kind of wage freeze. We might expect that if headline rates of pay growth are compressed or reversed, then wage drift might accelerate as people try to find ways to circumvent the headline freeze.

Pay growth in different occupations

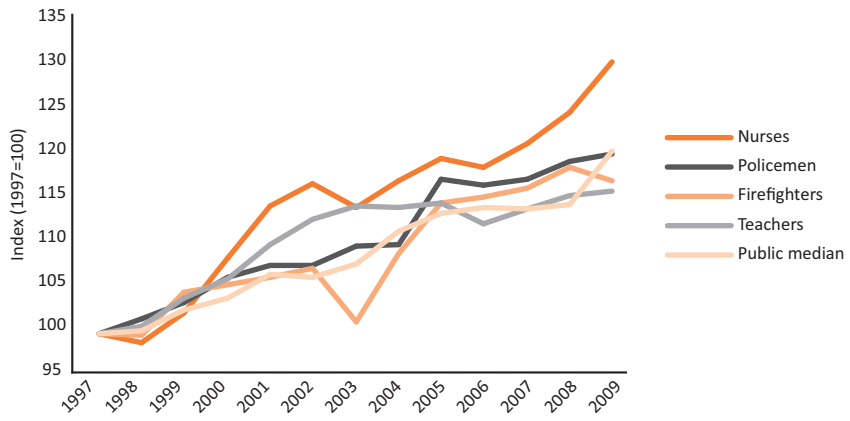
The public sector is not a monolithic organisation, and different sectors within it have seen very different trends in terms of pay growth.

We will return to the issue of pay growth in a later section. However, it is worth noting that some groups of workers have done much better than others.

19 In fact, the teachers' basic pay settlement in England and Wales was below RPI inflation for five years: from 2004 to 2008.

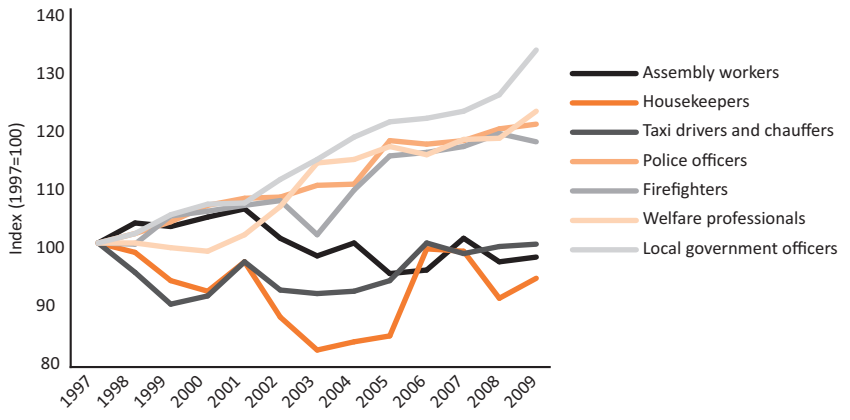
Of these categories of predominantly public sector workers, the 'winners' are (in order) nurses, policemen, firefighters and teachers, all of which outstrip the private sector median: nursing salaries growing at triple the rate. This is reflective of several categories of private sector workers whose incomes have stagnated since 1997, while some public sector incomes have taken off.

Figure 1.19: Stylised changes real terms changes in incomes, 1997-2009



Percentage change in nominal gross weekly salary. Category titles have been shortened for reasons of length. Categories also include some private sector workers.
Source: Annual Surveys of Hours and Earnings, 1997-2009, Tables 13.a, 14.a.

Figure 1.20: Index of real income changes for select occupations, 1997-2009



Percentage change in nominal gross weekly salary. Category titles have been shortened for reasons of length.
Source: Annual Surveys of Hours and Earnings, 1997-2009, Tables 13.a, 14.a.

Several predominantly private sector occupations have seen no real terms increase in their income since 1997. The typical housekeeper, taxi driver and line assembly worker has actually seen their income fall. Public sector workers have, by and large, enjoyed above inflation income increases.

Bonuses and incentives

There is a widespread perception in the public sector that initiative and hard work goes unrewarded. A study by the accountants Deloitte concluded that half the public sector employees whom they interviewed thought that financial incentives for them were weak.[xxi] Only 33% of public sector employers cite cash-based performance schemes compared to 89% in the private sector.[xxii] Performance assessments are considered by many to be soft. The introduction of bonus systems frequently caused antagonism because of the perceived 'inequality'. There exists a culture which frowns upon any deviation from a rigid payment system based on grade. The CIPD has stated that 'only 11 per cent of employers in the public sector have adopted a total reward strategy and … few evaluate the impact of their reward practices on the organisation'.[xxiii]

Those incentive and bonus schemes which do exist in the public sector tend to make little difference, because they are either small size or poorly designed. The Home Office, for example, offers top performers up to 2% on top of their salaries. Bonuses in the NHS are capped at 7%. More importantly there is only a weak link between a bonus and performance. For example, the Government was forced to abandon a performance bonus for teachers in 2003. The scheme was based on teachers themselves applying for the bonus and only 3% of applicants failed to qualify. Ironically, according to a study by academics at Exeter University, the small minority who were unsuccessful then felt 'bitter', threatened legal action and, in several cases, left their school in disgust.

Other incentive schemes tend to be shared out among teams, which undermines their purpose. For example, in 2004 the Jobcentre set targets for 90 teams involved in finding work – placements for the unemployed. Each team was set five targets, each of which earned members of the team an extra 1% in salary. If all five targets were met this was raised to 7.5%. When the results were analysed it turned out that small teams based in one office increased their performance by up to 10%, but larger teams working in several offices actually suffered a decline in performance – perhaps because individual members thought that their personal contribution would make little difference as to whether they received the award or not.[xxiv]

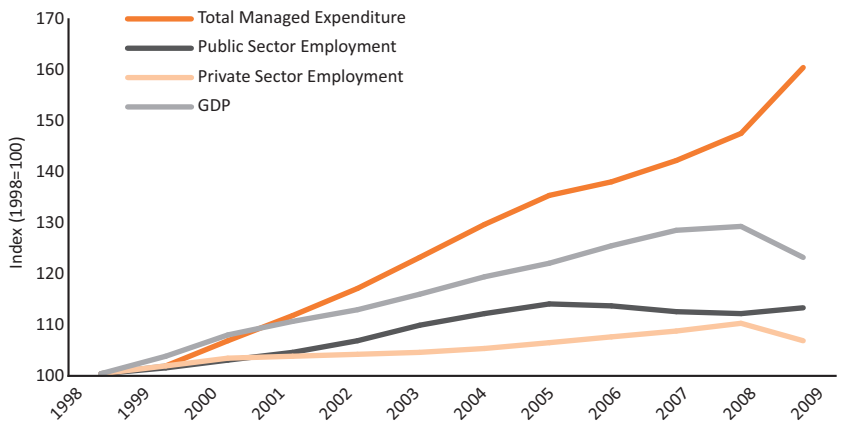
What efforts there are to monitor performance appear to be weak. In the Department for Communities and Local Government for example, there are around 5,000 staff. Just over half of them are given a performance review each year. But of the 15,682 reviews carried out over the last five years, only 64 people have been rated as unsatisfactory – just 0.4%.[xxv] Bonuses in the civil service have continued to grow this year, more than doubling in the Government Equalities Office, Welsh Office and Department for International Development.[xxvi]

2
Staffing

The overall size of the public sector

At first glance the very significant rise in public expenditure since 1998 has not been that strongly linked with public sector employment since 2005.

Figure 2.1: Expenditure, employment and GDP, 1998-2009



It *looks* like the expansion of the official public sector headcount has been considerably slower than the rise in public expenditure.

However, this is partly due to the effect of privatisation, outsourcing and the Private Finance Initiative. The "public service industry" – that is, suppliers who provide services to government but are not officially part of government – now employ some 1.2 million people and account for around 5.7% of GDP. This workforce is indirectly employed by the state and paid for through taxation. This has the effect of masking the total increase in the number of jobs providing public services.

The concept of the public sector defies easy definition – in the broadest sense of those paid in some way by the state (i.e. employees and welfare recipients), it exceeds two-thirds of the adult population in some parts of the UK.[xxvii] What is officially termed the 'public sector' may stray significantly from what is traditionally considered to be part of it. An employee may be part of the public sector in terms of function but not in terms of ownership. Some private sector employees

are in effect wholly or entirely dependent on taxpayer funding, while some public workers are only partially or not funded through public expenditure at all – Ordnance Survey and the Met Office operate on a commercial basis for example, the Financial Services Authority raises funds from the companies it regulates; Ofcom does too, but is supplemented by government funding. Network Rail is a company limited by guarantee with its debts underwritten by the government and government funded. Tube Lines is a private limited company, but carries out work entirely contracted from the public sector. This confusion is compounded by the increasing trend of outsourcing to private firms through public private partnerships – some of which are 'quasi-statal' as they are completely or largely dependent on public contracts.

> "The increasing difficulty of separating public and private makes a compelling case for direct salary comparability regardless of sector"

There are also public organisations not directly under state control, (Network Rail, the Post Office, the 2012 Olympic Delivery Authority) or with ambiguous status (the non-for-profit private institution status of universities, for example), which may or may not be included – and of course, the nationalised banks. The increasing difficulty of separating public and private makes a compelling case for direct salary comparability regardless of sector. 'The fact that boundary lines between the public, private and third sectors are blurred rather than clearly demarcated means that it would be not only wrong but impossible to look at public sector pay in isolation from pay elsewhere in the wider economy.'[xxviii]

Since government often pays for contracted services by invoice, total headcount from this source is not collated centrally. The ONS definition of the public sector employment total only includes employees who have a contract and whose salary is paid for by a public sector organisation. This means some state-employees are not included – GPs who are deemed self-employed or staff of the (technically independent) universities, for example. However, using Labour Force Survey (LFS) data (based on a poll of individuals – obviously not a perfect tool due to self-misclassification) we can gain a better view of the true size of the public sector.[xxix]

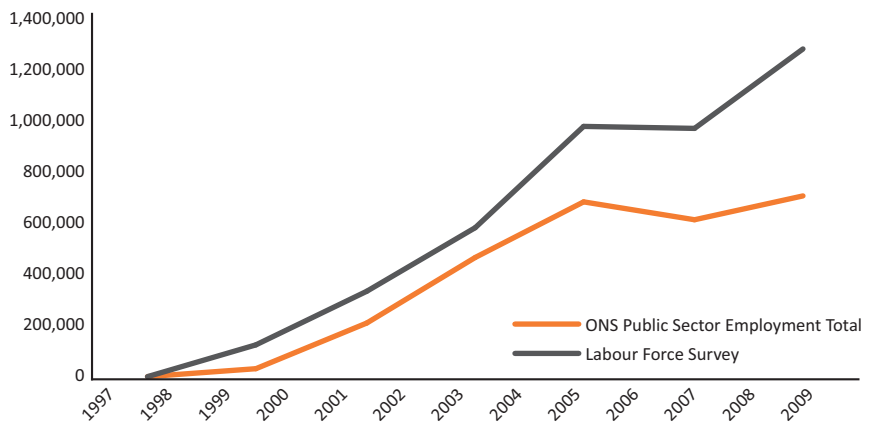
This creates a significant discrepancy – if we compare the ONS' Public Sector Employment estimates with the figures provided with the findings of the LFS, we find another 1.4 million workers:

Table 2.1: Public Sector headcount, 2007-9

Year	By ONS national accounts definition	By Labour Force Survey definition	Difference
2007	5,780,000	6,998,000	+1,218,000
2008	5,821,000	7,147,000	+ 1,326,000
2009	5,870,000	7,304,000	+ 1,434,000
Increase since 1997	692,000	1,258,000	566,000
Increase since 1997	13%	21%	

Source: Labour Force Survey, Office for National Statistics. At Q4 for each year.[xxx]

Figure 2.2: Cumulative change in public sector headcount, 1997-2009



Source: Labour Force Survey, Office for National Statistics.

While the ONS national account definition show headcount growth of 13% from 1997 to 2009, this rises to 21% on Labour Force Survey numbers: an extra 566,000 workers in addition to the 692,000 shown in the ONS national accounts figures.[20] The premium shown by the LFS has risen over time – from 14% over that of the ONS count in 1995 to 24% in 2009 – presumably due to the effect of outsourcing outstripping the growth of the traditional public sector. Unfortunately, most of the detailed statistics available relate only to the narrower ONS definition.

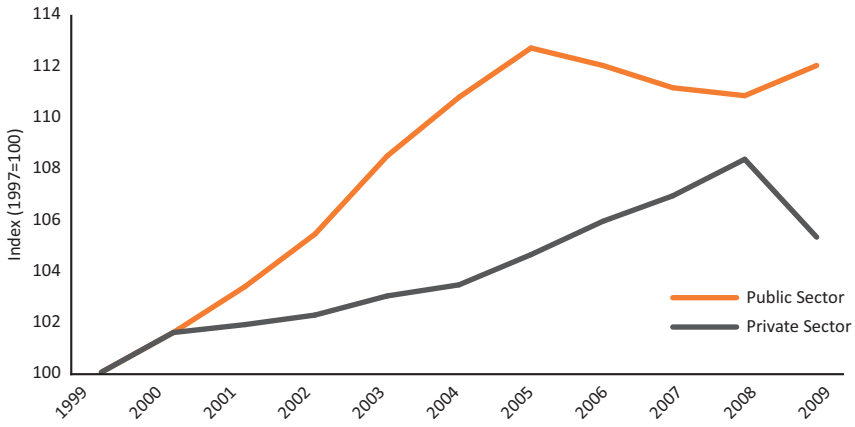
Comparisons with private sector headcount growth

Looking at the ONS definition, the most dramatic increases occurred between 1999 and 2005. In comparison to 1999, the number of people working in the public sector increased twice as fast as in the private sector. The most dramatic change is the sudden divergence in the public and private sector indexes between 2008 and 2009. An obvious thought might be that, in recessions, if public sector wages remain constant while private sector wages fall, the former become relatively more attractive, therefore increasing demand for public sector employment. One potential consequence is that the additional tax burden to sustain a growing number of public sector jobs further dampens private job creation, creates wage inflation and 'crowds out' the private sector labour market, increasing the length and depth of a downturn. Alternatively, additional borrowing to pay for these jobs is likely to retard growth and increase the cost of government borrowing.[xxxi]

An alternative might be to have a 'lean against the wind', countercyclical vacancies policy (i.e. to create more vacancies in times of recession) while enforcing a procyclical wages policy (i.e. reducing salaries by an equivalent amount, or more than, the falls being endured in the private sector). The goal would be to increase the public employment total to sustain overall employment levels without depressing private demand and output. However, as we have seen, public sector wages were not reduced during the recession, but increased, while the architecture of national pay bargaining effectively prevents such a policy.

20 The ONS figures exclude the nationalised banks. Since employees of the nationalised banks are unlikely to consider themselves public sector employees, this is unlikely to significantly affect the (unadjusted) LFS figures.

Figure 2.3: Index of public and private sector employment, 1999-2009



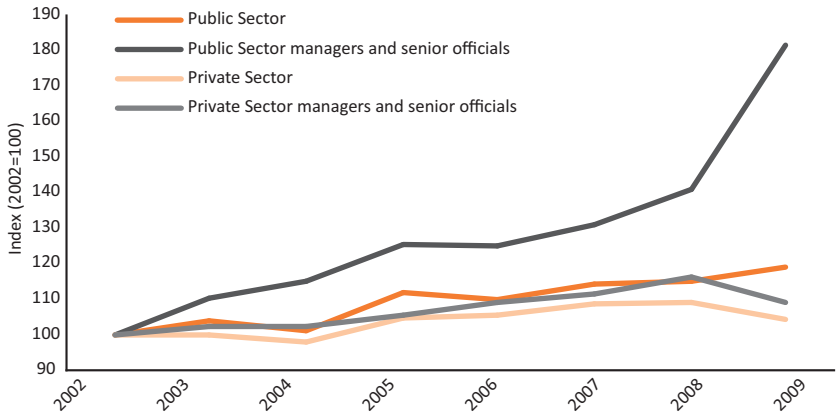
Source: Office for National Statistics (nationalised banks counted in the private sector).

The growth of top-heavy management?

While the number of managerial roles has remained largely stable in the private sector, the equivalent number of roles in the public sector has taken off – an 80% growth in the number of senior managers since 2002.

For example, while NHS expenditure increased in real terms by 84% between 1998 and 2008, the number of managers and senior managers increased by 76%; in contrast, the number of doctors rose only 46% and qualified nursing staff just 26%.[xxxii] Administrative staff numbers in English state schools have increased by 82% between 1997 and 2009 compared to just 10% for teachers.[xxxiii]

Figure 2.4: Headcount growth, total and managerial in the public and private sector, 2002-9



Source: Annual Survey of Hours and Earnings supplementary data, Office for National Statistics. Series labelled with an asterisk have one or more cells with coefficient of variation > 10% and <= 20% in ONS data and are indicative only.[21]

21 The dramatic rise in public sector managers in 2009 is exacerbated by the reclassification of the nationalised banks.

However, this could be the consequence of previous under management relative to the private sector. The proportion of all public sector workers categorised as managers remains far smaller in the public sector than the private. Between 2002 and 2008 the proportion of public sector workers categorised as management increased from just over 5% to just over 8%. In contrast the proportions of private sector workers categorised as managers were 18% and 19% respectively.

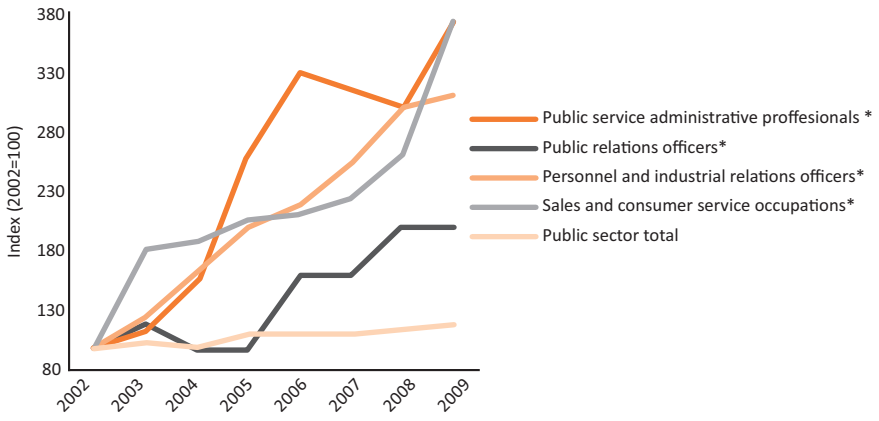
Another explanation would be the grade drift explored earlier. The private sector might be less prone to this phenomenon, given the lack of national pay bargaining.

The growth "non-jobs" in the public sector?

Public sector employment growth is not attributable entirely to managers, however, or 'frontline' staff. There has been much media attention devoted to the growth of "non-jobs" in the public sector and increasing numbers of people employed in non-core activities.

In one sense the statistics bear this out. PR officers, administrators, industrial relations officers and customer service personnel all more than doubled in number between 2002 and 2009 – far outstripping the growth of the public sector as a whole. However, other than administrators, who account for over a million of the public sector workforce, the other groups are quite small (although this means tens of thousands of people) and account for a very small proportion of all public sector employment.

Figure 2.5: Non-core public sector professions with high growth rates, 2002-9



Source: Annual Survey of Hours and Earnings supplementary data, Office for National Statistics. Series labelled with an asterisk have one or more cells with coefficient of variation > 10% and <= 20% in ONS data and are indicative only.

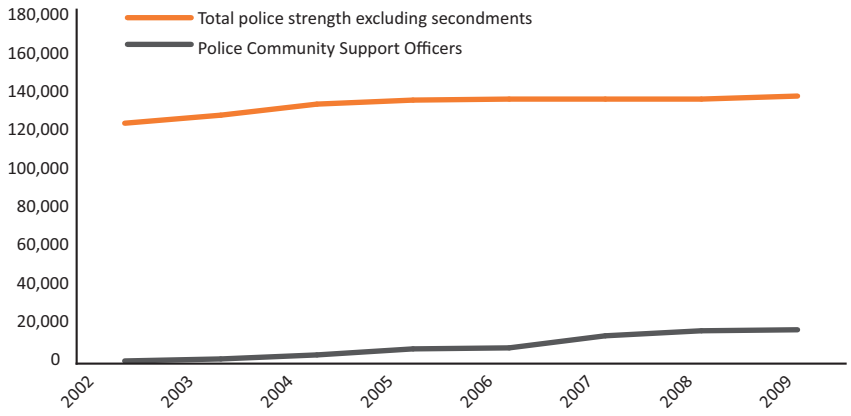
A three tier workforce? The rise of auxiliary occupations in the public sector

The number of classic frontline staff has been outstripped by the growth on supplementary staff in a number of areas. In schools the growth in the number of teachers has been outstripped by the number of classroom assistants. Police numbers have been outstripped by the number of Police Community Support Officers (PCSOs).

In the case of classroom assistants, they are now a major part of the payroll of most schools – roughly a third of the total. In the case of PCSOs they are only about a seventh of the total number of people. However, police workforce modernisation has tended to split people off from the main force into a number of other different categories, including designated officers. The number of civilians working for the police has also increased. In total only 78,000 of the 142,000 people now working for the police are counted as classic "police staff".

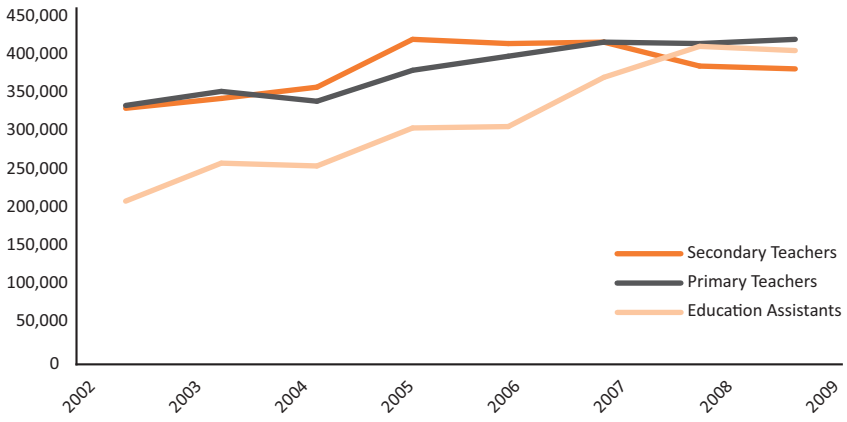
These groups are less well paid than "frontline" members of staff, but their numbers have increased far more rapidly, as a result they have made a significant contribution to the increasing payroll bill.

Figure 2.6: PCSOs and total police numbers



Source: Police Service Strength England and Wales, 30 September 2009.

Figure 2.7: School staff, 2002-9

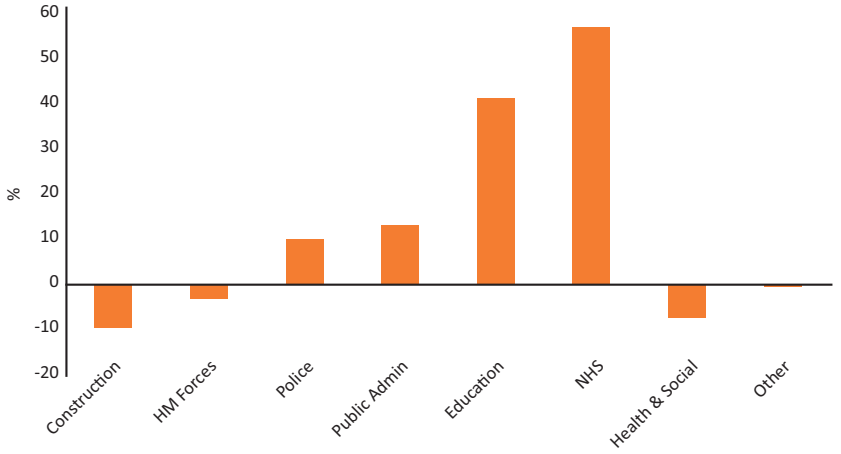


Source: Annual Survey of Hours and Earnings supplementary data, Office for National Statistics.

Growth in public sector staffing by sector

A remarkable net 97.7% of the increase in numbers has been in education and the NHS.

Figure 2.8: Contribution to increase in public sector workers, 1999-2009



Source: Office for National Statistics.

Since 1997, the pattern of headcount growth has been very uneven – ranging from a 56% reduction in the number of construction workers and 10% reduction for HM Forces to a 25% increase for education and 33% for the NHS.

The payroll bill

Increasing numbers of people employed in the public sector and rapidly increasing salaries have multiplied together to produce a large increase in the payroll bill.

Looking at the public sector as a whole (ignoring outsourced public sector jobs) in comparison to the private sector, we can see that both headcount growth and pay growth have outstripped the private sector. As a result, the payroll bill has increased nearly three times faster than in the private sector. Some categories of public sector workers have seen large increases in their numbers, but relatively normal (for the public sector) increases in their pay. The most important example of this is the growth of management roles in the public sector. Social and youth workers are also an example of this.

Some groups have seen substantial increases in pay, while numbers remained relatively constant, or even declined. Firefighters and manual roles are examples of this. In a number of categories both numbers and pay have increased sharply. This is particularly true of higher paid roles in health.

It is important to understand the relative significance of different groups. While there is certainly evidence of an increase in the number of non-core jobs (like marketing, customer service and officer managers), these groups are small as a share of the total. Nonetheless, the total spend on these roles has increased by £4 billion as the result of both rapid growth in numbers and rapid pay increases. Those who think these roles unnecessary will see this as a good place to start reducing spending. But they are relatively less important than the growth of frontline workers in health and education, and the growth of management, each of which account for tens of billions of increase in the payroll bill.

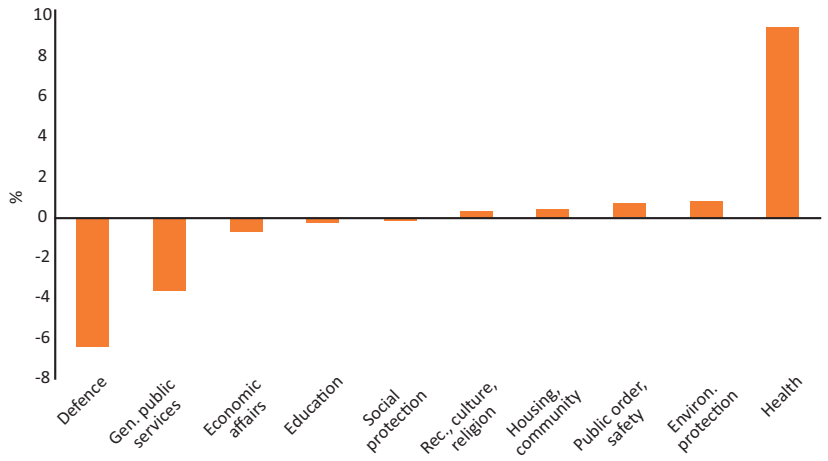
Table 2.2 Changes in the payroll bill 2002-2009 for selected categories of public sector workers

Description	Gross weekly pay 2009	Pay increase (2002-2009)	Pay increase % (2002-2009)	Number (1000s) 2009[22]	Number increase (2002-2009)	Number increase % (2002-2009)	Paybill 2009	Paybill increase (£m 2002 -2009)	Paybill increase % (2002 -2009)
All Employees	480.9	89.4	**23%**	24,251	2,276	**10%**	606,440	159,073	36%
Private sector	481.6	74.5	**18%**	15,378	616	**4%**	385,114	72,615	23%
Public Sector	490.8	128.5	**35%**	6,885	1,111	**19%**	175,716	66,936	62%
Difference			**17%**			**15%**			38%
Management, administration and professional roles									
Professional occupations	704.8	154.1	**28%**	1,473	358	**32%**	53,985	22,055	69%
Managers and senior officials	820.9	207.1	**34%**	570	256	**82%**	24,331	14,309	143%
Administrative and secretarial occupations	349.4	83.3	**31%**	1,169	92	**9%**	21,239	6,337	43%
Education									
Teaching Professionals	605.3	102.1	**20%**	896	153	**21%**	28,202	8,761	45%
Secondary education teaching professionals	656.4	116.3	**22%**	373	50	**15%**	12,732	3,660	40%
Primary and nursery education teaching professionals	592.4	100.7	**20%**	411	84	**26%**	12,661	4,300	51%
Educational assistants	209.0	75.8	**57%**	397	190	**92%**	4,315	2,881	201%
Childcare and related personal Services	217.6	68.5	**46%**	469	185	**65%**	5,307	3,105	141%
Health									
Health and social services managers	806.1	225.6	**39%**	66	28	**74%**	2,767	1,619	141%
Hospital and health service managers	863.3	272.2	**46%**	41	22	**116%**	1,841	1,257	215%
Medical practitioners	1,362.4	377.1	**38%**	160	55	**52%**	11,335	5,955	111%
Health professionals	1,226.5	324.5	**36%**	205	72	**54%**	13,074	6,836	110%
Health and social welfare associate professionals	505.7	127.0	**34%**	853	92	**12%**	22,431	7,445	50%
Health Associate Professionals	529.0	136.6	**35%**	629	65	**12%**	17,303	5,794	50%
Nurses	518.2	130.1	**34%**	523	46	**10%**	14,093	4,467	46%
Midwives	574.2	165.2	**40%**	36	6	**20%**	1,075	437	68%
Caring personal service occupations	262.4	70.3	**37%**	931	206	**28%**	12,703	5,461	75%
Nursing auxiliaries and assistants	295.5	80.8	**38%**	219	10	**5%**	3,365	1,032	44%
Police prison and fire									
Police officers (sergeant and below)	741.3	166.9	**29%**	251	18	**8%**	9,675	2,716	39%
Prison service officers (below principal officer)	507.0	65.6	**15%**	50	-2	**-4%**	1,318	125	10%
Fire service officers (leading fire officer and below)	511.0	128.4	**34%**	66	0	**0%**	1,754	441	34%

Description	Gross weekly pay 2009	Pay increase (2002-2009)	Pay increase % (2002-2009)	Number (1000s) 2009[22]	Number increase (2002-2009)	Number increase % (2002-2009)	Paybill 2009	Paybill increase (£m 2002 -2009)	Paybill increase % (2002 -2009)
Social work and caring roles									
Social workers	556.3	129.9	**30%**	94	40	**74%**	2,719	1,522	127%
Youth and community workers	377.1	94.4	**33%**	61	27	**79%**	1,196	696	139%
Housing and welfare officers	430.1	98.0	**30%**	88	-12	**-12%**	1,968	241	14%
Therapists	504.2	123.6	**32%**	75	12	**19%**	1,966	720	58%
Care assistants and home carers	306.3	100.5	**49%**	210	23	**12%**	3,345	1,344	67%
Marketing, sales and customer service									
Sales and customer service occupations	340.3	136.4	**67%**	63	46	**271%**	1,115	935	518%
Marketing and sales managers	910.2	266.2	**41%**	29	18	**164%**	1,373	1,004	273%
Office managers	664.8	116.5	**21%**	81	54	**200%**	2,800	2,030	264%
Manual work									
Elementary occupations	233.2	69.3	**42%**	640	-72	**-10%**	7,761	1,693	28%
Elementary Cleaning Occupations	186.3	52.4	**39%**	199	-50	**-20%**	1,928	194	11%

Across the board, the paybill has increased far more rapidly than in the private sector. However, some areas have grown particularly quickly. As noted above, healthcare spending is the main example of this. The only area where the paybill has been shrinking is in defence. Looking over the longer term using OECD data since 1990, 39% of the increase has been accounted for by health spending.

Figure 2.9: Employee compensation, change as % of total paybill, 1990-2008

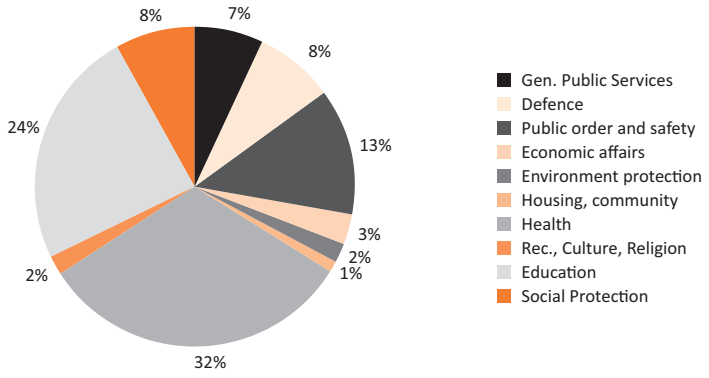


Source: OECD, Total compensation of employees paid by government, government expenditure by function.

22 Headcount numbers are based on weighted values and are indicative only.

As a result, over half the paybill is now spent on health and education. The major change in the paybill's structure has been the growth of health and the decline of defence spending; the health bill growing from 23% to 32% of the total since 1990.

Figure 2.10: Employee compensation by spending area, 2008



Source: OECD, Total compensation of employees paid by government, government expenditure by function.

Clarke's 1993 Budget and public sector pay

Given the trade-off between reducing headcounts and reducing pay, it might seem attractive to set a target for the total *paybill* as the government's overall objective. The choice between the two could then be devolved to lower levels, which might be more efficient.

In 1993/4, the budget deficit reached nearly 8% of GDP. To repair the damage, the then Chancellor Kenneth Clarke raised taxes and limited public spending increases. Clarke sought to reduce government spending by £3.5 billion by freezing public sector *paybills* at current cash levels. He also stated that:

> 'Pay increases for public sector staff will... have to be paid for by greater efficiency or by savings in the cost of running government itself.'[xxxiv]

Despite the nominal paybill freeze, public sector wages did not, in practice, fall, but rise. Trade unions were able to negotiate pay settlements increases through a package of savings over and above those stipulated in the Budget, such as greater outsourcing and efficiency measures. The median basic pay award fell to 1.5% in 1993 and remained below 3% until 2001.

The rule, that 'pay increases for public sector staff... have to be paid for by greater efficiency or by other economies' was reaffirmed for the rest of the Major Government.[xxxv] Since the freeze was in cash terms, the real paybill shrank as a consequence of inflation (though in cash terms it continued to rise due to efficiency savings). For example, the paybill rose slightly in cash terms from £90.0 billion to £90.1 billion between 1993 and 1995 but fell by 4% in real terms.

Since pay continued to rise, the burden of the paybill cut fell entirely on job reductions. The paybill cost per worker rose by 3.5% in real terms between 1993 and 1999 while the paybill fell by 3.5% from £130.5 billion to £125.9 billion. At the same time, the public sector workforce fell by 377,000, or around 7%.

3
Conditions of Work: Beyond Pay and Staffing

There are a number of aspects of the public sector compensation which are not fully captured in pay or staffing numbers.

- **Job Security:** Public sector workers enjoy greater job security. This could be seen as having a certain monetary value for public sector workers – you might be prepared to accept slightly lower pay for a more secure job. Alternatively it might be thought of as adding to the cost-per-unit-productivity of the public sector. If levels of job security are very high it may reflect a culture in which it is difficult to lose under-performing workers, or remove people from roles they are not suited to.
- **Pensions:** In general, public sector workers enjoy much more generous pensions than private sector workers, (although as we will see, this is not universally true). The cost of pensions is partly captured in the current paybill. However a large part of spending on pensions is not, and takes the form of an increase in the unfunded pension liabilities of the government, a subject which deserves attention in its own regard, but is also relevant to this discussion.
- **Time Worked:** As we have seen above, time worked can be partially captured by pay per hours worked, on which measure public sector workers now enjoy a 30% premium over their private sector colleagues. But this is not the end of the story, as public sector workers take more time off, and retire earlier. Again, we can think of this as either a benefit to the individual or a cost which shows up in productivity.
- **Productivity:** last but not least, we will look at measures of public sector productivity. Ultimately, whether the taxpayer is getting a "good deal" or not depends on whether those employed in the public sector are producing the services and goods we want. Productivity is affected by all the other elements discussed in this paper, but also many other factors which are harder to measure.

Job security

Job security is a nebulous concept and precious little data exists on actual dismissals (as opposed to voluntary redundancies, resignations, early retirement, etc.) A recent study by Gomes (2009) finds the separation rate (i.e. the proportion of terminations of employment to the total number of workers employed) for public sector em-

ployees is less than half that of their private sector counterparts (0.7% as opposed to 1.5% per quarter). High rates of absenteeism and under-performance in the public sector are perhaps buttressed by little fear of failure. This is a common observation among those who have worked in both private and public sectors. The former trade minister, Lord Digby Jones, has suggested that half the employees of the civil service would not retain their jobs were their ministry a private business:

> *'I was amazed, quite frankly, at how many people deserved the sack and yet that was the one threat they never ever worked under, because it doesn't exist as long as they have not been criminal,' he says 'I was always told [they] will just be moved sideways and they will go off to another department.'*[xxxvi]

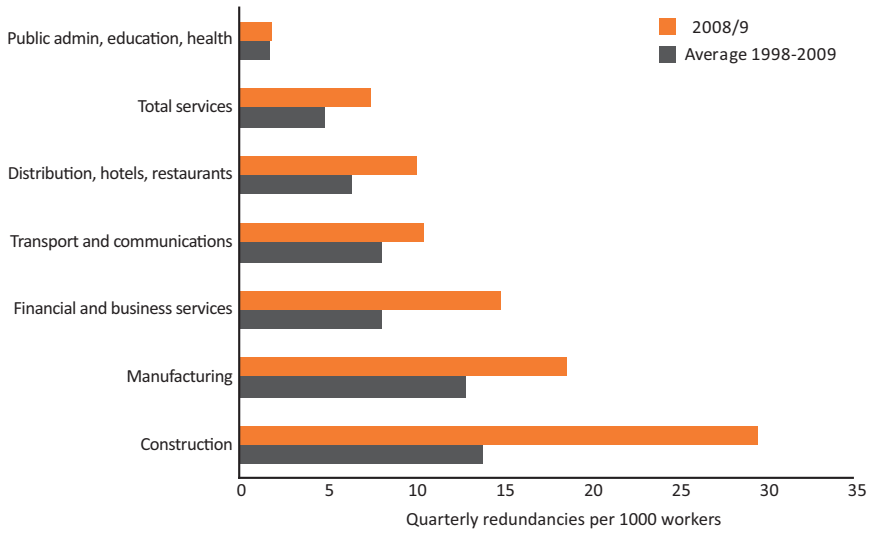
Concerns over job security are starting to place further downward pressure on wages in the private sector. The weaker private sector labour market may lead to the public sector becoming relatively more attractive, thus improving further the public sector's ability to recruit and retain staff. This is coupled with increased anxiety about job losses in both sectors, however. A 2009 CIPD Labour Market Outlook survey revealed that while net employment intentions in the private sector remain negative (up to -2% from -30% for the quarter), this mirrors intentions in the public sector, where net employment intentions fell from -3% to -28% in anticipation of a fiscal squeeze beginning in 2010/11. Some 350,000 public sector jobs were estimated to be lost by 2014/5 on the former Labour government's projections of the fiscal squeeze, a figure likely to increase.

In dealing with job security in the public sector, we must acknowledge the lack of good data. For example, the Public Accounts Committee said in 2008 'There are no definitive numbers available for the operating costs of HR and finance in government… The lack of value for money information – linking spending to outcomes – is a fundamental concern.' This tendency is particularly acute for redundancies – principally, it seems, because there are so few. Most are negotiated with generous voluntary arrangements, while the number which are compulsory is kept extremely low. Many organisations find it much cheaper – and easier – to keep people than to sack them – indeed, some even have units more or less openly created to put unproductive staff in. The Civil Service is the most extreme example of this. Less than 1% of civil servants take voluntary redundancy each year.[xxxvii] According to the Cabinet Office, 'there were fewer than 100 compulsory redundancies between 2005 and 2008'. Out of a total of 525,000 civil servants, this is less than 0.005% of the workforce a year.[xxxviii]

On the basis of these figures, it seems reasonable to assume that, over the last decade, redundancies in construction have been running at least 7.6 times the rate of those experienced in the public sector, or 7.2 times the rate in manufacturing (indeed the total may be actually be higher).[23] As redundancy rates increased rapidly across the private sector during 2008-9 (45% in manufacturing and 115% in construction, for example) they remained unchanged in the public sector, causing these ratios to rise to 16.4 times and 10.4 times respectively. In a large survey of 60 different public sector organizations coordinated by the Cabinet Office, just 13% employees disagreed with the statement that their organisation 'is too lenient with people who perform poorly here.[xxxix] Whichever figures are used, it is clear that job security in the public sector is dramatically higher than in the private sector.

23 Using ONS figures on 'public administration, education and health' as a proxy for the public sector; i.e. including private education and healthcare providers. Average 1998-2009.

Figure 3.1: Redundancy rates by sector, 1998-2009



A key element of this is that organisations often keep people on the payroll long after they would be dismissed in the private sector:

> *'Sir Stanley Kalms, the former head of Dixons and one of the more unlikely past chairmen of a National Health Service hospital, discovered how extensive is the culture of job security — and at whose expense — when he threw a tea party. He had decided that staff who had served for more than 25 years deserved a reward. It proved a revelation. Neither he nor anyone in the hospital had ever seen the majority who turned up. Some were ill, others grotesquely overweight, "all no longer fit and proper people to be in a hospital". But they were still on the payroll.'*[xl]

Over-generous redundancy payments are one reason that so few people are let go. In the civil service, £432 million was spent on payouts to 7,718 officials between 2005 and 2008 – an average of £56,000 a piece.[xli] This is quite apart from any pension pot they will take with them. In services such as the police and prisons, there are extremely generous incentives to take early retirement. Just 16% of civil servants will retire at or above their normal retirement age.[xlii]

Moreover, there often seems to be little rationale in determining the size of the payments. For example, in the civil service there are large variations even between different government departments. During the period of the Gershon Review from 2004 to 2007 the cost of sacking someone varied between over £160,000 at the Foreign Office to £34,000 at the Department of Work and Pensions.[xliii] Reform is proving a slow process. For example, if made redundant, civil servants over 50 qualify for compensation of three years' pay, while those who joined before 1987 can qualify for 6.5 years' pay. In 2009 the government proposed reducing these payoffs a little, by capping compensation at two or three years' pay for lower paid staff and introducing repayment of the severance pay if the employee rejoins the civil service (which is not necessary at present).

Outside the civil service the majority of public sector organisations have similar problems. According to one survey, the average cost of redundancy is £17,900 in the public sector and £8,900 in the private sector.[xliv] The process of hiring people in the public sector can be extremely formalistic and consume huge amounts of time and money. For example, a 39-step process must be followed when hiring someone to the Prison Service.

The National Audit Office found that it cost an average of £2,000 to hire someone, and that 'It can typically take an average of 16 weeks (112 days) to recruit a new member of staff.' At HM Revenue and Customs it typically took 212 days. The NAO also found that 'between 14 and 52% of staff leave within 12 months of being appointed'.[xlv] The report also found that public sector bodies were demanding academic qualifications for positions that did not require them. It suggested that departments 'could improve the relevance of the recruitment process to the vacancy by testing candidates in the workplace using realistic work scenarios. There is also the potential to remove the need to hold academic qualifications for specific positions such as contact centre staff'.[xlvi]

In 2008 the government struck an agreement with the Council of Civil Service Unions about what it euphemistically refers to as 'handling surplus staff situations.' The agreement contains about a hundred bullet points, but the general drift is clear – to protect insiders at the expense of outsiders:

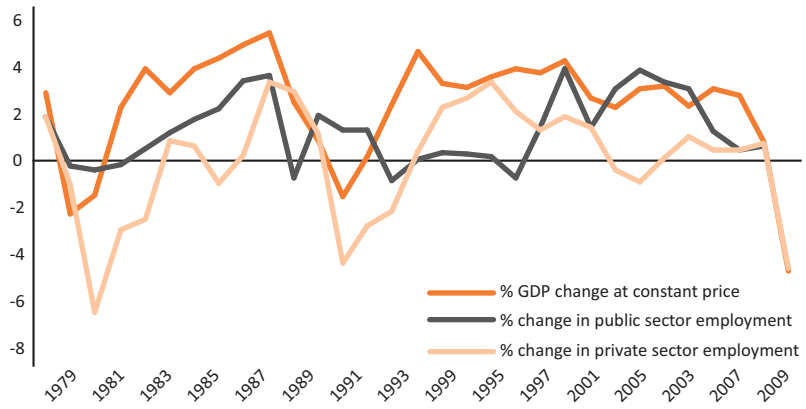
> *'Positions filled by agency workers, consultants, temporary staff and similar appointments should be reviewed to establish if these would be suitable for permanent members of staff whose jobs are at risk" … There will be "a formal Meaningful Consultation period (90 days)" … and civil service employers must "Ensure proposals are subject to Equality Impact Assessments and that monitoring is ongoing" … "A Period of Reflection meeting will then be arranged between senior members of the Department, the Cabinet Office, the National TU Side and the Departmental TU Side. This must be in the diary at least six weeks before any planned redundancy notices are issued.'*[xlvii]

As noted above, making it so hard to hire and fire reduces work incentives and leaves public services with a sluggish, low-morale culture. Public sector bodies need to dismantle prescriptive hiring and firing policies, and to create the right incentives for managers so that they are not encouraged to leave poor performers in place.

The influence of trade unions and the tendency towards litigation make sacking workers in many areas of the public sector slow, difficult and expensive, especially for senior staff. For example, teachers who are failing in their job or facing disciplinary action can take up to two years to dismiss, often given non-contractual 'compromise agreements' pay-offs on condition they quit their job. Often this might mean simply moving to a different school, a process known as 'passing the lemons'. In 1998, Chris Woodhead, the chief schools inspector estimated there were 15,000 incompetent teachers in England; today, the General Teaching Council suggested the figure could be as high as 24,000.

There is also evidence that public-sector redundancies tend to be less cyclically driven than their private sector counterparts.

Figure 3.2: Change in public, private sector employment, GDP, 1979-2009



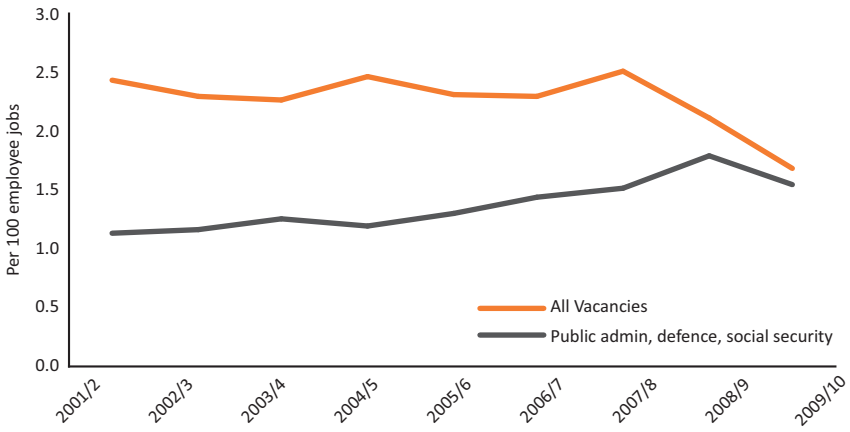
Both show a clear correlation to economic growth, but private employment tends to be mildly more pro-cyclical than the public sector (with a correlation co-efficient of 0.60 and 0.33 respectively). This means that private sector employment is more likely to fall when the economy falls, but also more likely to rise when the economy is growing.

To put it another way, this means that public sector employees are less likely to lose their job at a time when others are losing theirs, something which adds to the value of the additional job security they enjoy.

Recruitment rates

Higher levels of job security can also be detected in lower recruitment rates. It has been the case for several years that a significantly smaller proportion of public sector jobs are unfilled at any one time than in the private sector.[24]

Figure 3.3: Vacancies by industry, 2001-9



Source: NSA Vacancy Survey.

24 Using public administration, defence and social security as a proxy for the public sector.

The gap has narrowed during the recent recession, however. Vacancy rates across the economy fell by 39.5% from October 2007 to November 2009.[xlviii]

Future evolution of job security in the private sector

As a lagging indicator, there is a widespread view among economists that unemployment will continue to rise during 2010/11 even if there is a swift economic recovery. Many private sector employees are likely to see an improvement in pay rises, however. A recent survey by Incomes Data Services estimates average rises of between 2.5% and 3%, with around 3/5ths of companies who froze pay last year discontinuing the policy.

In addition, productivity has plummeted as firms have 'held on to' workers they are unable to use productively due to slack demand, presumably in hope of an earlier recovery meaning they could quickly utilise the workers they have retained. Many economists believe that a double-dip recession is likely, during which the practice of many private firms to hold on to employees by such mechanisms as restricting their hours or pay restraint will no longer be tenable. Unsustainably high labour unit costs will continue to hamper profitability and ultimately push up unemployment in the private sector. Much of the private sector has followed the route of pay cuts or redundancies but there has been little or no equivalence in the public sector. The OECD has predicted 1% GDP growth and a total decline in the UK's employed workforce of 2.6%.[xlix] A recent study of Hymans Robertson shows that 31% of public sector employees are concerned about being made redundant in the short term.

Pensions

In the 2009 Pre-Budget Report, the then Chancellor Alistair Darling stated that 'Public pensions need to be broadly in line with those offered in the private sector.' There can be no doubt that implementing this aspiration would require a very significant adjustment. Indeed, the perception of lower wages in the public sector ties in with the expectation of higher pensions: 'In a way there is a deal that is done with the public sector that people accept lower pay than they would get elsewhere in return for having a more generous pension arrangement.'[l] As we have seen, however, it is not the case that public sector workers are less well paid.

Public sector workers are led to believe that they are paying for their pensions, but they are not. For example, at the moment the government asks NHS employees and teachers for a contribution of, on average, 6% of pay and employers for an additional 14%, in order to help meet the pension promises it has made, i.e. 20% of total employee pay. But over 40 years a typical public sector worker needs to have paid 48% of his salary into his scheme in every year of his career in order to pay for the pension payouts at the end of it. The Treasury currently covers this annual 28% gap. According to research by the Pensions Policy Institute, the average public sector pension is worth three times as much as the typical scheme still open to workers in the private sector.[li]

A typical example is that of the Local Government Pension Scheme. This costs 6% of gross pay to join, attracts tax relief at source and provides a retirement pension based on 1/80th of final salary for each year of employment and a tax

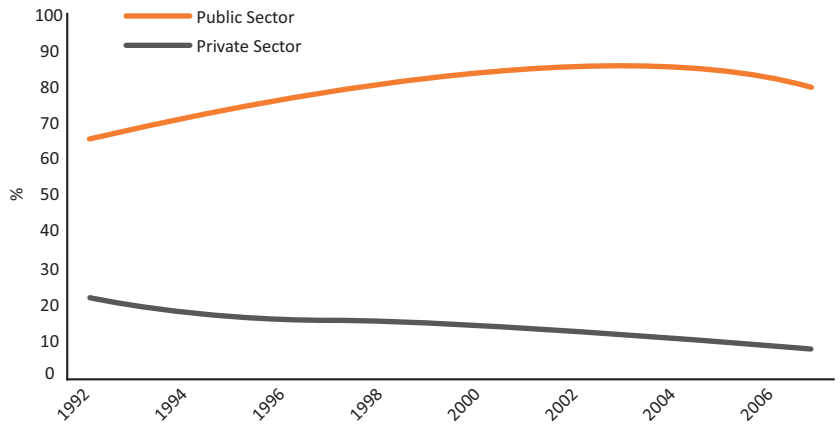
free lump sum equal to three times the annual pension and life assurance of two years' pay while contributing. Comparing such schemes to the private sector is difficult and compounded by the notorious actuarial difficulties comparing defined benefit (i.e. those where benefits are defined by contract) and defined contribution pensions (where the employer makes a contribution to a pension fund 'pot' and actual benefits are defined by investment returns).

One way to examine the extent of auxiliary benefits in public sector remuneration packages is to examine when public sector workers are transferred into private sector bodies. This is increasingly frequent (NHS work being carried out in the private sector, for example, or the reclassification of employees of bailed out banks as employees of the state). The CBI has stated that businesses are often prevented from bidding for public service contracts by their inability to pay a premium – of between 25% and 50% – to match the pension entitlements of formerly public sector staff. The actual cost as a proportion of the payroll is often so high as a consequence of many employees in the public sector not working until retirement age – often retiring in their late 50s or early 60s.

One option might be to increase pension contributions for public-sector employees to reflect the future costs of their defined-benefit pensions. However, direct quantification of the value of a final salary pension scheme (normally a figure based on an index-linked calculation of 1/80th of the employee's final salary multiplied by the number of years they have worked in that area) is actuarially very complex – indeed, such pensions are scarcely available in the open market. This mechanism ensures that if someone stays in the public sector for their whole career they will often retire with an annual pension higher than their average wage when they were working.[lii]

In contrast, private sector pensions are generally subject to the uncertainties of macroeconomic risk – the general level of asset prices, for example – while public sector pensions are implicitly or explicitly guaranteed by the state and thus only subject to the near impossibility of a sovereign default – a much lower risk.

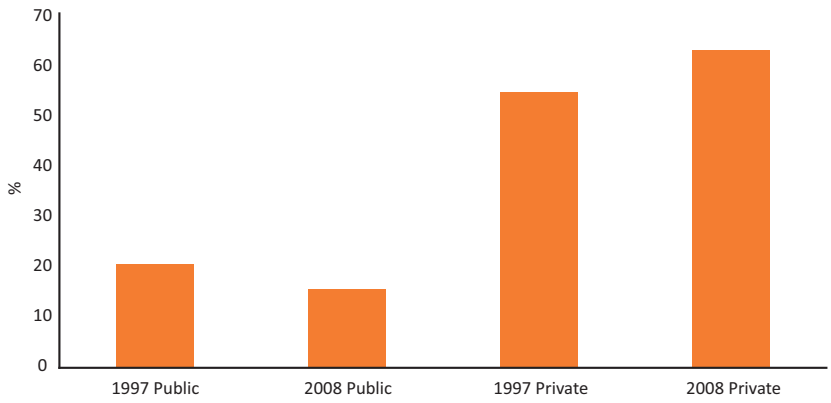
Figure 3.4: Contracted out defined benefit pensions, 1992-2007



Department for Work and Pensions, Second Tier Pension Provision Statistics, (http://research.dwp.gov.uk/asd/asd1/tabtools/stpp_summary.xls), Office for National Statistics.

While the proportion of public sector workers in defined-benefit schemes largely rose until 2006, the number in the private sector has progressively declined – to just 8% of its workforce compared to 80% in the public sector by 2007. However, this underestimates the scale of the gap – many of the schemes which private workers are still in have been closed to new employees. By 2008, 82% of public sector workers were participating in defined-benefit schemes that were still open compared to just 4.6% of the private sector.[liii] The latter figure is still falling as firms – most recently BP – find such schemes too expensive to continue to keep open, partly due to longer life expectancy, partly due to poor returns. This 'pension apartheid' is a key factor in the public sector compensation premium. It is exacerbated by the fact that more than half of the private sector have no pension provision at all, a problem which has increased over time, while the proportion in the public sector has fallen.

Figure 3.5: Workforce without pension provision with employer



Office for National Statistics, Table P2.1 Pensions Backseries – For all employee jobs.

Since many private pension funds have seen the gains of the last decade wiped out by the recent recession, some private pensions have seen dramatic falls in payout, making the gap has even more stark. In consequence of these factors, the average public sector salary is effectively worth 15.6% more than the same nominal amount in the private sector.[liv] Other estimates have put the figure at around 12%.[lv] The mean value of pension accrual is 9.3% for a private sector defined-contribution pension compared to 30.5% for a defined-benefit public pension.[lvi] Public employees also have to make a far smaller salary sacrifice than is prevalent in the private sector. For example, to be part of the Civil Service's Premium Pension Scheme (giving a remarkable 1/60th of final pensionable earnings per year of service), an employee must make contributions of 3.5% of their salary (tax exempt); each department must then make a 22% addition.

Other public sector pensions work rather like a normal company scheme. Most local councils have some form of shared contribution by the employer and employee, which is then invested to pay pension payments. However, many other

public sector organisations are not obliged to make a contribution sufficient to secure their liabilities (the Pensions Regulator has no statutory right to order public sector organisations to top up their contributions as they can with the private sector), with the implicit assumption that any shortfall will be made up out of future taxation. In total, of the six largest public sector pension schemes, only one (the Local Government Pension Scheme) is funded (though centrally guaranteed); the other five (those for the NHS, teachers, the Civil Service, the Police and the Armed Forces) are not. The annual cost of servicing the debt of these final salary schemes already stands at £45.2 billion, and is rising rapidly as pensioners live longer.[lvii]

"A public sector worker aged 50 might be able to increase his or her salary by moving to a private sector job, but would compromise the value of their pension. So they have an incentive to stay on and become an under-performing time-server"

Public sector pensions thus need urgent reform on cost grounds alone. But there is another aspect to over-generous pensions: it is trapping public sector workers in jobs and disincentivising them from seeking work in the private sector. A public sector worker aged 50 might be able to increase his or her salary by moving to a private sector job, but would compromise the value of their pension. So they have an incentive to stay on and become an under-performing time-server. The flip side of this is that it becomes more difficult for the private sector to compete with the public sector – further reducing competition and innovation in the public sector. A natural thought might be to place new public sector employees on more transferrable, money-purchase schemes which cut costs and eliminate this effect. There should also be greater clarity to reveal the size of the problem, and prevent the government from running up further off-the-books debt.

How big are the unfunded liabilities?

Unfunded pension scheme liabilities stood at 78% of GDP (£1.1 trillion) in 2008; the cost of servicing these schemes was £45.2 billion, more than doubling since 2003.[lviii]

When the government receives contributions from public sector employees and employers for pension schemes, it spends the money immediately rather than investing it for the future – hence the fact they are known as "unfunded" schemes. Yet even though the Government has "saved" money in one year by not having to borrow money to finance general spending, it still has to pay interest on the debt that it is building up in paying for the pension promises it has made to past employees. But when it does this, the government does not pay interest on the borrowing; it adds it to the total liability instead. So the £45.2 billion is thus a debt-on-debt payment.

Unfortunately, the method that the government uses to calculate both the liabilities and how much workers need to contribute to their schemes is not financially defensible. In order to work out what the value of its promises to pay out money in the future are worth today, it applies an interest rate to those promises that allows the final figure to be expressed in today's money. The prevailing market interest rate would be the most natural one to use, but the government has decided to adopt a rate that exceeds it. This has the effect of making the liabilities look smaller than they are.

These calculations mean that public sector workers are receiving a nearly unknown subsidy that is rapidly inflating the liability that future taxpayers will have to meet. In 2007-08, according to a proper market calculation, the total cost of making pension promises was £34.1 billion. But because the government is not applying a proper interest rate to the contributions it asks for, it is only receiving £19 billion, of which £13.2 billion it is paying itself in the form of employers' contributions. So the full subsidy to public sector employees is £28.3 billion, of which £13.2 billion is employers' contributions, £10 billion is acknowledged as "under-charging" by the Treasury, and the remaining £5.1 billion is not acknowledged at all. That is the equivalent of about £5,700 for each of the five million employees in unfunded public pension schemes.

The Irish pension levy

In February 2009, the Irish government announced that all public sector workers (not retirees) would pay 'pension levy' amounting to some 7.5% of total earnings on average. This is composed of a graduated scale: a 3% levy on the first €15,000 of pay, 6% on the next €5,000 and a 10% levy for the remainder.

The Irish Department of Finance said at the time: "The basis for the deduction is that public service pensions are acknowledged to be significantly more favourable than the generality of pensions in the private sector, both in regard to their terms and their overall security, and it is therefore appropriate that a deduction should be made to reflect this reality at a time when savings are needed from the public service paybill."

In 2007-08, the Treasury estimated that it would receive about £19 billion in total from these contributions. So, in one sense, the pensions *are* funded – the Treasury receives real money from all the public sector employees and employers. However, it does not invest the pension contributions but instead uses them for current expenditure. By doing so, the Treasury avoids having to borrow that amount in the gilts market and thus saves itself the interest on the debt that it would otherwise have had to pay.

Bringing unfunded liabilities onto the balance sheet?

A natural thought might be for public sector employers that make pension provision for their staff to pay (jointly with employees for contributory schemes) a cash amount each year equivalent to the full market value of the pension benefits (i.e. current service cost) accrued by staff in that year.

At the moment the government asks employees for a contribution, on average, of 6% of pay and employers for an additional 14% in order to help meet the pension promises it has made, i.e. 20% of total employee pay. But over 40 years a typical public sector worker needs to have 48% of his salary paid into his scheme in every year of his career in order to pay for the pension payouts at the end of it. The Treasury covers this annual 28% gap. Even taking into account people who take career breaks and do not stay for long in the public sector, the whole public pension system requires annual contributions of 35% of pay each year to fully cover the cost of new pension promises.

Consequently, there is an average gap of 15% of a public sector workers' pay which is unfunded either via employee or employer contributions and is not

shown in government paybill figures.[lix] To eliminate further accrual of unfunded liabilities for existing employees would require the additional payment (as well as existing pension contributions) to be used to buy index-linked gilts. Adding this would increase the general government paybill by £19.7 billion in 2010/11.

However, to ask public sector workers to start making up this 15% shortfall in their pensions all at once might seem politically infeasible.

In the 2009 Pre-Budget Report, the government started to move in the direction of Irish style reforms. It moved to limit the contribution the government will make to public pension schemes. According to the report:

> *"Cap and share reforms to the Teachers, Local Government, NHS and Civil Service pension schemes will cap the contribution to pensions made by employers, thereby limiting the liability of the taxpayer as pensions become more valuable. Cost increases below the cap will be shared equally between employers and employees, and those above the cap met solely by employees. In addition, as part of cap and share, the Government will expect those earning the highest salaries to pay a greater contribution towards their pension. These reforms will save an estimated £1 billion a year from 2012-13, and at least twice this amount over the long-term."*

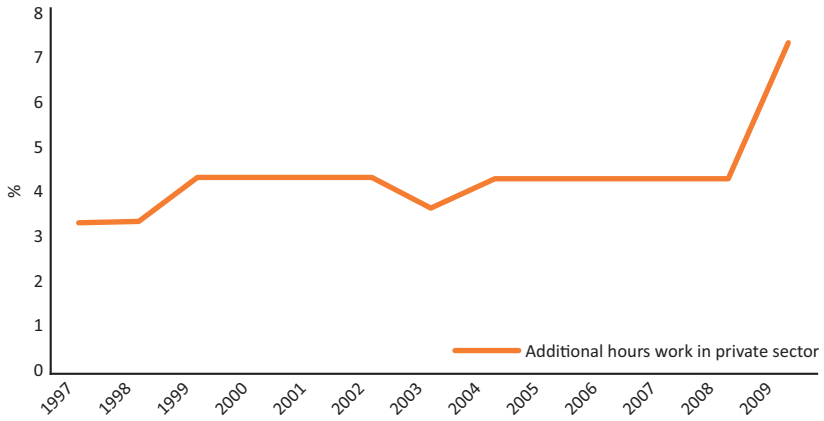
If we were to follow the lead of Ireland and introduce a pension levy averaging 7.5% of total earnings (on a graduated basis) this would have the neat effect of splitting the real additional cost of funding public sector pensions 50:50 between government and public sector employees (who would pay an additional £9.9 billion in 2010/11).[25]

Time worked

Changes in working hours

Median working hours have remained consistently higher in the private sector since 1997. Working hours in the private sector for the average employee are 2.5 hours longer per week than in the public sector. The gap widened markedly to 7% in 2009.

Figure 3.6: Private sector premium, median, number of hours worked per week, 1997-2009



Source: Annual Survey of Hours and Earnings, Office for National Statistics.
All hours worked, 1997-2003, hours paid, 2004-2009.

25 Excluding public corporations.

Holidays

The public sector enjoys a remarkable 38% premium for paid holidays, with 29 working days a year compared to an average of only 21 days in the private sector. In some sectors, the difference is even more stark: distribution, hotels and restaurant staff have only 18 days off per year, giving the public sector a 61% premium.[lx] Some public workers enjoy even greater entitlements: firefighters and teachers can accrue up to 33 and 35 days' holiday respectively, while the Civil Service enjoy an additional 2.5 'privilege days' on top of their usual vacation days and public holidays.

Absenteeism

Public sector workers also have significantly longer absence rates due to illness. The average public sector organisation loses an average of 9.7 days per employee per year through absence compared to just 6.4 days in the private sector: around 50% more.

Certain sectors show even starker discrepancies – just 3.7 days for employees in the textile industry compared to 11 days for NHS employees and 10.7 for local government workers, for example – almost triple the rate of absence. Non-manual telecommunications employees take an average of just 1.2 days off a year compared to 14.8 days taken off by manual NHS workers – a remarkable 12-fold difference. This totals to an average of an additional 1.4% of the working year lost to absence in the public sector above that of the private sector.[26]

This clearly suggests a problem of low morale and by one estimate costs the public sector an additional £6 billion a year.[lxi] According to a study by the charity Roffey Park, nearly 40% of managers in the public sector believed morale was low in their organisation. This compared with 16% in the private sector and 6% in the not-for-profit sector. Too much bureaucracy was identified by half the respondents as the main problem. Poor management was rated second; and more than a third also pointed to lack of recognition as a key factor.[lxii]

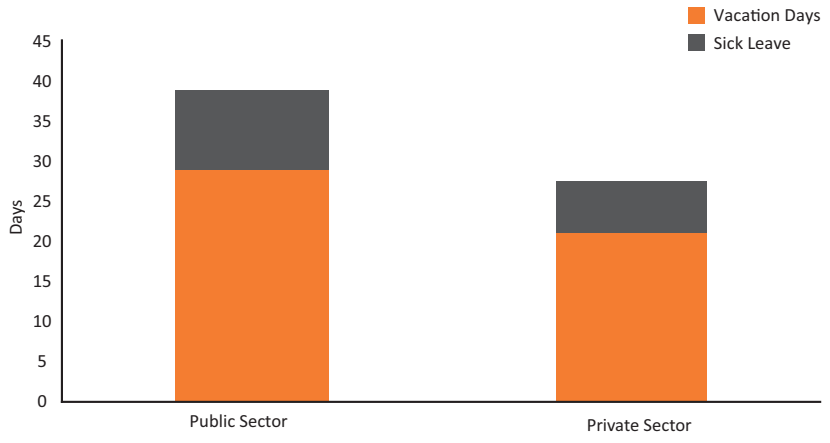
This situation is perhaps compounded by the very generous terms of public sector sick pay. For example, NHS employees are paid an average of their previous three months' salary for their first six months on sick leave – including any extra for unsocialable hours or overtime pay – then a further six months on half pay – in fact, the rules allow the employer to extend either of these arrangements indefinitely.[lxiii] The police terms are six months on full pay (though excluding overtime) and six months half pay; maintained school teachers have 25 days full pay and 75 days half pay, rising to 20 weeks' full pay and 20 weeks' half pay after four years. In contrast, standard sick leave in the private sector is generally four or six weeks on full pay, followed by statutory sick pay (though some companies will transition an employee onto this after the statutory minimum of four days). Critics have said these very generous terms contribute to the 10.3 million working days annually lost in the NHS due to sickness, at an estimated cost of £1.7 billion a year.

Total time off per year

If we total up the average annual time on sick leave and holiday, we get a remarkable result.

26 Assuming working year of 230 days. CIPD Absence Management Annual Survey Report 2009, p. 6.

Figure 3.7: Annual total days off per worker in the public and private sector (excluding weekends and public holidays)

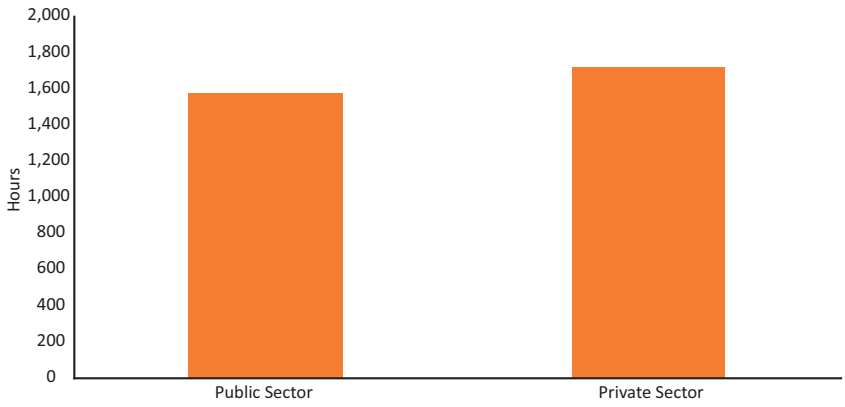


That is, there are 11.4 working days per year – more than two working weeks – in which the average private sector worker is at work, but the average public sector worker is not. This equates to 213.2 days worked in the public sector and 224.6 days in the private sector.[27]

Total hours worked per year

We can combine the number of extra days off per year taken in the public sector with the extra time private sector staff work each day (an additional seventeen minutes).[28] The disparity in actual hours worked per year is striking.

Figure 3.8: Total hours worked per year



People in the private sector are typically working an additional 147 working hours per year: 9.3% more. In essence, a typical full-time public sector employee works an average of 9.3% fewer hours for 12.5% more pay.

27 Full-time, excluding weekends and eight statutory public holidays i.e. 252 days.

28 Full-time employees on adult rates whose pay for the survey pay-period was not affected by absence. Annual Survey of Hours and Earnings, Office for National Statistics, total number of hours worked per week.

Total time worked over the whole career

However, this is not the end of the story, since private sector workers generally have a higher retirement age. A typical public sector work is able to retire on a full pension at the age of 60: this is the case for existing employees of the NHS, police and teachers, for example (though new arrangements have been introduced for current joiners).[lxiv] Since a private sector worker will not only be working more hours per year, but also a greater number of years, a still greater disparity occurs in terms of lifetime hours worked.

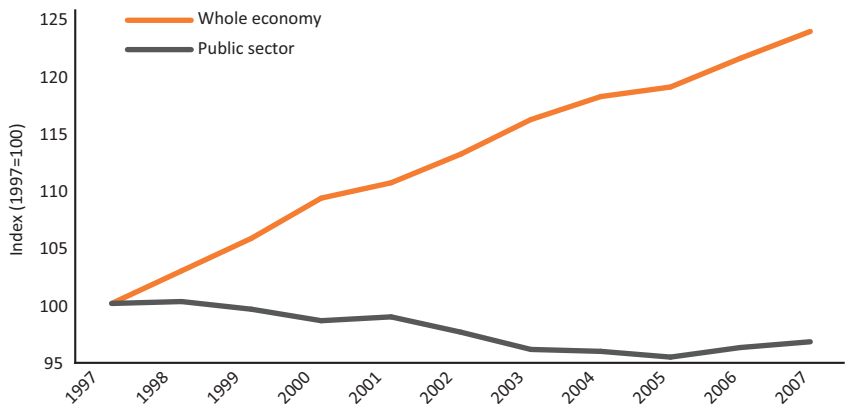
If a typical public and private sector worker retires at their sectors' usual retirement ages, it is not an unreasonable estimate that the private sector employee will have worked around 14,500 additional hours in their lifetime – the equivalent of 9.2 years of a public sector employee's working life – where their public sector counterpart will either be on sick leave, holiday, strike or in retirement. In other words the private sector worker will work 23.0% more hours in their lifetime.

Productivity and remuneration

> 'Public services in the past tended to be something... that went a tacit understanding that the service might be a bit shabby, slow and bureaucratic. But that was the price of getting something free... now... they expect service of the kind which they would get from the private sector.' – *Sir Richard Wilson, former Cabinet Secretary, 2000.*

We may well question whether salaries in the public and private sectors ought to be the same. An obvious thought might be that salaries should be related to productivity – economic theory suggest that wages ought to equal the marginal product of labour. In fact, public sector salaries have risen while productivity has fallen. Comparing public sector productivity with that of the whole economy, we see that productivity increases have been entirely driven by the private sector:

Figure 3.9: Productivity changes since 1997



Source: ONS, Total Public Service Output and Productivity, June 2009.
http://www.statistics.gov.uk/articles/nojournal/TotalPublicServiceFinalv5.pdf

Estimating productivity is notoriously difficult in the public sector. However, using the Office for National Statistics' analysis, growth in output per worker in the public sector has been considerably slower than in the private sector - Public Administration, Education and Health has produced negative productivity growth per worker in over half the quarterly recordings since 2001.[lxv]

Public sector pay increases are rarely based on performance. In fact, productivity is still lower than it was in 1997: the latest ONS Total Public Service Output and Productivity survey (June 2009) shows it 3.2% down from that year in 2009; a decline of about 0.3% year on year – despite – or perhaps because of – remarkably sustained increases in public sector expenditure and employment over this period. The comparison between this and comparable rates in the private sector (around 4% rises in manufacturing and 2% in services), is stark. While private sector salary rises have often been less than productivity gains, the public sector has had proportionately even larger pay increases than the private sector alongside falling productivity.

Public sector productivity metrics

Quantifying levels of efficiency in the public sector poses unique problems not found in the private sector. Whereas market actors have an easily verifiable metrics for their success or failure, such as profit, revenue, turnover and so on, the public sector has no similar standard – prices are often arbitrary or non-existent, while quality improvements, which have several useful yardsticks such as customer demand in the private sector, are notoriously difficult to measure since demand is relatively unchallenged by either price or competition. Simple productivity in the NHS could be determined, for instance, by dividing the number of doctors by the number of patients – leading to the naïve conclusion that fewer doctors are inherently more efficient and neglecting the probable side effects (reduced recovery rates, life expectancy, general quality of patient care and so on).

Nevertheless, while the precise figures can be challenged or revised, official statistics have made great strides towards accurate qualitative assessment in the public sector – and the overall trend is striking. Of 22 estimates of productivity in the public sector since 2004, 18 show falls in productivity – ranging from a modest 2% yearly increase by one ONS estimate to a remarkable 15-20% decrease in education and NHS productivity between 1997 and 2003.[lxvi] As we have seen, the ONS' most recent estimate in June 2009 – based on General Government Final Consumption Expenditure and even including generous upward revisions for qualitative improvements in health and education – shows a 3.4% fall between 1997 and 2007 or about 0.3% per year. Since private sector productivity improved by 27.9% over the same period, we are left with the remarkable total of a 31.3% gap in productivity relative to the private sector or, in terms of unit labour costs, a rise of 30.5% relative to the private sector – even this, we should recall, starting from much lower levels of productivity and unit labour cost efficiency.[lxvii] This leaves a £58.4 billion shortfall from what an equivalent level of public service would have cost had productivity gains matched that of the private sector.[lxviii] As the CBI's Director General has put it 'If the public sector had matched the private sector's produc-

tivity performance over that period, then we could now have 11% more public services for the same money.'[lxix]

A further recent trend has clearly been a strong correlation between large spending increases in the public sector and productivity falls – reflected in the large spending increases from 2000 onwards. A 2003 ONS survey, publicly acknowledged as a first attempt to quantify whole public sector efficiency, showed a 2% increase in productivity between 1995 and 1998 – at the same time, total managed public expenditure fell in real terms by 2.2%. However, between 1998 and 2001, the same survey shows a 5% fall in productivity as spending rose by a total of 11.4% in real terms.[lxx]

The survey also showed a 5% fall in NHS productivity and 13% in education between 1995 and 2001.[lxxi] At the same time, health and education spending rose in real terms by 25.8% and 20.7% respectively.[lxxii] Interestingly, a confidential assessment prepared by the Treasury and the Prime Minister's Strategy Unit, leaked to the Sunday Times in 2004 gave an even more pessimistic outlook – a 10% decrease in overall productivity from 1997 to 2004. This prompted urgent calls from a cabinet committee for the ONS to change the way it presented productivity figures.[lxxiii]

A 2008 ONS survey of NHS productivity showed a 2.5% fall per annum between 2001 and 2005, or 2% p.a. including quality adjustments (short-term survival, health gains following hospital treatment etc.), but a less than 1% decline p.a. between 1995 and 2000. This implies a causal relationship between the big spending rises from 2000 and a sharp fall in productivity. The June 2009 ONS survey showed the largest annual falls were in 2002 (1.3%) and 2003 (1.5%), also the years of the highest input growth, indicative of diminishing returns in output terms of additional expenditure.[lxxiv]

Trade Unions in the public sector

Trade union membership has fallen significantly over the last thirty years – from a peak of almost 12.2 million members of TUC affiliated unions in 1980 to just 6.5 million today. However, this disguises a dramatic change within the trade union movement. The public sector has essentially replaced the traditional industrial base as the vanguard of trade union activism – last seen in the large-scale industrial actions over public sector pay restraint in 2008. Despite being just over a fifth of the total UK workforce, the public sector now makes up a remarkable 49% of trade union members (3.6 million of a total of 7.4 million).

"The public sector has essentially replaced the traditional industrial base as the vanguard of trade union activism – last seen in the large-scale industrial actions over public sector pay restraint in 2008"

In a fully efficient labour market, wages should be equal for the same occupations and types of labour. In practice, however, a series of factors intervene – not least that of national pay bargaining and social-political factors such as 'public sector clientalism' and sentiment. This can lead to arbitrary differentials. For example, a cleaner in the NHS has a basic salary of £13,758, but this is only £12,145 in local government.[lxxv] The inclusion of trade union influence is crucial to rationalise the observed existence of a wage

premium. A recent European Commission report found that, between 1999 and 2007, the highest annual growth gap between public and private compensation was in those countries with 'strong representation… in collective bargaining.'[lxxvi]

To some degree, trade union power in the public sector is augmented by its lack of competition. A private company is necessarily limited in what staff it can hire and the remuneration it can offer simply because of its financial health – if it continually loses money because wages are too high it will eventually go bankrupt, normally causing all its employees to lose their jobs. It is thus generally in the best interests of trade unions in the private sector to make reasonable remuneration demands (indeed, Britain is atypical by the standards of continental Europe in having no form of social contract involving trade unions in management and pay decisions – an idea essentially abandoned after the failure of the 1969 White Paper, *In Place of Strife*).

Government, however, is seemingly unconstrained by such pressures. Staffing, wages, pensions and benefits can be raised without the necessity to make a profit or improve efficiencies – the sole constraint is the government's willingness to tax and borrow – and, in consequence, the very high propensity of the bond market to absorb government debts due to the negligible risk of sovereign default. In effect, trade unions in the public sector can always pressure government to increase the public paybill – save the (extremely unlikely) prospect of sovereign bankruptcy – because their workers can never face the adverse consequences of a private sector bankruptcy.

There is considerable overlap of large trade unions involved in different areas of the public sector.

Table 3.1: Largest Public Sector Trade Unions in the UK

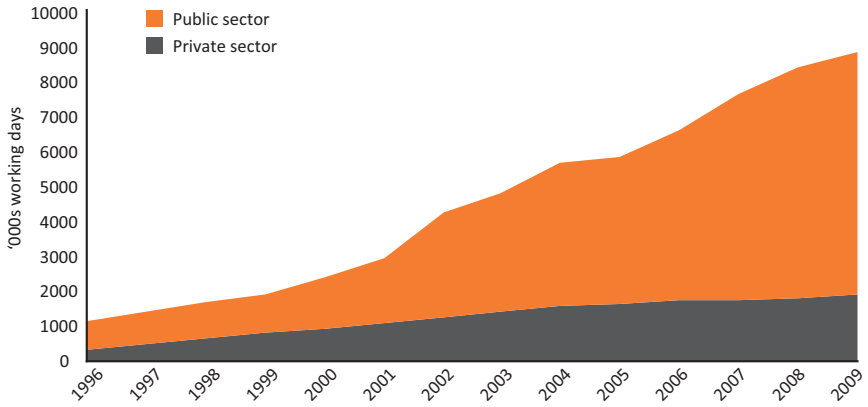
Name	Main areas	Membership (to nearest '000)
Unite (formerly Amicus and TGWU)	All public and private sector	1,977,000
Unison	Public sector	1,317,000
GMB	All public and private sector	575,000
Public and Commercial Services Union	Civil service and government agencies	313,000
National Union of Teachers	Education	255,000
NASUWT	Education	249,000

The above six unions, with a combined membership of 4.69 million, make up almost 16% of the total UK working population – the majority of the 28% of the workforce that is in a trade union. The principal exclusively public sector union, Unison, has a membership of almost 22% of the public sector workforce alone. Trade union membership is more than triple as likely in the public sector (59% as opposed to 16.1%), than the private sector.[lxxvii]

By 2008, collective bargaining coverage had fallen to 20% for the private sector, but was still 72% in the public sector.[lxxviii] Public sector unions often compound their influence further by making joint demands. This influence is reinforced by a markedly greater propensity to trade union militancy:

Figure 3.10: Days lost to strikes (per 1000 workers per year), 1996-2009

Figure 3.11: Cumulative days lost to strikes, 1996-2009



Source: ONS, Labour Disputes Public and Private Breakdown.

Cumulatively, almost 7 million working days have been lost since 1996 in public sector strikes. The disparity in strikes with the private sector means a disproportionate impact on the provision of services – on average, since 1996 a public worker has been on strike twenty two times more than a private worker has. The tendency of strikes to occur across entire sections of public services or not at all creates hugely unpredictable outcomes each year – from a low of 172% of the private sector level in 1999 to a remarkable 10,438% in 2007 – a 104-fold difference. This significantly restricts the power of government to make plans mitigating the effects of strike action on the public.

Trade union influence also extends to direct employment within central government. The Civil Service spends about £22 million a year on full-time, paid union representation, for example. There are an estimated 750 full-time equivalent trade union posts paid for by the taxpayer.[lxxix]

As already noted, strike action is banned in some parts of the public sector – for example the armed forces and police. But in similarly vital areas such as the prison and fire services, it is allowed. Since public sector workers are employed by the state rather than individual organisations, trade unions are able to 'get around' bans on secondary picketing as applied to the private sector. A particular union can effectively call their entire public sector membership out on strike by national ballot, leading to disruptions across whole swathes of public services. A 48-hour strike by Unison and Unite in July 2008, led to the closure of services as diverse as Leicester's central library to severe disruptions of Southampton's rubbish collections, for example.[lxxx] More recently, a strike by the PCS union in March 2010 saw court hearings postponed, driving tests cancelled, job centres on minimum service and even included emergency services such as 999 operators and coastguards.[lxxxi] In effect, this gives public sector unions the power to cripple public services nationwide. This necessarily gives them immense leverage in negotiations with government – particularly since it extends to life-saving personnel.

Case study: the fire-fighter dispute of 2002/3

The most egregious example of lifesaving services going on strike in recent years is perhaps the Fire Brigades Union strike of 2002/3. Despite having around 40 applicants for every vacancy, the union demanded a 40% pay award. When this was rejected, a nationwide ballot was held and firefighters across the country went on strike. The Armed Forces were forced to take their place. Unable to cross the picket lines to gain access to modern fire engines and equipment, the army had to use its own stock of archaic 'Green Goddesses', the last of which was produced in 1956 and which have lower speed, shorter ladders, less water and lower pressure.[lxxxii] Though the Armed Forces were widely praised for their performance during the strike (and firefighters sometimes crossed the picket lines to help) this posed an obvious risk to life. The same contingency plans are still in place.

At present the situation is made worse by the "Code of Practice on workforce matters in public sector service contracts".[lxxxiii] The Code, introduced in March 2005, requires that where a private service provider recruits new staff to work on a public sector contract alongside staff transferred from a public authority, the service provider will offer employment on fair and reasonable terms and conditions which are, overall, no different to those of transferred employees. This is essentially a form of protectionism aimed at preventing 'unfair' competition from the private sector for the provision of public services by banning them offering less generous terms for the same work. This is an attempt to export the rules which tie down the public sector to the private sector, thus buttressing the power monopoly of the public sector unions.

Examples of strike action in the UK during periods of wage restraint

Seamen Strike, 1966	The National Union of Seamen struck in May 1966 to demand higher wages above that of the governments' incomes policy limit of 3.5%, and to reduce their working week from 56 to 40 hours. This caused widespread disruption to shipping, especially in London, Southampton and Liverpool, leading to a balance of payments crisis and run on sterling. Harold Wilson's government declared a state of emergency, taking sweeping powers to cap food prices and even have the Royal Navy clear ports for use, though these were not used. The strike did not come to an end until July.
Railway 'Go Slow', 1968	The National Union of Railwaymen began a work to rule and ban on overtime in June 1968, later joined by the Associated Society of Locomotive Engineers and Firemen, paralysing the rail network. Emergency measures had to be implemented to maintain essential supplies and services; temporary car parks were opened across the country. The NUR settled for a 3% rise (as opposed to the 9% they had demanded) after 12 days.
TUC national strike, 1973	As part of its ongoing dispute with the Heath Government over pay restraint, the TUC staged a one-day protest on May Day 1973, calling out some 1.6 million workers, crippling industry. Labour unrest would continue for the rest of the decade.
'Winter of Discontent', 1979	In protest at the government's 5% wage ceiling, public sector unions called out their 1.6 million members on strike in January and February 1979, the largest mass stoppage since 1926. Thousands of school caretakers, grave diggers, hospital workers, cleaners and even ambulance staff (necessitating army ambulance cover in some areas) complied, causing whole sections of public services to shut down. This would later be looked at as the beginning of the 'Winter of Discontent'.
National Health Service Strikes, 1982	A series of stoppages by nurses and healthcare workers in the NHS occurred throughout 1982. The Government offered a 7.5% rise which was ultimately accepted in June by the Royal College of Nursing after a national ballot; other health workers were offered a 6% rise. TUC-affiliated health service unions, however, refused to negotiate and demanded a 12% across-the-board rise for all health workers. Strikes continued into August and September, including complete withdrawal of even emergency care in some regions, with management and volunteers stepping into the breach.

There is obvious potential for similar disruptions across whole sections of the UK's public services and infrastructure during the coming period of fiscal consolidation. This has already been evident in those countries where public sector cuts have already been significant.

International Lessons

Reactions to the recession

Many countries have reacted to major fiscal deficits by seeking to cut their public sector wage bill, often through straight wage cuts or redundancies – Greece, Ireland, Spain and Portugal perhaps being the most conspicuous. The approach taken in the different countries has been remarkably similar, typically involving:

- Pay freezes and pay cuts (often focused on high earners);
- Recruitment freezes, or rules specifying a number of people who must leave for every new recruit;
- Paybill freezes or cuts;
- Pension cuts and cuts in other allowances.

Interestingly, relatively limited use has been made of compulsory redundancies, suggesting that governments either prefer not to use this tool, or find it difficult to implement.

All these have been carried through (or shelved and then returned to) in the face of strong trade union opposition. It is notable that two of the countries perhaps most affected by the current recession, Ireland and Spain, have been the first to implement significant public pay reform. In May 2009, Ireland cut public sector pay by around 10 percent through a combination of a pension levy and an overt cut in pay. In Spain the government has opted for a paybill freeze – i.e. devolving the decision about the headcount cuts /pay cuts trade off to a lower level.

Several countries which have taken less dramatic action have looked upon the financial crisis as an opportunity to significantly restructure their public sector: a 2008 public sector employment reform programme in Italy, for example, recommended a system based on productivity rather than the previous seniority-based system; lately a four year pay freeze for all public workers has been proposed.

Ireland

Ireland's economy has been one of the most conspicuous victims of the financial crisis, with GDP contracting 3% in 2008 and 7.5% in 2009. Recession and a severe property crash have led to collapsing tax revenues and a government deficit exceeding 12% of GDP.[lxxxiv] Its government has predicted a further contraction of 1.5% in 2010 and a deficit of 14% of GDP unless corrective action was taken. In February 2009 the government announced an emergency budget, effecting a 7.5% cut in take-home pay through a pension levy and suspending a previously agreed 2.5% increase in pay. This has meant an effective real terms cut in pay for all public sector workers of between 5 and 15%, including civil servants, the police, teachers, the armed forces and nurses. Specifically, a 5% cut is to be implemented for the first €30,000 of salaries, 7.5% for the next €40,000 and a 10% cut in the next €55,000.

The path by which this was arrived at is itself instructive, as an example of a government trying, but failing, to achieve cuts by consensus. In his December 2009 Budget, soaring borrowing costs led the Finance Minister, Brian Lenihan, to seek cuts of a further

€4 billion from public spending. Of this, the government sought to cut the public sector paybill by 6.85%, or €1.3 billion. Reductions were to take place for senior civil servants and government ministers, compressing wage differentials by targeting the highest earners. This included a 12% cut in salaries up to €200,000, 15% for salaries of more than €200,000 and several 20% voluntary cuts at the senior level (including the Prime Minister).

The Irish Public Service Benchmarking Body recommended in 2008 that public sector salaries should reflect private sector pay practices 'at a time when the economy is facing more uncertainty and employment growth is slowing'.

Union leaders were told these reductions could come about through pay cuts or alternative measures, such as scaling back on numbers employed, curbing allowances, overtime rates or pension payments. Organisations affiliated to the Irish Congress of Trade Unions opted for a united front, opposing any cuts in pay, pensions or jobs, however. Further alliances were formed between unions whose members had special allowances and premium payments.

The largest public sector union, Impact, voted overwhelmingly to strike. In concert with other Irish Congress of Trade Union (ICTU) affiliated organisations such as the Teachers Union of Ireland, this has resulted in the largest strikes seen in Ireland for thirty years. A 24-hour shut-down on 24th November 2009, for example, included the closure of schools, hospitals and fire stations. To save €1 billion, the ICTU's Public Services Committee proposed 12 unpaid leave days across the public sector for 2010 (though these could be taken over a number of years), certain reductions in overtime and pay cuts for politicians and senior civil servants – it also committed to achieving further savings through efficiency reforms – though these were not spelled out. The government did not accept that this could provide an alternative to pay cuts, however, and talks collapsed in December 2009, effectively ending Ireland's system of social partnership. Further strikes have been proposed and some unions have refused to participate in any discussions involving pay cuts and even advocated non-cooperation with any future reforms.

Before talks collapsed in 2009, a number of interesting proposals were hammered out between the government and trade unions. These included:

- Redeployment of public sector workers across organisations to prioritise key delivery objectives as budgets and staff are cut;
- Reforming work rosters to increase flexibility and reduce overtime payments;
- Extending opening hours in key services;
- Improve efficiency by sharing HR, payroll and procurement services across organisations;
- Promoting competitive and merit-based promotions across the public sector; and
- Standardising and reducing annual and sick leave arrangements.

However, in the end it was not possible to make the scale of reductions required consensually, and the Irish system of social partnership has effectively been ended by the spending control programme.

Stylized public sector reactions to the economic crisis

Country and main points	Summary
France *"Not replacing half of retirees"*	• Major reforms of the civil service were carried out in 2009. A new law promotes occupational mobility, increasing possibilities of secondment and outplacing. • It also increases the possibility of using temporary agency staff and recruiting under private law contracts. • In additional to the reorganisation of its ministries, the government has adopted a rule of not replacing half of all civil servants who retire by 2013. • A new system of occupational assessment has been introduced. In place of the old rating system, annual interviews are to be used in which line managers assess employees' skills, value and prospects.
Netherlands *"wage freeze"*	• A social agreement programme was agreed in April 2009 which pledged wage moderation in exchange for job security in the public sector. • This has been supplemented by public sector employers at both the municipal and provincial level proposing a wage freeze for 2010.
Spain *"Paybill cut of 4%"* *"Limits on promotions"* *"Ten out, one in"*	• As part of its planned fiscal adjustment of 5.7% of GDP by 2013, the government has agreed to reduce expenditure on public administration staff by 4% and limiting the replacement rate (i.e. the jobs refilled after a public worker leaves) to 10%. • Job offers in the public sector are 87% lower than in 2009; recruitment of temporary workers has been similarly reduced. • Limits have also been set on internal promotion, with only 660 to be offered against almost 2,000 in 2009. • Public sector wages are to be cut by an average of 5% in 2010 and frozen in 2011. The Spanish Cabinet's salaries are to be cut by 15%.
Portugal *"5% pay cut"* *"pensions cuts"*	• The government initially proposed a real-terms public sector wage freeze this year (which may be extended to 2013), now extended to a 5% pay cut. • Partial freezes and cuts have been imposed for public sector pensions, including greater penalties for earlier retirement – a 6% per year reduction rather than the current 4.5% – from 2015.

Country and main points	Summary
United States *"unpaid leave"* *"towns go bankrupt to shed pension liabilities"*	• Plunging revenues have forced state governments to reduce public sector wage bills. • Though some layoffs have occurred, the main mechanism has been unpaid leave. States such as California, Maine, Georgia, Wisconsin, Colorado, Maryland and Michigan have been doing this on a rolling basis since 2009. • Other states, such as Arizona and Michigan have put some staff on long term unpaid leave. Some states have cut pay (by 4% for teachers and higher education employees in Nevada, for example) though this is rarer. • Unpaid leave orders have led to legal challenges in some states, such as in New York, though many unions have accepted them as preferable to layoffs. • Some municipalities have declared bankruptcy to get out of onerous payroll and pension costs.
Romania *"Across the board pension and salary cuts"*	• Romania's budget deficit reached 7.2% of GDP in 2009. Some of this was attributed to ballooning public sector staff costs, more than doubling between 2005 and 2008, with an additional 79% spent on base salaries, 136% on fringe benefits and 270% on bonuses and overtime. The net average salary in public administration reached 47% more than the national level. • A new public wage law was approved in November 2009 to address this: • Public sector salaries in Romania are calculated as a coefficient of the minimum wage. The ratio for the national minimum wage and the maximum salary is to be reduced from 1:29 to 1:15. This would have meant the cuts would bite more at the top end. • Savings were initially to be achieved by cutting jobs, hiring freezes, freezing high salaries and accelerating pay increases for low paid workers rather than reductions in gross salary. Auxiliary benefits (such as meal, holiday and gift tickets) are to be cut back. • However, to comply with an IMF rescue deal, the government has now announced a 25% cut in all public sector wages, including the lowest paid and a 15% cut in pensions.
Lithuania *"Cuts focused on the higher paid"*	• The government attempted to cut the basic salary (which serves as a reference point for different grades of public worker) across the public sector in June 2009 from LTL 128 to LTL 115 per week, or about 10%.

Country and main points	Summary
	• This initial attempt was shelved after protests; however, the government has since gained agreement with trade unions for pay cuts, but with most of the burden taken by the highest grades. • Pay for civil servants grades are being cut from 10-15% for the lowest to 30-50% for the highest qualification grades. • Public sector wages are expected to fall between 20% and 30% on average and pension entitlements by 11%.
Greece *"four year pay freeze"* *"five out, one in"* *"allowances stopped"*	• The Greek government announced a pay freeze until 2014 for all public sector workers whose earning gross pay over €1,700 a month and pensioners whose income is over €1,100 a month. • Those earning gross monthly pay ranging from €1,501 to €1,700 will receive an allowance of €300. • A ban has been imposed on the stipulation of automatic salary increases in collective agreements and individual contracts. • Apart from in education, health and safety, the creation of new jobs and appointments has been suspended throughout the public sector. • A ratio of one hire to five departures for permanent employees and for those with indefinite-term private law employment contracts is to be introduced – although a ratio of one hire to one departure is to be established for the health, safety and education sectors. • The Government has also announced a 30% cut in civil servants' bonuses for Christmas, Easter and summer – an equivalent cut of one month's pay on average. Overtime afternoon payments limits have also been reduced by 30%. • Including a 12% cut in all allowances and expenses and 7% in ordinary earnings and compensation, this equates to a 16% cut in public sector wages.

Source: Eurofound, International Labour Organisation.

Clearly, the scale of cuts to the public sector workforce being implemented internationally is unprecedented in the modern era, as has been the scale of trade union opposition. Whether through redundancies, increased employee pension contributions or direct wage cuts, governments of all political stripes have concluded that cuts are necessary – even at the expense of dramatically increased social unrest. The severe unrest experienced in many countries may be repeated in Britain unless an explicit link is made between avoiding redundancies and cutting remuneration.

Examples of international trade union reaction

Romania	Trade unions have reacted by uniting in their demands and opposing all consolidation measures. A general strike has been proposed, with the police union even threatening to overthrow the government.
Greece	Mass demonstrations, protests and national strikes have occurred since 2009, including three general strikes in the three months up to May 2010 alone, shutting down many public services. This has included violence against the police, petrol bombs and arson attacks on businesses. This lead to the death of three workers in an Athens bank in May. Protesters have tried to storm Parliament and even set alight a department of the Finance Ministry.
Netherlands	Opposing the government's pay freeze, the major trade unions, FNV and CNV, have demanded a 1% pay rise. Rotating strikes have taken place across the country.
Portugal	Public sector unions, led by the FC coalition have united to stage major demonstrations and strikes against Government measures across the public sector. The Communist leader Jerónimo Carvalho de Sousa, invoking the civil war of 1383, urged people to oppose the 'protectorate of Brussels'.
Lithuania	Lithuanian public trade unions have refused to countenance wage or job cuts, with strenuous protests since last year, including a hunger strike by the Lithuanian TUC.

4
Summary of Findings from our Analysis

Pay

- On any measure, public sector workers are now, on average, better paid than private sector workers. The median salary in the public sector is 12% higher, or 30% higher on an hourly basis.
- This pay advantage is not evenly distributed. It is higher in lower grades, with the bottom 10% of public sector workers now 25% better paid than their private sector equivalents. This is a post 1997 phenomenon – they were 4% less well paid in 1997.
- We do not believe that the public sector premium can be explained away by differing qualifications or age (although no-one has suggested it can be fully explained away). Paper qualifications are used in the public sector where informal CV experience tends to be used in the private sector. Using previously unpublished ONS data, we find that in two thirds of cases where people are doing the same job in both sectors, public sector workers are substantially better paid. This might be thought surprising in the case of private nurses or teachers, given the high cost of private healthcare or education.
- National pay setting means the same wage everywhere in the country, despite huge differences in costs in different areas. "London weighting" and other fixes are not enough to offset this, so the public sector wage premium is small in the South East and London. It is higher in Scotland, Wales, the North East and North West, where public sector workers enjoy a 17-20% premium.
- National pay setting results in wasteful overpayment in some areas, and under-payment and staff shortages in others.
- Public sector wage growth has been higher than private sector across the overwhelming majority of occupations. In three quarters of categories where there are equivalents, public sector wages have grown faster. However, wage growth has been particularly high in some sectors, such as health.
- These factors all combine. A low paid worker in a lower income region, in a sector where the pay premium is higher will enjoy a huge premium over his or her peers in the private sector.
- Wage drift is an important part of public sector pay growth, adding 30-40% to the "headline" increase in a normal year. We should expect that wage drift would accelerate if a freeze in the headline rate is announced, and some other countries have announced promotion freezes to counteract this.

- The Labour government set in train a real terms cut in public sector wages by capping nominal increases at 1%. This would lead to a 4% real terms cut in the absence of wage drift. Any political argument is not, therefore, about the principle of whether there should be real pay cuts in the public sector, but about the magnitude of such reductions.

Headcount

- Outsourcing and the Private Finance Initiative have further blurred the already unclear boundary between the public and private sector and may have masked the rising numbers of people working for the government to some extent. On the narrow ONS definition, the number of people working in the public sector has increased by 692,000 (or 13%) since 1997, bringing the total to 5.9 million. But on the ONS Labour Force Survey definition, based on people's own reports, the total number of people working for the public sector has increased by 1,258,000, or 21%, bringing the total to 7.3 million. Over the period 2002-2009 the number of people working in the public sector increased nearly five times more quickly than numbers in the private sector.
- The number of management positions has increased particularly rapidly in recent years, increasing by over 80% between 2002 and 2009. However, the proportion of people in management in the public sector is still lower than in the private sector.
- The increases in headcount are highly concentrated in certain sectors. A remarkable net 97.7% of the increase in numbers has been in education and the NHS.

The payroll bill

- Because both headcount and pay have grown faster than in the private sector, the paybill has increased very rapidly. Public sector pay costs increased 33.2% in real terms between 2002 and 2009 alone, nearly three times faster than in the private sector.
- Some categories of public sector workers have seen large increases in their numbers, but relatively normal (for the public sector) increases in their pay. The most important example of this is the growth of management roles in the public sector. Social and youth workers are another example of this. Some groups have seen substantial increases in pay, while their numbers remained relatively constant, or even declined. Firefighters and manual roles are examples of this. In a number of categories both numbers and pay have increased sharply. This is particularly true of higher paid roles in health.
- It is important to understand the relative significance of different groups. While there is certainly evidence of an increase in the number of non-core jobs (like marketing, PR, customer service and office managers), these groups are small as a share of the total. Nonetheless, the total spend on these roles has increased by £4 billion as the result of both rapid growth in numbers and rapid pay increases. Those who think these roles unnecessary will see this as a good place to start reducing spending.

- The growth of management is a more serious issue, and accounts for £14 billion of the £67 billion increase in the payroll bill between 2002 and 2009.
- However, the growth of the paybill is, nonetheless, dominated by the growth in the pay and numbers of frontline workers in health and education.
- The most recent attempt to freeze the payroll bill in the UK, back in 1993, led to the majority of the cuts falling on headcount, rather than pay.

Beyond the paybill

- There are several aspects of public sector remuneration (and costs) which are not fully captured in the payroll bill. These include job security, pensions, and time worked. The old idea that public sector workers have "lower salaries but job security and gold-plated pensions" is out of date. Workers in the public sector now enjoy both higher salaries *and* better conditions.

Job security

- Data on job security is limited. Over the last decade the redundancy rate in manufacturing or construction has been seven times higher than in the public sector, roughly defined. During the recession these multiples increased to 16 and 10 times respectively. In a large survey of 60 different public sector organizations coordinated by the Cabinet Office, just 13% of employees disagreed with the statement that their organisation "is too lenient with people who perform poorly here." The Civil Service is the most extreme example of this. Less than 1% of civil servants take voluntary redundancy each year, and compulsory redundancies are even rarer, affecting less than 0.005% of the workforce a year. Job security can be seen as a benefit for the individual worker, which might be worth a certain amount of salary.

Pensions

- Between 1997 and 2008 the proportion of public sector workers without pension provision from their employer fell from 21% to 16%. However, in the private sector the same figure rose from 54% to 63%. While the proportion of public sector workers in more generous defined-benefit schemes largely rose until 2006, the number in the private sector has progressively declined – to just 8% of its workforce compared to 80% in the public sector by 2007. There are various estimates of the value of these more generous pensions, putting the value at between an extra 12% and 15.6% of total salary.
- In the 2009 Pre-Budget Report the government moved to cap its contributions to pensions, saving £1 billion. If we were to go further we could try to close some of the 15% of salary gap which is currently "met" through increasing unfunded liabilities. These liabilities are not captured in the pay bill. An Irish style pension levy of 7.5% would close half this gap.

Time worked

- Public sector staff work 23% less hours over their lifetime, thanks to a combination of shorter hours, more time off – and earlier retirement. This is not fully captured in the paybill, and is a benefit to the people who work in the public sector.

International lessons

- Most countries currently undergoing fiscal consolidations are using a mix of wage freezes and cuts (often falling more heavily on the higher paid). Few have explicitly targeted headcount reductions, though many are using partial or total recruitment freezes to drive down headcounts through natural wastage. Ireland is implementing a 10% reduction in pay, three quarters of which takes the form of increased pension contributions. Portugal has also targeted the pension bill, along with a 5% wage cut. In France the public sector is not replacing half of retirees, using natural wastage to drive down headcount. The Netherlands have introduced a one year wage freeze, and Greece has announced a four year wage freeze. The Spanish government is pursuing a 4% cut in the total pay bill. It has also introduced a "ten out, one in" rule: nearly, but not quite, a total recruitment freeze.
- Less developed European countries like Lithuania and Romania are simply cutting wages by around a quarter. In the US the response is most visible at the state level, where there has been extensive use of unpaid leave, and the municipal level, where towns have declared bankruptcy in order to to shed their pay and pensions commitments.

Part Two

Proposals for Reform

Introduction

Before the General Election, the then Prime Minister Gordon Brown spoke of a 'culture of excess' in the public sector which 'can change and must change'. The then Chancellor Alistair Darling signalled pay cuts for some recent public sector posts and a curtailment of bonuses which 'don't pass… the next-door neighbour test. If you can't justify them to your neighbour, you've probably got it wrong'.[lxxxv] As our analysis has shown, it is quite clear that a 12.5% median salary premium, a notional 15.6% premium for pensions[lxxxvi], 12.9% fewer working hours per year due to longer holidays, longer sick leave and strike action, earlier retirement ages, plus the benefits of much higher job security rates totals to a significant compensation package advantage a typical public sector worker enjoys over his or her private sector counterpart.

If public sector workers are to be given the equivalent of private sector remuneration, it follows necessarily that benefits other than pay should be given relevant weight. As we have shown, benchmarking by reference to private sector basic pay does not encompass the entirety of the compensation package. The old idea that public sector workers have 'lower salaries but job security and gold-plated pensions' has long since passed into history. A fair comparison should explicitly quantify the value of job security, pension entitlement, overtime pay, average hours worked, sickness pay and other auxiliary benefits. A guiding principle should be that public workers are not entitled to maintain more generous salaries and benefits than those available in equivalent jobs in the private sector.

It is clear that we need to construct a new framework for the remuneration of public sector workers. It is also very likely public sector compensation will have to bear a significant portion of the cuts taking place during the coming fiscal consolidation – indeed, this was already planned by the former Labour government. There may be some 'low hanging fruit' to achieve this. However, the degree of spending reductions required is likely to require tough policy decisions in a number of areas. We will now consider some of the options.

In the following section we:

- Propose an overall approach to questions of pay;
- Present a specific proposal, and examine what it would mean in practice;
- Propose a number of longer term, structural changes to public sector employment practices.

5
The Overall Approach: Should we Target Pay, Staffing, Pensions – or the Paybill?

Party proposals on pay

The Conservatives and the Labour Party advocated a broadly centralised approach to public sector pay cuts during the 2010 General Election. The former Labour government ordered a 1% cap for pay settlements in 2010, a 1% cap for all workers for two years from 2011 except the Armed Forces and a freeze on the top 40,000 paid positions. The Conservatives pledged to freeze pay across the public sector in 2011 excluding those earning less than £18,000 and said they would set a pay cap of 20 times the lowest salary for every public organisation. The Liberal Democrats proposed setting a £400 pay rise cap for all public sector workers, initially for two years, but senior figures in the party also floated the ideas of a paybill freeze (see below). Since these plans all implied real-terms pay cuts due to inflation, it is clear that the debate shifted from whether to cut public sector pay, to how. Each of these approaches was a variant of cutting public sector wages through the capping or freezing of national salary scales and did not imply significant change in the underlying pay structure.

In office, the Conservative/Liberal Democrat Coalition has only committed itself to 'public sector pay constraint' and a fair pay review, measures to protect those on low incomes and a 20-times multiple pay cap for any public sector organisation. It has also hinted at more radical measures, including reform of the national pay system for teachers, police terms and conditions, pay levels in the Armed Forces and Civil Service remuneration, but has given few details.[lxxxvii]

Should we target pay, or the paybill?

An alternative to centrally targeting all public sector workers' pay, would be to target a certain reduction in the public sector paybill as a whole. This would mean setting a defined limit on the total cost of employing all workers in the public sector, including their pay and other costs such as pension and NIC contributions and enforcing this limitation on all future spending plans. This approach has been advocated by the Chartered Institute of Personnel Development and the CBI, both of whom advocated a paybill freeze.[lxxxviii] The Liberal Democrats have also floated this approach, with their leader Nick Clegg hinting at the idea in a *Guardian* interview

in 2009.[lxxxix] The then Liberal Democrat Treasury spokesman Vince Cable floated the idea of a 25% reduction in the paybill of staff earning over £100,000 in 2009.[xc]

It also fits with a more decentralised approach to pay bargaining. Departments or local units could be given a total amount for pay costs, and negotiate their own trade off between headcount reduction and salary reduction.

There are a number of arguments for trying to control the total paybill, rather than just headline pay:

- Placing restrictions on national pay settlements is likely to be less effective than it appears. As we have seen, a typical public sector worker's pay can continue to rise significantly faster than the basic pay settlement. Wage drift is likely to accelerate during a consolidation as managers attempt to 'get around' pay settlement constraints (by moving staff to a higher grade or artificially increasing bonuses in lieu of a rise, for example), making such an option much less effective at cutting costs than it might at first appear.
- In some areas it might be more efficient to reduce headcount than reduce pay, yet a simple pay freeze might take away this option.
- Targeting the paybill might help to educate the public about the trade offs involved. Presenting departments, workers and the public with the choice between pay restraint and redundancies might help to make the choices facing the country clearer. It might open up greater possibilities for fiscal consolidation and/or salary reductions: indeed, politicians in several countries have tried to make the point that reductions in pay will help to "save jobs."
- Across-the-board salary cuts and freezes will necessarily incur inefficiencies as the more productive workers leave to obtain higher paying jobs in the private sector, leaving the less productive in post. This is a reflection of the basic nature of national pay bargaining.
- A paybill target might give government a more definite figure with which to negotiate and base its fiscal planning, if it worked successfully.
- In the final analysis, capping all public sector employees' pay reaffirms, rather than reforms, the architecture of nationalised pay bargaining. It effectively means denying, from the outset, even outstanding employees a greater basic pay rise than a nationally mandated cap. It also effectively locks in a 1% increase or other across-the-board change to which everyone will feel entitled, including poorly performing employees. As we have seen, this system also severely limits the ability to respond to local labour markets or the regional cost of living. Brendan Barber, the General Secretary of the TUC, has described a centralised pay cap as 'unfair' and 'inefficient'. If he were consistent, he would say the same thing about national pay bargaining.

The main objections to capping the paybill are that:

- Trade union pressure will lead to the whole burden being borne by headcount reductions. As we have seen, this is largely the story of the paybill freeze adopted in Kenneth Clarke's 1993 Budget. If this was the outcome, it might be inefficient, and lead to services suffering. Instinctively we might think that the more that pay reduction could take the burden the better: effectively getting us "the same service for less money". Faster than private sector pay

growth in recent years might make this argument particularly compelling. Obviously, in the longer term reducing salaries might lead to a reduction in the quality of people attracted, or even shortages. But with large pay premiums at present, this seems like a less serious problem.

- If a paybill cap is combined with a decentralised approach, lower level managers, either in departments or local units, might not have the authority or negotiating ability to force through difficult decisions in the face of trade union opposition. The Treasury might be able to play "bad cop" more effectively than local managers. A centrally imposed pay freeze or pay cut might allow the centre to use its elected authority to push through difficult changes.
- A pay freeze or cut might be better in terms of guiding people's expectations, and might be simpler to communicate. A pay freeze or cut might be more popular, if redundancies are unpopular. If unions are heavily biased towards redundancies over pay cuts, then it might make political sense for politicians to start negotiations with them with an offer entirely comprised of pay cuts, and negotiate from there.
- While controlling the paybill deals with wage drift better than a pay cap, controls on the paybill could still be circumvented – particularly through greater outsourcing and private sector involvement – as has happened in previous paybill freezes. One reaction might be to freeze paybill spending as an element of outsourced contracts (where it could be appropriately specified), though this may not always be commercially practical. While this would defeat the objective of cost control in one way, some people might think that increased private sector involvement would reduce costs and increase productivity; the 'straightjacket' could, in fact, increase innovation in the provision of public services. Indeed, this process could potentially be accelerated by abolishing the Code of Practice on workforce matters in public sector service contracts.

A hybrid approach?

There are powerful arguments for and against targeting the paybill rather than pay. Would it be possible to combine these different advantages with some kind of hybrid approach?

While targeting the paybill overall, it might be possible to also set a minimum pay reduction, rather than allowing a completely free trade off. Conversely it would also be possible for policy makers to impose some headcount reductions centrally or locally. Perhaps most attractively, a paybill target could be combined with a centrally imposed levy on pensions, as seen in Ireland. This would mean the total saving needed from pay cuts and staffing reductions would be smaller.

A hybrid approach might compensate for the observed trade union bias against pay reductions, while still having some of the efficiency advantages of a paybill cut, and also its presentational advantages, in terms of clarifying the trade-off between salaries and headcounts.

Introducing a pensions levy to fund part of the government's unfunded liabilities

There is an average gap of 15% of a public sector workers' pay which is unfunded either via employee or employer contributions and is not shown in government paybill figures. To eliminate further accrual of unfunded liabilities for existing em-

ployees would require the additional payment (as well as existing pension contributions) to be used to buy index-linked gilts. Adding this would increase the general government paybill by £19.7 billion in 2010/11.

As a first step, one option might be to limit government's ability to run up unfunded pension liabilities, perhaps by strengthening the powers of the Pensions Regulator to order increased contributions by public sector employers.

As noted above, in February 2009, the Irish government announced that all public sector workers (not retirees) would pay 'pension levy' amounting to some 7.5% of total earnings on average. This is composed of a graduated scale: a 3% levy on the first €15,000 of pay, 6% on the next €5,000 and a 10% levy the remainder.

If we were to follow the lead of Ireland and introduce a pension levy averaging 7.5% of total earnings (on a graduated basis) this would have the neat effect of splitting the real additional cost of funding public sector pensions 50:50 between government and public sector employees (who would pay an additional £9.9 billion in 2010/11).[29]

A further solution might be to set a defined benefit pension cap and make public pension contributions on a defined basis above this level. This would follow the Conservative proposal to freeze any increase in government pensions paying out more than £50,000 a year and capping all future taxpayer-funded pensions at the same level.

A pensions levy was felt to have political advantages in the Republic of Ireland. The Irish Department of Finance said at the time: "The basis for the deduction is that public service pensions are acknowledged to be significantly more favourable than the generality of pensions in the private sector, both in regard to their terms and their overall security, and it is therefore appropriate that a deduction should be made to reflect this reality at a time when savings are needed from the public service paybill."

Mandating some headcount reductions centrally?

Policy makers have announced their intention to reduce headcounts in certain areas. The Conservatives, for example, have followed Labour and proposed to reduce the size of the civil service by a third. Polling evidence suggests that the public are far less sympathetic to civil servants than other categories of public sector worker.

An obvious thought might be to examine where additional staff have been employed over the last few years. Many people's instinct is that the number of managers in public services has grown. As we have noted above, this instinct seems correct. The number of "non-frontline" jobs of the sort christened "non-jobs" by the media does also seem to have increased very rapidly, although we should not delude ourselves that stripping away such roles will make a huge dent in the budget deficit.

The same targeted reductions in headcounts could equally be carried out at a devloved level, either in departments or local units. Nontheless, it is likely that politicians are likely to be seen to squeeze particularly hard on headcount in some areas. There might be some policy rationale for this, in so far as the centre might fear that local managers might be less likely to fire local managers...

29 Excluding public corporations.

Table 5.1: Select managerial and services employees in the public sector, 2002 and 2009

Occupational group	Staffing levels, 2002	Staffing levels, 2009	Increase between 2002 and 2009	Potential saving if headcount increase only reversed
Sales and customer service occupations	17,000	63,000	46,000	£800 million
Senior officials in national government*	5,000	9,000	4,000	£252.6 million
Marketing and sales managers*	11,000	29,000	18,000	£852.0 million
Personnel, training and industrial relations managers*	10,000	23,000	13,000	£554.3 million
Legal Professionals*	13,000	21,000	8,000	£350.2 million
Management consultants, actuaries, economists and statisticians*	5,000	23,000	18,000	£670.0 million
Culture, media and sports occupations	44,000	59,000	15,000	£385.9 million
Public relations officers*	5,000	10,000	5,000	£126.0 million
Personnel and industrial relations officers*	11,000	34,000	23,000	£559.3 million
Occupational hygienists and safety officers (health and safety)*	7,000	9,000	2,000	£61.0 million
Accounts and wages clerks, book-keepers, other financial clerks	37,000	57,000	20,000	£431.6 million
Personal assistants and other secretaries	39,000	42,000	3,000	£61.7 million
Receptionists	18,000	30,000	12,000	£160.0 million
Leisure And Travel Service Occupations	48,000	52,000	4,000	£43.8 million
Housekeeping Occupations	50,000	56,000	6,000	£90.7 million
Total	**320,000**	**517,000**	**197,000**	**£5.4 billion**

Source: Calculations from Annual Survey of Hours and Earnings, Office for National Statistics. Series labelled with an asterisk have one or more cells with coefficient of variation > 10% and <= 20% in ONS data and are indicative only.

It is not the case that all non-frontline roles created since 2002 should necessarily be got rid of – or that all of the roles created in the examples above are really unproductive "non-jobs". One should be cautious about drawing broad conclusions from statistical categorisations, particularly in an area as complex as the labour market. It is also true that the public sector could not function without a great number of 'back office' and managerial roles and that 'frontline worker' is a very subjective term. As in the case of centralised, across-the-board pay cuts, centralised, across-the-board staff cuts are, by definition, arbitrary and likely to be inefficient.

Rather, we see this as a useful thought exercise to illustrate where potential cuts might be made in different areas of the public sector. It is not readily apparent, for example, why the public sector needs double the number of public relations officers in 2009 it had in 2002 or triple the number of personnel and industrial relations officers. Such an analysis allows organisations to ask of themselves – preferably at the lowest possible level – 'We provided this public service without

these additional workers in 2002. Are they really necessary?' The response to this question will obviously vary from job to job – some institutions might find they need to keep all the staff they have taken on; conversely, others might find cuts that can reduce staff levels below that of 2002. The key point is: it only seems prudent to look first at where non-'frontline' staff have grown disproportionately as the 'starting point' for headcount reductions.

Summary of conclusions

- We should adopt a hybrid approach. Overall we should set a target to reduce the paybill, rather than introduce a single across the board wage freeze. This allows different trade offs to be made between headcount reductions and pay reductions in different areas.
- However, we should also introduce an Irish style levy on public sector pensions. If this can be successfully implemented, the total amount that will need to be found from pay cuts and headcount reductions can be smaller.

6
A Public Sector Paybill Cash Freeze

The numbers in practice

One option for an overall pay policy would be to implement a public sector paybill cash freeze until 2014/15. Although this might sound tough, this could prove a very generous settlement relative to the squeeze required in overall public spending, which even on the previous Labour government's deficit reduction plans (which are likely to be increased), implied 25% real-terms cuts in non-ringfenced departments.

The idea of cutting the paybill directly is essentially an extension of current policy, which, as we have seen, already projects real-terms cuts in public sector pay because of the effects of inflation and has begun shifting the burden of the increased cost of public sector pensions onto current employee contributions.

Practically, a cash freeze would involve a nominal freeze in the central government's contribution to public sector pay and social contribution costs. Local government and other public organisations could follow the same path with or without an explicit mandate. Again following the rule established in Clarke's 1993 Budget, exceptions from the nominal paybill limit could be made if efficiency savings were found (though the scope of these beyond those earmarked by the Coalition for deficit reduction might be very limited or non-existent). Given the scale of the fiscal consolidation necessary, this could involve a ratio of paybill increase to savings implemented – a £1 paybill increase for £2 of savings, for example. There might also be exemptions for those elements of the public sector whose pay is not determined centrally, such as academy schools.

> "A cash freeze would involve a nominal freeze in the central government's contribution to public sector pay and social contribution costs"

Option 1) A cash freeze across the whole public sector

Were this principle extended across local, central government and public corporations to 2014/15, this would save £78.6 billion over a real-terms freeze, reaching a total reduction of £26 billion p.a. in its final year, or a real terms cut of 14.6%.[30]

With Departmental Expenditure limits set to be cut by 11% on average (or 25% if some departments are ringfenced) this feels like the right order of magnitude, although it is worth noting that our structural deficit is around £120 billion.

30 RPI projections based on assumptions in 2010 Budget, 2008/9 prices. 2009/10 projected from average growth, 1998 and 2009. The actual bill would be higher due to the reclassification of the nationalised banks; since this effect is temporary it is not included.

Figure 6.1: Future public sector staffing costs: trends

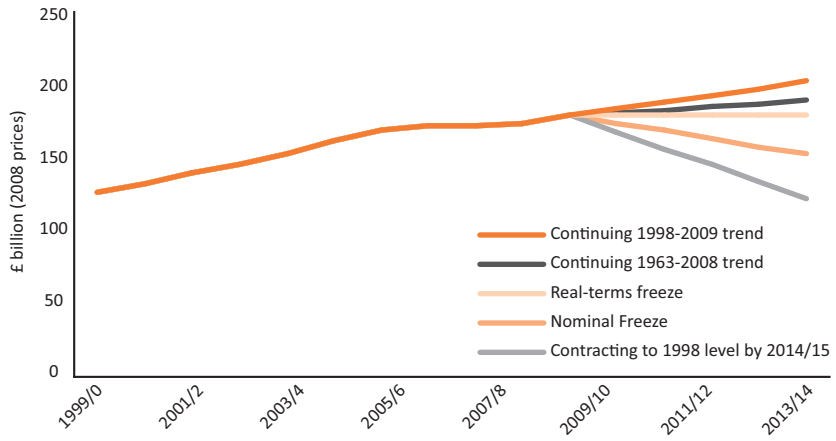


Table 6.1: Public sector paybill projections (£ million, 2008 prices)

	Continuing 1998-2009 trend	Continuing 1963-2008 trend	Nominal Freeze	Contracting to 1998 levels by 2014/15	Real-terms freeze
2009/10	£178,875	£178,875	£178,875	£178,875	£178,875
2010/11	£183,581	£180,964	£173,061	£167,579	£178,875
2011/12	£188,288	£183,053	£168,735	£156,283	£178,875
2012/13	£192,994	£185,142	£163,251	£144,987	£178,875
2013/14	£197,701	£187,231	£157,945	£133,692	£178,875
2014/15	£202,407	£189,320	£152,812	£122,396	£178,875

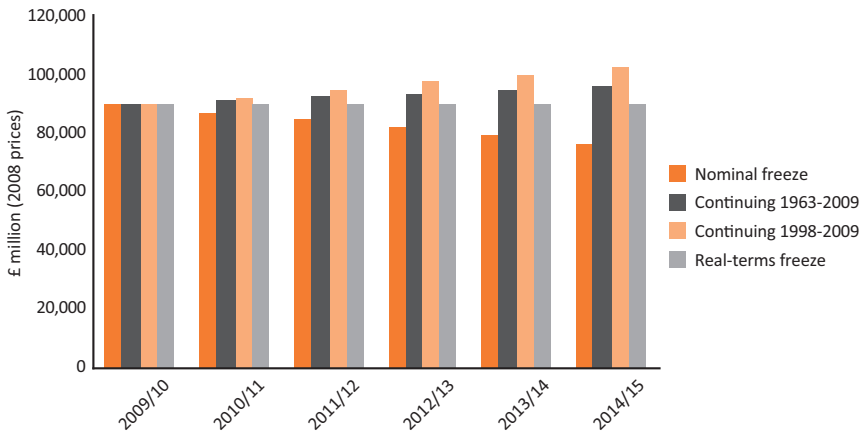
Option 2) Cash freeze across central government only

Alternatively, central government could freeze the paybill in cash terms across central government only. It could leave local government to tackle its problems in its own way. A central government only freeze would, of course, reduce spending by less.

Table 6.2: Central government paybill projections (£ million, 2008 prices)

	Nominal Freeze	Continuing 1963-2008 trend	Continuing 1998-2009 trend	Real-terms freeze
2009/10	£ 89,547	£ 89,547	£ 89,547	£ 89,547
2010/11	£ 86,637	£ 90,840	£ 92,078	£ 89,547
2011/12	£ 84,471	£ 92,133	£ 94,609	£ 89,547
2012/13	£ 81,726	£ 93,426	£ 97,140	£ 89,547
2013/14	£ 79,070	£ 94,719	£ 99,672	£ 89,547
2014/15	£ 76,500	£ 96,012	£102,203	£ 89,547

Figure 6.2: Central government pay and social costs projections



The staffing/pay level trade-off

Any paybill reduction involves a clear trade-off between staffing levels and remuneration – indeed, publicly setting a paybill target makes this link explicit. While Shadow Chancellor, George Osborne made this case, saying of the Conservatives' proposed pay freeze in 2011 that it would 'protect' 100,000 jobs, for example.[xci] If we wish to cut the paybill by, say, 10%, this can be done by cutting the cost per worker by 10% (while leaving workforce levels the same), or cutting the number of jobs by 10% (while leaving cost per worker the same), or a combination of the two. If, as in the 1993-9 example, pay continues to rise, then staffing levels must fall proportionately even more than the paybill.

Below we see the sort of trade-off that would be involved in freezing the paybill to 2014/15. The lower line shows the various combinations of pay and headcount reductions which would be needed to implement a nominal paybill freeze to 2014/15.

Figure 6.3: Tradeoff in public sector employment totals, average salaries for nominal paybill freeze to 2014/15

* Including pay, pensions, employer taxes etc.

Simply to restore the public sector wage bill to (just above) 2003 levels requires tough choices. If one wished to avoid redundancies, this could be achieved by cutting the average level of remuneration by around 15%. Alternatively, if one wished to avoid remuneration cuts, this could also be achieved by laying off around 850,000 workers. Between these, there is the option of both remuneration and job cuts.

Obviously, if greater savings are found above those already identified in existing spending plans, this proposal would allow the trade-off line to shift up and to the right – i.e. allowing low levels of either job cuts, wage cuts or a mixture of the two. This would be the consequence of using the proceeds of an 'Irish style' pension levy to mitigate the effects of a cash freeze – allowing 322,000 fewer layoffs if the consolidation was conducted without pay cuts, or only 9% pay cuts were the consolidation done without layoffs. In either case, if those workers being laid off were on higher than average wages (rather than the average shown above), then the total headcount reduction would be smaller, shifting the curve to the right.

This trade off looks rather stark. But to put these numbers into some context around 400,000 people per year leave the public sector. David Cameron has said that the focus of headcount cuts should be on not replacing staff leaving the public sector. Not replacing half of staff who leave for three years would reduce headcount by around 600,000. This is why recruitment freezes have already been implemented in several countries – notably a blanket ban in Ireland, and the "ten out, one in" rule implemented in Spain.[xcii]

Ringfencing health?

The Coalition has pledged that NHS spending will increase 'in real terms in each year of the Parliament.'[xciii] Given the scale of consolidation required, this policy has serious consequences for any attempt to reduce the public sector paybill.[31]

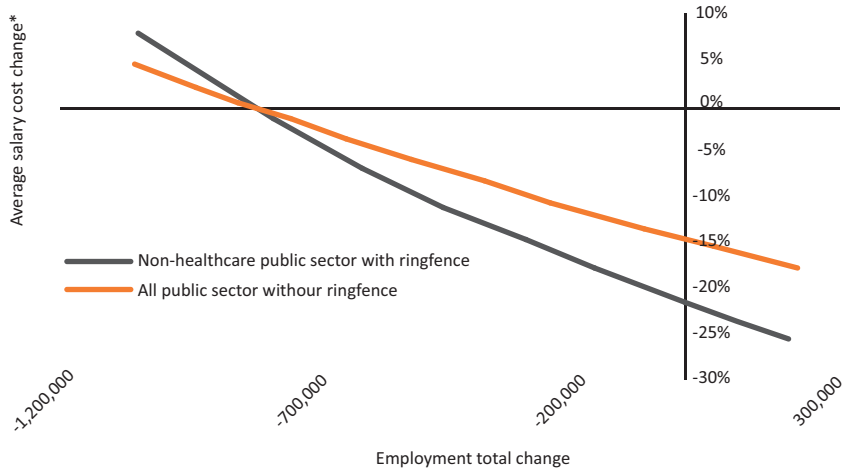
It is difficult to understand the implications of this for the public sector wage bill. The pledge is not that there will be no reduction in the pay or numbers of NHS staff, although it might strongly suggest that. With no reduction in health spending overall, it is difficult to imagine pressure for dramatic decreases in the health paybill. On the other hand, NHS spending is said to increase 1% a year purely due to the effect of demographic pressures.

In the same way that ringfencing health spending means very large cuts in other departments budgets, any reduction of the paybill which excludes the NHS paybill would require around half as much again is cut from all other departments than would otherwise be necessary to achieve the same saving from the payroll bill. A 1% fall in heathcare employee compensation is the equivalent to a 0.48% fall in all other areas. Such a policy would increase health spending from a third of the payroll bill to 40%.

To achieve the same level of paybill reduction would now require a salary reduction of 22% (or headcount reduction of 22% – or mixture of the two) for non-healthcare workers rather the 15% required were the NHS paybill included.

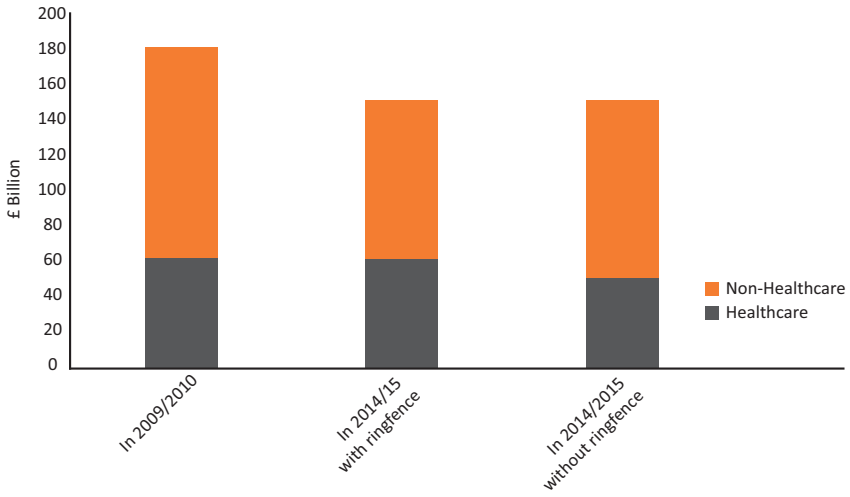
31 We could also include the Department for International Development, whose budget the Coalition is pledged to rise to 0.7% of Gross National Income. However, this paybill is too small to be statistically significant.

Figure 6.4: Tradeoff for nominal paybill freeze to 2014/15 with healthcare ringfence



* Including pay, pensions, employer taxes etc.

Figure 6.5: Public sector paybill



Summary of conclusions

- We should freeze the public sector paybill in cash terms until 2014/15.
- This is a real terms cut of 14.6%, saving £26 billion per year by the final year.
- It would take the paybill back to where it was in 2003/4 in real terms.
- It is unrealistic to expect the entire burden to be borne by pay decreases alone.
- Unless healthcare is included in the paybill freeze, it is probably not plausible to target the same reduction.

7

Longer Term Reforms: Solving Underlying Problems in Public Sector Employment Policy

Case study: OFCOM

'**The moment of change was extremely valuable...** We did the right things on value for money but without any specific external pressure to do them. We were not explicitly expected to. But we have managed to reduced the budget every year of Ofcom's existence.'
– Chief Executive Ed Richards in conversation with Policy Exchange.

- Ofcom was created by the amalgamation of five previous regulators in 2002-3. All functions in each legacy organisation went through a process of review, assessing its function and utility.
- This led to an open process for the selection of the new staff; in essence, everyone had to apply for new jobs. It identified people with the closest skills to match the jobs needed in the new organisation, rather than jobs being created for them to fill. Where there were too many people matched to a job, a selection process took place based on fair and objective criteria.
- Momentum was sustained by the 'moment of change' brought about by the merger – some staff were made redundant, others transferred to different public sector bodies. Of the combined total of 1,152 full-time staff in the legacy organisations, 700 were matched up with jobs in the new organisation out of a headcount budget of 880. 220 were made redundant; 50 returned to the Civil Service. Staff numbers fell to 823 in 2004/5, a 28.6% headcount reduction in just one year – staff costs, however, fell by just 8% because of increases in average pay.
- Ofcom's report on the merger emphasised that 'Remuneration, particularly pensions, is an important policy point and a key part of culture – a remuneration strategy should be a conscious focus of all leaders, not just HR'. It also spoke of creating an 'explicit programme to assist cultural integration, including breaking down old 'silos' and if appropriate, celebrating the best of predecessor organisations.'[xciv]

- Initially, there was equivalence with the civil service salary the person had enjoyed before, but subsequently adjustments were made according to the principle of ending generalised pay increases. A process of performance assessment replaced it. Underachievers and 'coasters' got no increase, those who excelled got a lot.
- Individual awards are now based on a combination of performance (on a rated scale), external market pay relativities (benchmarking private sector equivalents in the telecoms industry, albeit towards the lower end of the scale), internal relativities and potential. (Salaries were frozen for 2009/10 with the total amount accountable for bonuses halved).
- Ofcom staff pensions are distributed through an allowance, determined as a percentage of base salary, which can be taken as extra salary or invested in a pensions scheme of the employee's choice. While it began with an entirely defined-benefit workforce, over 80% of Ofcom's current employees are now employed with access to a stakeholder plan – its legacy defined-benefit schemes are closed.
- In order to persuade people to forgo the defined benefit pension they were entitled to, most employees received a raise in basic pay.
- Job security has been greatly reduced, with a performance management process undertaken every year. Ofcom makes provision for future redundancy costs in its annual budget.
- Ofcom has reduced its budget five years in a row - £136.8 million for 2009/10, 21% lower than the original 2004/5 in like-for-like terms.
- The number of working days lost is 3.4 days per employee per year – well below the public (or private) sector average.

Case study: Sweden

Sweden's system of public sector remuneration combines collective bargaining and high unionisation with a sophisticated, differentiated system of pay bargaining. Despite progressive decentralisation, the coverage rates of collective agreements have remained well above the EU average. A very high proportion of the workforce are involved in negotiations; up to 10% of the workforce are trade union representatives. 68% of Swedish workers are union members against just 28% in the UK; 91% of employees are covered by collective bargaining agreements against the UK's 34.6%.[xcv] Despite this, Swedish has an extremely low number of days lost to strike action – just 1.88 per 1,000 employees per year between 2004 and 2007, for example; the UK figure is 26.5 – a 14-fold difference.

The system emphasises that wages should largely reflect international levels and be negotiated locally so that the specific organisation the employee works for can find the right solution. Certain sectors act as pace-setters – particularly export-orientated major industries. Public sector wages negotiations are often conducted on the basis of this comparability with the private sector. Perhaps importantly, government takes a 'hands off' approach to labour market regulation – direct intervention is frowned upon and rare. The process is now widely supported among trade unions.[xcvi]

This change was brought about by the fiscal crisis of the early 1990s, leading employer associations to withdraw from central bargaining.[32] A further trend was set in 2000 by an agreement between the Swedish Engineering Employers' Association and the Swedish Organisation for Managers, based on wholly individual pay determination. In 2006, there was some discussion of introducing 'opening clauses' to the central agreements to allow downward wage flexibility in times of economic hardship and working time extensions to prevent layoffs. Though opposed by trade unions at the time and not officially adopted, such measures have been used in the current financial crisis.

Deconstructing national pay bargaining

Some attempts have been made to 'roll back' the system of national pay bargaining – the relative freedom of academy schools and foundation hospitals to set their own salary levels, or the forty-four councils which have opted out of the national scales, for example. These reforms have largely been 'at the margins', however – of 114 foundation status hospitals in the UK, only one – Southend University Hospital – has opted out of NHS payscales (albeit in order to increase pay) – even then, the move was opposed by trade unions and NHS Employers.[xcvii]

National pay bargaining is likely to prove hard to reform. A first step might be to allow more institutions to derogate from the standard national rate. As we have seen, Sweden's experience of gradually abolishing national pay bargaining and moving to a system of individual contracts in the early 1990s could prove instructive. Peter Steiner, of ST – the big Swedish union representing white-collar civil servants – explained that, when the reforms were first introduced, the central offices were wary of the idea. But local branches embraced them immediately. "We said we'd go slowly but within a year the whole central structure went – the locals, given the chance to negotiate, grabbed it, and there's no way we could go back." Of course, he agreed that, familiar with the old system, local employers and union sections did not know how to negotiate at first. "But now they do." People at the centre "can't know what is the right wage, what someone is actually doing".[xcviii]

There are, of course, significant transaction costs involved in local negotiation. But in Sweden, some conditions like holiday entitlements, and grievance procedures are still nationally agreed. Some national agreements still set guidelines for the total amount by which total wage bills will increase. But any increase individuals receive is on their personally agreed salary, not an addition to their 'point' on a national scale.[xcix] This makes local negotiation essentially a simple matter of pay, rather than a complex process of contractual renewal.

Somewhat similar schemes have been proposed before – such as a system of zonal pay suggested by the Social Market Foundation.[c] The then Social Services Secretary John Moore floated the idea of local pay negotiations for nurses as long ago as the late 1980s. The Chartered Institute for Personnel and Development and Public Sector People's Management Association have both called for partial deconstruction of national pay rates.

32 See Lilico, Holmes and Sameen, 'Controlling Spending and Government Deficits: Lessons from History and International Experience', Policy Exchange, p. 67.

Segmenting the public sector paybill

Following this model could mean abolishing national salary scales and segmenting the public paybill into defined budgets for particular public organisations, devolving responsibility, for example, from a pay review body or government department to a local council or PCT. This would involve defining small-scale paybill 'pots' in departmental spending limits, and it could lead to wage setting at the level of a particular council department or hospital and ultimately to individuated pay negotiations on the Swedish model.

Such an approach would give the responsible manager full discretion on how their pay budget is spent in negotiation with local, rather than national trade union representation. Pay and promotion would be at the discretion of local managers and more easily tied to performance (particularly without a national salary scale). A particular employees' salary would follow from this negotiation; the double raises of the 'going rate' nationally mandated increase and annual scale point increases would end. Remuneration would then be subject to the supply and demand of the local labour market. This would make explicit the link between retaining public sector jobs and pay at a very local level.

As stated above, this would still mean a tradeoff – it may mean salary freezes, cuts, reductions in auxiliary benefits – but might also mean salary rises for exceptional performers, skills in particular demand or in particular regions. The advantage of this trade off decision is that it is likely to be more efficient: by avoiding centrally mandated salary cuts and lay offs, local bodies, with greater acquaintance with their own particular needs, are likely to make better decisions about what staff and remuneration levels should be in light of the total 'pay pot' available. Removing national salary scales is also likely lessen wage inflation, as managers will not be subject to mandatory national pay settlements and annual scale point increases for all their employees. This may mean fewer job losses than might otherwise be necessary. This could prove much more meaningful than an ad hoc centralised programme of redundancies and across-the-board salary cuts which would necessarily have a short-term effect. It would probably also improve productivity by linking salaries more directly to performance.

As we have seen, particular categories of public sector worker are 'underpaid' or 'overpaid' relative to regional private sector incomes; this varies greatly from region to region. A further element might therefore be to redistribute the total paybill on a regional basis. This could mean, for example, redirecting the paybill to better reflect regional private sector salaries and mitigate the lack of regional differentiation previously evident due to the national pay bargaining structure. Even some trade unions have argued for an explicit link between public and private sector pay.[ci] It could also be effective in achieving national policy objectives. We may want, for example, paybill budgets in an area of particular poverty to rise (allowing them, say, to cut salaries and hire more workers given the conditions of the local labour market) and support this as a desirable social outcome. In other areas, we may be content to see the paybill fall significantly. It would not necessarily mean paying public sector workers less in low salary areas – police in a high crime, low-income area might command a higher salary than in a low-crime, high-income area because of the greater demands of the job, for example – it would be for the local organisation to judge what relative weight should be given to these factors.

Giving public servants a direct say over what they wish to prioritise in terms of their total remuneration might allow, for example, GPs to choose whether to accept higher salaries in return for more responsibilities, such as evening or weekend work (from which they can currently effectively opt out of for a 6% base salary cut since a new contract imposed in 2004), or administrative workers accepting lower pay for more flexible working patterns, as occurs at Southend University Hospital.

Case study: Southend University Hospital

- NHS trusts have had greater flexibility than the rest of the NHS to negotiate locally and use performance-related pay since the 1990s. However, trade unions have fiercely opposed a transition to local pay bargaining. Southend University Hospital is the only trust in the country to buck the trend. It has opted out of the NHS' 'Agenda for Change' payscales since June 2006. Upon its creation as a Foundation Hospital, it balloted staff on whether to continue with NHS payscales or adopt a local version; 95% voted for the latter. Southend is competing for staff against London and Basildon, both of which qualify for high cost area status, hence increasing their equivalent salary levels.
- NHS paybands now largely set a floor for Southends' uprating, while many of the terms and conditions are still heavily influenced by the centralised system. The job evaluation and grading structure are the same as in the rest of the NHS. There has, however, been significant differentiation in other areas. Management negotiate separately with staff representatives. Individual staff have the option of deciding which system they are employed under - around 95% choose the local option.
- There are long service and retirement bonuses, as well as a range of recognition awards. Exceptional performers can move through the pay bands more quickly – even two levels at a time. There is improved annual leave, with 33 days' accrued after seven years service rather than the NHS' usual ten years. Staff can buy and sell five days annual leave a year and take up to 12 weeks' leave (8 paid) for terminally ill relatives and short periods of leave for domestic emergencies. There also additional leave entitlements for dying relatives, payments for long service and retirement presents.
- In return, staff have lower levels of parental leave and additional payments for unsocialable hours. Staff can only take unpaid parental leave for children up to five rather than fourteen as allowed nationally. Each member of staff receives an annual bonus if the trust's targets are met. This is given at a flat rate and can mean up to an additional weeks' salary for lower paid staff. However, unions have indicated they may recommend staff return to the NHS payscales should Southend's fall behind.

Reducing the cost of redundancies

As we have seen, there is a very significant cost involved in sacking public sector workers. Complex hiring and firing processes cost huge amounts time and money. Creating a more flexible labour market in the public sector is likely to drive up performance. One particular difficulty in reducing headcount is the initial cost of redundancies, which are disproportionately high compared to the private sector.

One option might be to annualise a redundancy rate in future pay costs to ensure that headcount can be reduced if and when it is necessary without the additional problem of obtaining redundancy funding; the system already adopted by Ofcom. In the interim, a redundancy bond – specifically ringfenced to meet redundancy payments – might be floated to pay these one-off costs.

But the costs of redundancies must be reduced. In the civil service, £432 million was spent on payouts to 7,718 officials between 2005 and 2008 – an average of £56,000 a piece.[cii] This is quite apart from any pension pot they will take with them. In services such as the police and prisons, there are extremely generous incentives to take early retirement.

Reform is proving a slow process. For example, if made redundant, civil servants over 50 qualify for compensation of three years' pay, while those who joined before 1987 can qualify for 6.5 years' pay. In 2009 the government proposed reducing these payoffs a little, by capping compensation at two or three years' pay for lower paid staff and introducing repayment of the severance pay if the employee rejoins the civil service (which is not necessary at present). This would have been a tiny step in the right direction, and even it has been thwarted after legal action by the PCS union.

Outside the civil service the majority of public sector organisations have similar problems. According to one survey, the average cost of redundancy is £17,900 in the public sector and £8,900 in the private sector.[ciii]

If sacking an underperforming member of staff is costly, risky and time consuming, it is no wonder that many public sector managers don't think it is worth their while. In the short term sacking people causes difficulties and increases costs. And in the long term the Treasury will probably take any savings that are made. But even if it doesn't, the manager responsible is likely to have moved on. Most managers in public sector departments or teams are only in place for a year or two. So if it will take several years for redundancies to pay for themselves, then you have little incentive to rock the boat. All this means public sector managers have every incentive to allow slackly performing staff to drift on. This increases costs and reduced productivity.

Trade Unions, strikes, and the decentralisation of pay negotiations

As we have seen, public sector workers strike more than 2,000% more frequently than private sector workers in the UK, while industrial action has escalated dramatically in those countries implementing cuts and public sector reforms. We are likely to see similar action in the UK once our fiscal consolidation begins in earnest. It may therefore be necessary to review how strike action is triggered. One option would be a ban on secondary picketing in the public sector.

This could be achieved by making it a requirement that individual strike ballots must be held for each legal public sector employer – rather than, as is the case presently, on a sectoral or national basis. This would be implementing the intention of the 1982 Employment Act, which stipulated that strikes should be about a dispute between 'workers and their employer.'[33] Since the legal employer of most public workers is at a much lower level than strike ballots are currently held – a particular hospital or university, for example – and these ballots would be counted separately, this would have the effect of making strikes local rather than national, since it is very unlikely that each ballot would produce a vote in favour of strike action.

33 See Tim Leunig, The Financial Times, 27th October 2009, http://www.ft.com/cms/s/0/bf0dfe70-c339-11de-8eca-00144feab49a.html?catid=171&SID=google

This would likely significantly reduce the number of days lost to strike action more towards the private sector norm and minimise disruption to public services. It would also compliment a shift towards Swedish style regional pay bargaining, giving trade unions the power both to negotiate pay levels and call strike ballots at the local level.

This would simply bring the public sector into line with the legal requirements of private sector strikes. A union cannot, for example, hold a nationwide ballot calling all of its members who are (private sector) office workers out on strike – but it is perfectly legal for a union to do the same thing even for (public sector) emergency services – as was demonstrated so dramatically in firemen's strike of 2002/3. Since strike action is already illegal for the police and Armed Forces, some may see it as incongruous that other life-sustaining and emergency services, such as firemen, 999 operators and healthcare workers – are still allowed to strike. A further option might therefore be to review whether this is still appropriate. We might also consider passing legislation making all unions drafting an enforceable plan allowing for minimal cover for essential public sector staffing in the event of a strike.

Summary of conclusions

- We should aim to phase out national pay bargaining, and replace it with local wage bargaining.
- We should reduce the cost of redundancies.
- We should consider the future role of trade unions in the public sector, particularly in the light of moves to local pay bargaining.

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