Centre for Policy Studies

Public Sector Pay: The Case for Restraint

Introduction

The economic impact of the Covid-19 pandemic has been severe, but the pain has not been shared equally. Many struggling businesses are finding it necessary to cut hours and wages, furlough workers on reduced incomes, and in some cases lay off workers altogether. Some businesses are simply folding under the strain. In the public sector, by contrast, the picture is much rosier. It is true that for some workers - particularly those in the NHS - the pandemic has imposed very severe strains, but in general the public sector has escaped the layoffs and pay cuts seen elsewhere. The result is that its existing advantages over the private sector - in terms of higher pay, greater job security and significantly better pension provision - have dramatically increased.

The pandemic has also had a calamitous impact on the public finances. Even as the economy shrank, it has been necessary to vastly increase government spending to support incomes, businesses, employment and public services. Borrowing is expected to be well in excess of £400 billion this financial year.[1]

While things will improve as the economy comes out of lockdown, the deficit will not just automatically return to roughly where it was before the pandemic. A combination of a permanently smaller economy and significant new spending commitments, in particular on health, social care and welfare, will mean borrowing will remain at a high level for years to come without some action to address the gap in the public finances.

With these two things in mind, this paper sets out the case for public sector pay restraint over the next three years. This is desirable for reasons of both fairness and fiscal necessity.

In terms of fairness, it is difficult to justify generous pay rises in the public sector when private sector wages are actually falling. At the same time, there is a need to control public spending and reduce the structural deficit which the pandemic is likely to have opened up.

We argue that in the context of significantly lower private sector earnings than was expected at the start of this year, and much higher unemployment, it makes sense to adjust

[1] Bangham, Corlett et al, 'Unhealthy Finances', Resolution Foundation, November 2020, link

pay policy in the public sector. With fewer vacancies and lower pay on offer in the private sector, the need for public sector pay rises to compete for workers has been dampened. There is already a public sector pay premium over the private sector, and while that premium (as modelled by the Office for National Statistics) is lower now than in 2010, it has been rising over the last few years as pay policy has been loosened.

We also present estimates of how much might be saved from different potential approaches to pay restraint, including the possibility of excluding the NHS from the policy, in recognition of the role health workers have played on the frontline of the fight against Covid-19.

With both living costs and private sector earnings lower than was anticipated before March, the normal benchmarks for uprating public sector pay have changed. It would be reasonable to conclude, therefore, that the public sector should share at least some of the pain as we rebuild the nation's finances.

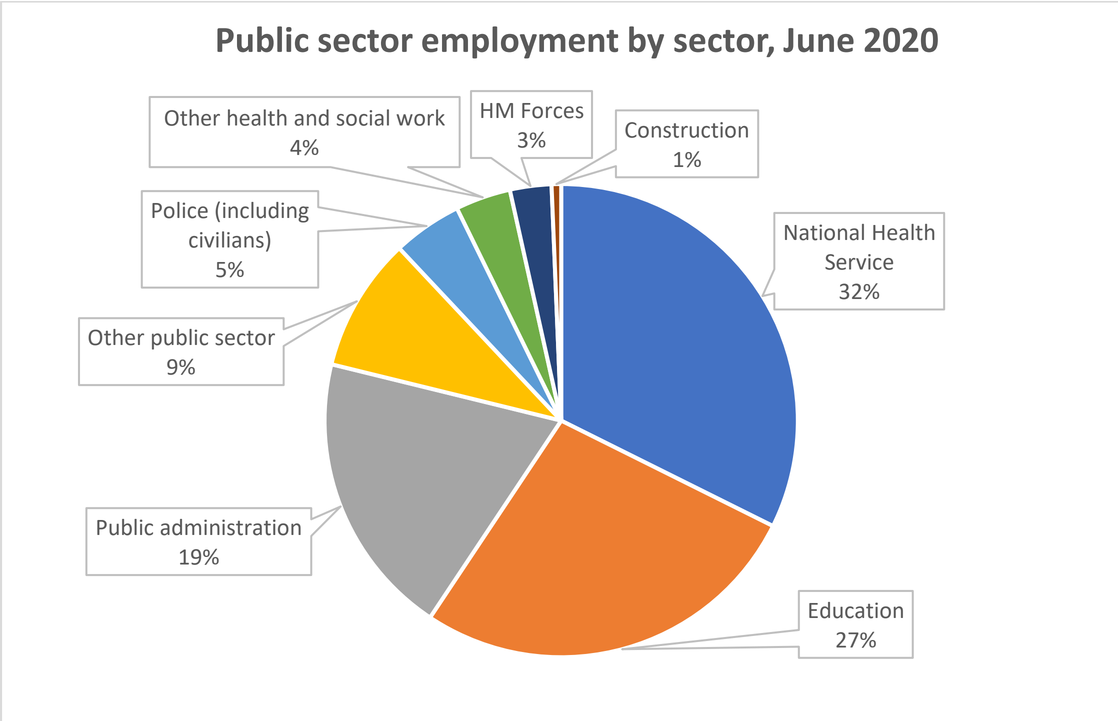
What does the Government's pay bill currently look like?

Within the public sector workforce of roughly 5.5 million employees, almost a third (32.4%) work in the NHS alone, or 36.1% if we include the wider health and social care workforce. More than a quarter (27%) work in education, and almost a fifth (19.5%) work in public administration roles such as the Department of Work and Pensions (DWP) and Her Majesty's Revenue and Customs (HMRC). Together these sectors make up more than 80% of all public sector employment.

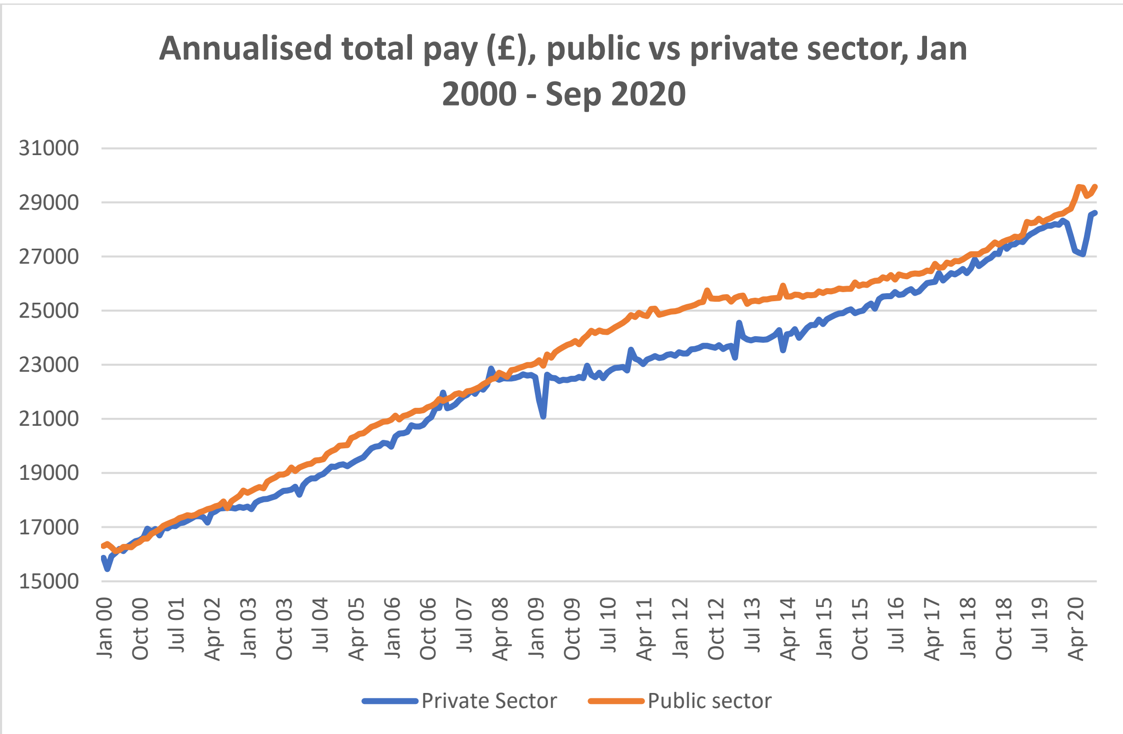
The total cost of paying all of these workers, including the cost of employer pension contributions, is around £190 billion.[2]

During the financial crisis and resulting recession, private sector earnings stalled and the public sector pulled away. Over the last decade, public sector wage restraint has gradually narrowed this gap as private sector earnings returned to growth. The Government has recently allowed public sector wages to begin rising at relatively modest rates, meaning that before the pandemic the public and private sectors were roughly on a par, just as they were around 2007-08.

[2] Cribb, Davenport and Zaranko, 'Public sector pay and employment: where are we now?', IFS, November 2019, link



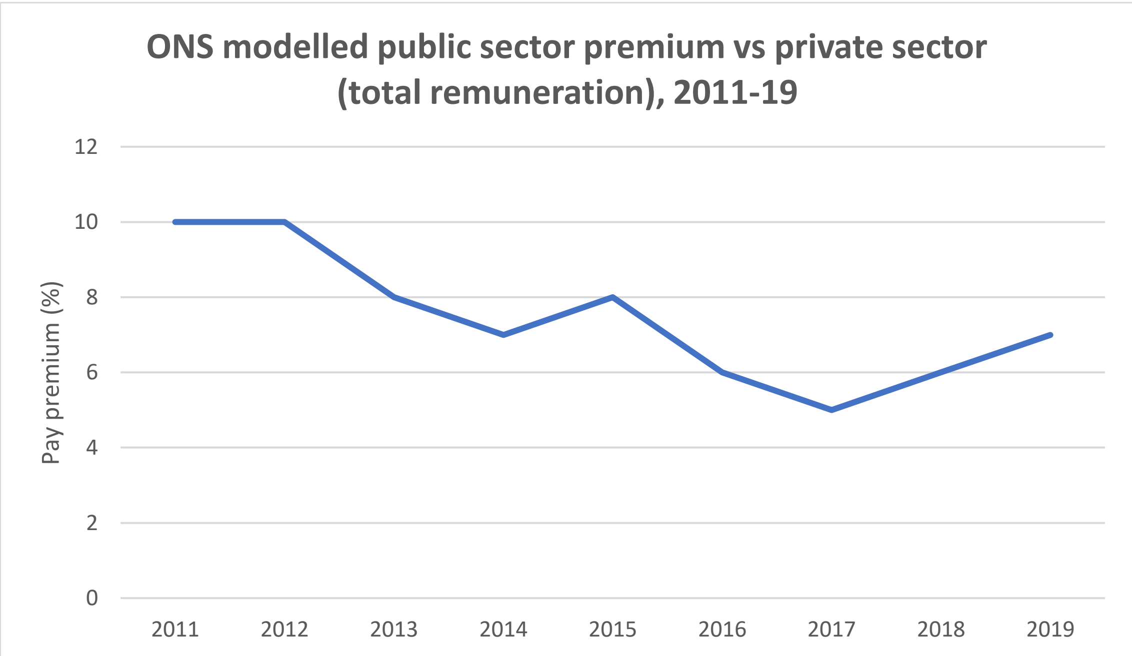
Source: ONS, Public Sector Employment, June 2020, Table 2 [link]



Source: ONS, Average weekly earnings, Table 1, [link]. Public sector excludes financial services

However, there are a number of other factors which are relevant when determining the relative generosity of remuneration between the two sectors. Pension provision, for example, is vastly more generous in the public sector, with 86% of public sector workers receiving implicit employer pension contributions worth 10% of earnings or more, compared to just 10% of private sector workers.[3] A 2016 study in the National Institute Economic Review using data from 2012 found that while the differential in hourly remuneration between the public and private sectors was 4.6% when looking at pay only, once pension provision was included the differential was 13.7%.[4]

The Office for National Statistics (ONS) estimate that the modelled average public sector earnings premium in 2019 was 7%. This modelling controls for variables such as job type, industry and level of qualification, and is calculated based on total remuneration including pension contributions. The ONS estimate that this gap has only narrowed by 3 percentage points since 2011 and has been rising since 2017.[5]



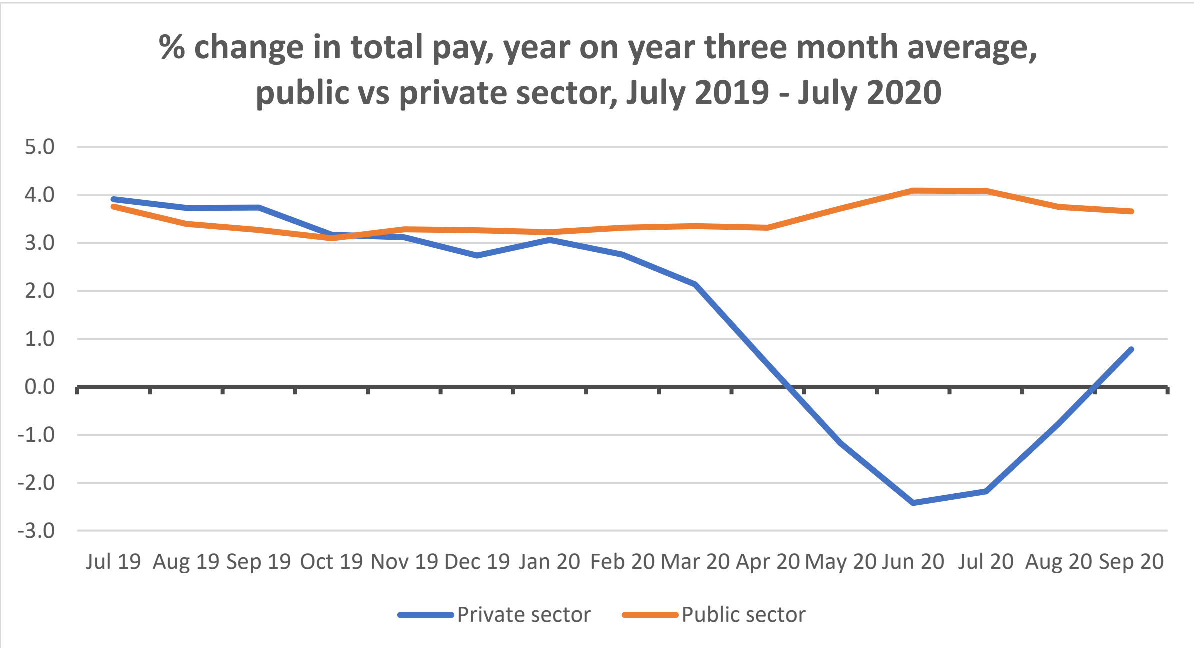
Source: ONS, Public and private sector earnings: 2019, link

[3] Cribb, Davenport and Zaranko, 'Public sector pay and employment: where are we now?', IFS, November 2019, link
[4] Cribb and Emmerson, 'Workplace Pensions and Remuneration in the Public and Private Sectors in the UK', National Institute Economic Review, August 2016, link
[5] 'Public and private sector earnings: 2019', ONS, September 2020, link

There is also a job security premium in the public sector compared to the private sector. It seems fair to note that the incredible uncertainty many face about their jobs over the next year will be mostly limited to the private sector. The latest CIPD Labour Market Outlook found that 34% of private sector employers plan to make redundancies in the final quarter of 2020, compared to just 14% of public sector employers. The survey found that the 'net employment outlook '(i.e. the net reported intentions of employers for their overall staff levels) for the public sector was +14 compared to -5 in the private sector.[6]

The case for wage restraint

Since, as set out above, there is already a comfortable pay premium in the public sector over the private sector, a very substantial pay differential between the public and private sectors is likely to emerge over the coming years without policy adjustment. And sure enough, recent months have seen a dramatic divergence. The chart below, based on the latest ONS earnings data, shows how private sector workers have suffered far more severely since the pandemic began.



Source: ONS, Average weekly earnings, Table 1, link. Public sector excludes financial services.

[6] 'Labour Market Outlook: Autumn 2020', CIPD, November 2020, link

The justification for removing the pay cap in the public sector in recent years was that the original case for the policy – that private sector workers had been left behind due to the recession – no longer held, as pay growth had picked up and private sector workers had caught up. Now that a major new economic crisis has hit, it is fair and reasonable to re-evaluate that premise. If pay policy in the public sector has been based, in part, on what is happening elsewhere in the labour market, how can we justify not adjusting policy when private sector workers are suddenly facing a very raw deal?

In March 2020, the Office of Manpower Economics (OME), which is the independent secretariat to the pay review bodies, published a major study into the dynamics of public and private sector wages and employment, for which they commissioned the National Institute of Economic and Social Research (NIESR).[7] This study provides evidence to suggest that wages in the public and private sectors form a '*persistent relationship*' and public sector wages tend to adjust over time to maintain this relationship. If public sector wages fall relative to the private sector, then the public sector's ability to recruit and retain workers will decrease.

However, as the Bank of England noted in their August economic update, it is unlikely that wages will be rising in the private sector. The Bank stated that: '*There is likely to be less pressure to increase wages because of a larger pool of unemployed workers' and 'a range of surveys suggest pressures to increase pay have fallen sharply'*.[8] In this context, the likelihood that public sector remuneration will need to rise to keep pace with the private sector is significantly reduced. The CIPD Labour Market Outlook survey of employers for Autumn 2020 found that more than half of private sector employers expect to freeze pay over the next 12 months, compared to average expected rises in basic pay of 2% by public sector employers.[9]

NIESR also found that public sector wage increases lead to significant short-term 'spillovers' in the private sector, probably related to the fact there is evidence of public sector pay settlements acting as a pull factor from other sectors. This suggests that generous public sector pay increases could force up wage costs for employers at a time when many businesses will be struggling to keep their employees on the payroll and not shed staff.

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[7] Dalton, Hantzsche and Kara, 'The dynamics of public and private sector wages, pay settlements and employment', NIESR/OME, March 2020, link

[8] 'Monetary Policy Report: August 2020', Bank of England, August 2020, link

[9] 'Labour Market Outlook: Autumn 2020', CIPD, November 2020, link

We should also note that for many public sector workers, the headline percentage increases are not the actual increase they will see in their pay packet, since these are percentage increases in the pay *scales*. For example, NHS staff whose salaries are negotiated under the 'Agenda for Change' regime (which covers the vast majority) are currently in the final year of a three-year pay deal agreed in 2018, which consists of a 3% increase in 2018-19, 1.7% in 2019-20 and 1.67% in 2020-21.[10] In reality, a nurse not yet at the top of their pay band would, due to moving up the increment scales, actually see their pay increase by 4.4% on average this year, not 1.67%.[11] (See the Centre for Policy Studies report 'An NHS Bonus' for more on the idiosyncrasies of the NHS pay regime.)[12]

Options for pay restraint

The Institute for Fiscal Studies (IFS) note that as a 'rough rule of thumb', a 1% increase in public sector pay across the board amounts to an additional £2 billion of government expenditure.[13] This is based on the IFS figure of £190 billion in total pay spend, so we might more accurately say £1.9 billion.

We can calculate savings relative to a number of potential counterfactuals, not least the OBR's fiscal projections in its Economic and Fiscal Outlook. In its March forecast, the OBR assumed pay bill per head growth of 2.8% in 2021-22 (this is partly based on forecasts for earnings growth across the economy). On a crude basis, then, if pay were to be frozen across the public sector, we might expect savings of £5.3 billion. However, in reality the OBR's per head pay bill growth estimates are not the same as public sector pay policy and this is likely to be an overestimate.[14]

If instead we were to use the counterfactual of a 2% increase, based on the Bank of England's target for CPI inflation, which seems more realistic, we would estimate savings in 2021-22 of around £3.8 billion.

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[10] 'Framework agreement on the reform of Agenda for Change', NHS Staff Council, June 2018, link

[11] 'Pay rises for doctors, police and more in the public sector', HM Treasury PR, July 2020, link

[12] Goldsmith, 'An NHS Bonus', CPS, July 2018, link

[13] Cribb, Davenport and Zaranko, 'Public sector pay and employment: where are we now?', IFS, November 2019, link

[14] Note for example that during the period of the pay freeze under the Coalition the OBR's assumptions still involved rising paybill per head.

However, considering the heroic efforts of NHS staff over the course of this year in dealing with many thousands of sick patients, it may be that the Government would wish to exclude them from a wider policy of pay restraint in the public sector. Many doctors and nurses across the country have knowingly and willingly exposed themselves to a potentially deadly virus on a daily basis, and some have died in the line of duty. Without their incredible commitment we may have seen many more deaths and the system could have been overwhelmed.

According to the Department of Health and Social Care's evidence to the NHS Pay Review Body, roughly 45% of health spending is to cover staff costs.[15] Health spending for 2021-22 is currently £145 billion,[16] so we can roughly estimate the total cost of public sector health pay to be around £65 billion. This would imply that £1.3 billion of the £3.8 billion saving given above would be from the DHSC, meaning if we were to exclude Health from the policy the saving would be £2.5 billion in year one.

Table 1: Savings from a freeze for three years, relative to 2% counterfactual (£bn)

	Year 1	Year 2	Year 3
Applied across the public sector	3.8	7.7	11.6
Excluding health	2.5	5.1	7.7

Table 2: Savings from a 1% rise each year for three years, relative to 2% counterfactual (£bn)

	Year 1	Year 2	Year 3
Applied across the public sector	1.9	3.9	5.9
Excluding health	1.3	2.5	3.9

[15] 'The NHS Pay Review Body (NHSPRB) Review for 2018: Written Evidence from the Department of Health and Social Care for England', DHSC, January 2018, link, see Figure 3.2
[16] 'The NHS budget and how it has changed', King's Fund, March 2020, link

These hypothetical pay policies refer to average increases in pay levels across the workforce. As noted above, many public sector workers benefit from incremental pay rises if they are not already at the top spine of their pay scale, and there should still be room for pay flexibility to reflect and reward good performance.

The estimated savings from reducing average pay rises across the public sector by 1% each year over three years are, on their own, roughly equivalent to a penny on the basic rate of income tax (though should be noted that the savings would be slightly lower once reduced PAYE tax revenue is taken into account).[17] Regardless, there is a fundamental point of fairness. As the charts and figures presented throughout this paper show, without policy change the public sector pay premium will be significantly expanded over the next few years as private sector workers are left behind.

In its pre-pandemic Economic and Fiscal Outlook, the OBR forecast that the Government's planned spending increases would likely mean an expansion in government employment of almost half a million, bringing public sector employment back to around the level it was at in 2010. This would amount to a 9% increase in the number of public sector employees. Furthermore, this was the forecast before the impact of Covid-19 had been factored in, which is likely to increase both political and demand-based pressures for spending expansion in health, social care and possibly other areas. As a result, generous increases in public sector pay levels now are likely to be even more expensive by the end of the spending envelope.[18]

Conclusion

There seems to be little justification for continuing with public sector pay policy as normal when many private sector workers are facing freezes or cuts in their pay, reduced hours, and redundancy. Renewed public sector pay restraint makes sense both in terms of fairness and in pure policy terms.

Of course, some parts of the public sector have been on the frontline of the fight against Covid, and this paper does not seek to suggest that everyone in the public sector is having an easy ride. Our estimates of potential savings from lower public sector pay rises include a potential exclusion for the NHS from the policy.

[17] 'Direct effects of illustrative tax changes', HMRC, May 2020, link
[18] 'Economic and Fiscal Outlook: March 2020', OBR, March 2020, link

The economic impact of this crisis is being felt acutely by huge numbers of businesses and their workers. A significant proportion of their taxes fund the wages and pensions of public sector workers, who are often getting a substantially better deal than they are. The Government has sought to stress throughout this pandemic that ‘we are all in this together’. If Ministers want to send a signal that they mean what they say, public sector pay would be a good place to start.