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The government is considering easing the current restraint on the pay of public sector workers. It had previously announced in 2015 that public sector pay scales would only increase by an average of 1% per year up to and including 2019–20. This briefing note describes the trade-offs faced by the government when deciding how to set public sector pay.

Key findings

- Public pay restraint means that average pre-tax weekly earnings in the public sector in 2016–17 were 4% (£22 per week) lower in real terms than in 2009–10 (and in 2007–08). Mean private sector weekly pay in 2016–17 was 5% lower than in 2007–08.

- Public sector pay grew faster than private sector pay in the aftermath of the recession. Subsequent pay restraint in the public sector reversed that trend, meaning that by 2016–17 the difference between public and private sector pay had returned to its pre-crisis level. Controlling for workers' characteristics such as education and experience, average pay is quite similar in the public and private sectors.

- Continuing to increase public sector pay scales by only 1% per year in 2018–19 and 2019–20 would likely lead to growth in public pay falling significantly behind growth in private sector pay, exacerbating the emerging recruitment, retention and motivation problems in the public sector. Increasing public sector pay in line with prices or private sector earnings would likely mitigate these problems.

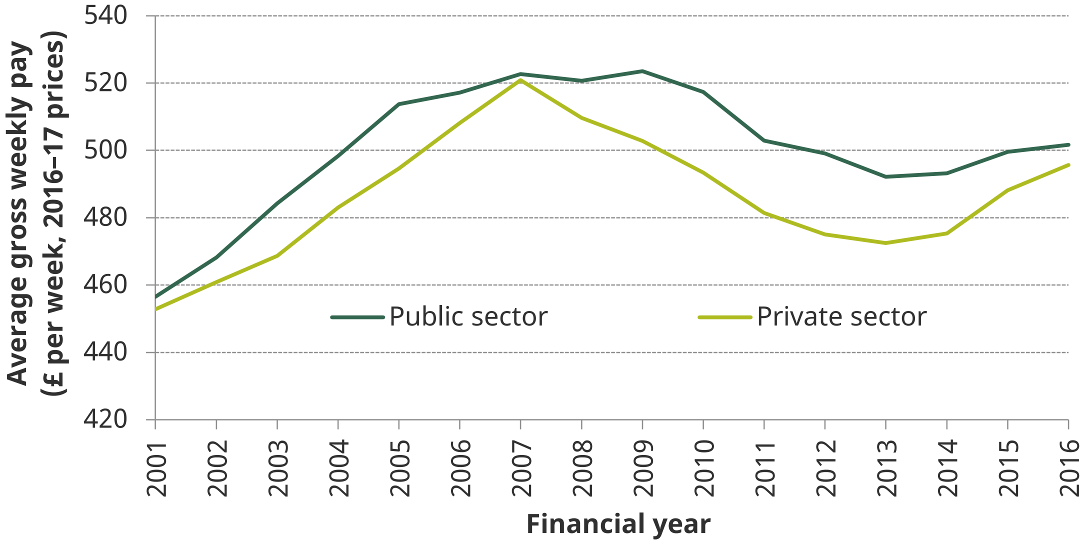
- Workplace pension provision in the public sector remains far more generous, on average, than in the private sector. This is despite automatic enrolment boosting pension coverage among private sector workers. 83% of public sector workers receive an employer contribution to their pension worth 10% or more of their salary, compared with only 11% of private sector workers.

- Compared with private sector pay, public sector pay is lower for highly educated workers than for low-educated workers. Indeed, the pay of lower-educated workers in the public sector is now higher relative to equivalent private sector workers than it was in 2007–08. However, graduates in the public sector have seen their pay fall relative to private sector comparators. Based on the performance of pay, it is among better-paid and higher-educated public sector workers that we might expect greater recruitment and retention issues and a more pressing need for pay increases, though there may well be cases where the converse is true. Public pay is also low relative to private pay in London and the South East and higher than private pay in most other regions.

- The public sector paybill was £181 billion in 2016–17. Therefore even small percentage increases in average pay can lead to significant extra costs for public sector employers. Increasing average public sector pay in line with either prices or private sector earnings would increase the cost of employing the 5.1 million public sector workers by around £6 billion per year by 2019–20. If the Treasury were not to provide extra funds to pay for higher pay, public sector employers would need to make cuts elsewhere. The Treasury could increase spending on departments by increasing taxes, cutting other spending or borrowing more.

Average weekly pay in the public sector in 2016–17 was 4% lower than its peak in 2009–10

Figure 1. Average real gross weekly earnings in the public and private sectors



Source: Author's calculations using ONS average weekly earnings series KAC4 and KAD8 (public sector excluding financial institutions). Adjusted for inflation using the Consumer Prices Index (CPI).

There has been significant pay restraint in the public sector since the formation of the coalition government in 2010. In 2011–12 and 2012–13, public sector pay was frozen for all but the lowest-earning workers, and since then pay scales have increased by only 1% per year on average. Under plans announced at the Summer Budget 2015, public pay scales would only rise by 1% per year up to and including 2019–20, though pay rises (for prison service staff and police officers) in excess of 1% were announced on 12 September 2017.

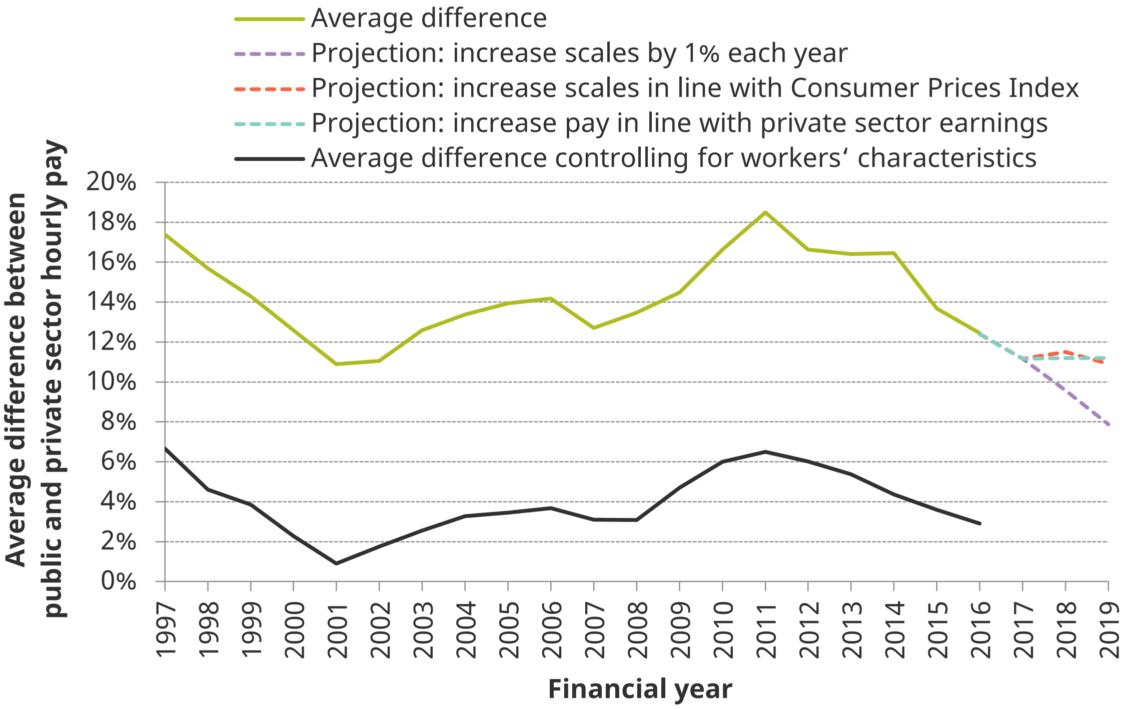
Figure 1 shows how mean public and private sector weekly earnings have performed over recent years, after accounting for inflation. Average public sector pay is 4% (£22 per week) lower than it was at its peak in 2009–10. It has actually recovered by a small amount (2%) since its recent trough in 2013–14, mainly driven by low inflation in 2014–15 and 2015–16. The pattern of changes in private sector pay has been very different. Average private sector pay fell sharply during and in the years immediately after the Great Recession, falling by 9% between 2007–08 and 2013–14, since when it has partially recovered. Mean private sector weekly pay was 5% lower in 2016–17 than in 2007–08. (Average public sector pay was 4% lower over the same period.)

Of course, these are average changes in pay, and some types of employees will have seen bigger (or smaller) changes than this. On average, public sector workers are becoming more educated, which we would expect to push up average pay to some extent. However, this has been occurring at a similar rate in the private sector too, meaning that comparing changes over time between the two sectors remains sensible.

The statistics in Figure 1 do not account for the fact that private sector workers are more likely to work part-time and that, on average, public sector workers are more likely to be highly educated professionals who can command higher wages in the labour market. Therefore, in Figure 2, we compare average hourly pay rather than weekly. In addition, we estimate the difference between public and private sector pay controlling for differences in the characteristics of workers in the two sectors.

Difference between public and private sector pay returned to pre-crisis level in 2016–17; differential set to fall significantly if 1% cap continues, prompting recruitment and retention problems

Figure 2. Difference between average public and private sector hourly pay, including projections under different scenarios



Note: A positive difference means that public sector pay is higher than private sector pay on average. Difference controlling for workers' characteristics controls for differences in age, sex, education, experience and region.

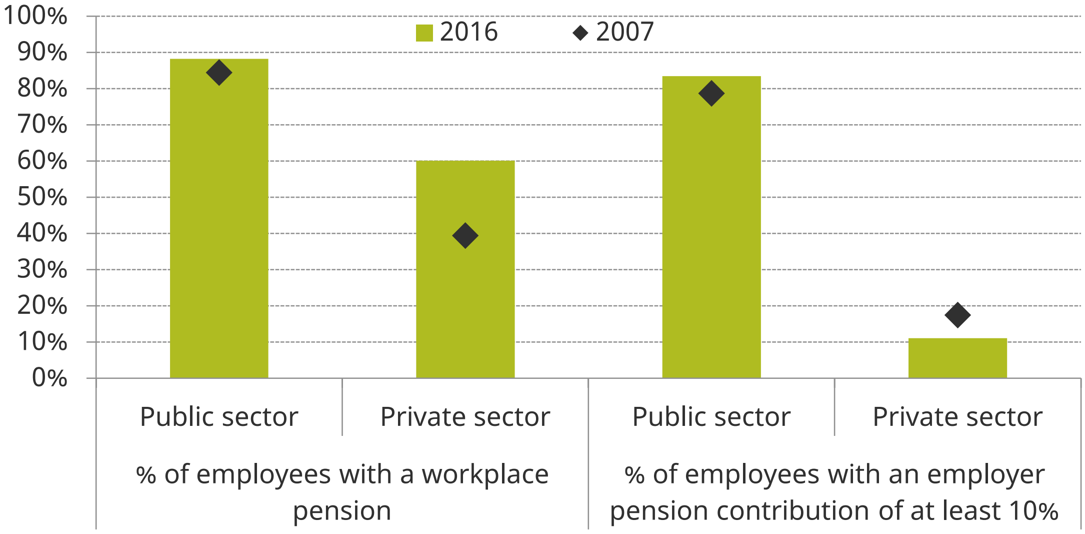
Source: Author's calculations using the Labour Force Survey. Projections based on author's calculations using OBR's Economic and Fiscal Outlook March 2017 and the Consumer Prices Index.

Figure 2 shows that average hourly pay in the public sector was 12% higher than in the private sector in 2016–17, but that once you control for differences between the workers in each sector, the estimated differential is much smaller. Pay restraint in the public sector has closed the gap that opened up between the public and private sectors during the recession, and the pay differential in 2016–17 was back to its pre-crisis level.

Using the Office for Budget Responsibility (OBR)'s forecasts for earnings growth from the Spring Budget 2017, we can project how the differential would change in coming years. If the government continues to increase public sector pay by only 1% per year, public sector pay is likely to fall substantially relative to private sector pay. It would mean that the difference in pay would be lower than at any point seen in the last 20 years, and well below the level seen in the early 2000s when there were shortages of nurses. Some Pay Review Bodies are currently reporting recruitment and retention problems, and further pay restraint would be likely to exacerbate such problems. If public sector pay were to grow in line with either the CPI or private sector earnings, the pay differential would likely stabilise around its current level.

Far more public sector workers receive significant employer pension contributions than private sector workers, despite public sector pension reforms

Figure 3. Workplace pension participation and contributions in public and private sectors



Source: Author's calculations using the ONS Pensions Tables from the Annual Survey of Hours and Earnings, 2007 and 2016.

Wages and salaries are not the only form of payment that employees receive from their employers.[1] The largest and most widespread additional benefit is the provision of employer contributions to workplace pensions. Public sector employees receive much better pensions, on average, than their private sector counterparts. Figure 3 shows that while 88% of public sector workers were a member of a workplace pension scheme in 2016, only 60% of private sector workers were, although that had increased rapidly since 2007 due to automatic enrolment.

When we compare the proportion receiving substantial employer contributions to their pensions, the gap is even wider: 83% of public sector workers receive employer pension contributions worth at least 10% of their earnings, compared with only 11% in the private sector (where it has actually fallen from 17% in 2007). This difference is despite reforms to public sector pensions under the coalition government which reduced the value of public sector pensions (including replacing 'final salary' with 'career average' schemes).

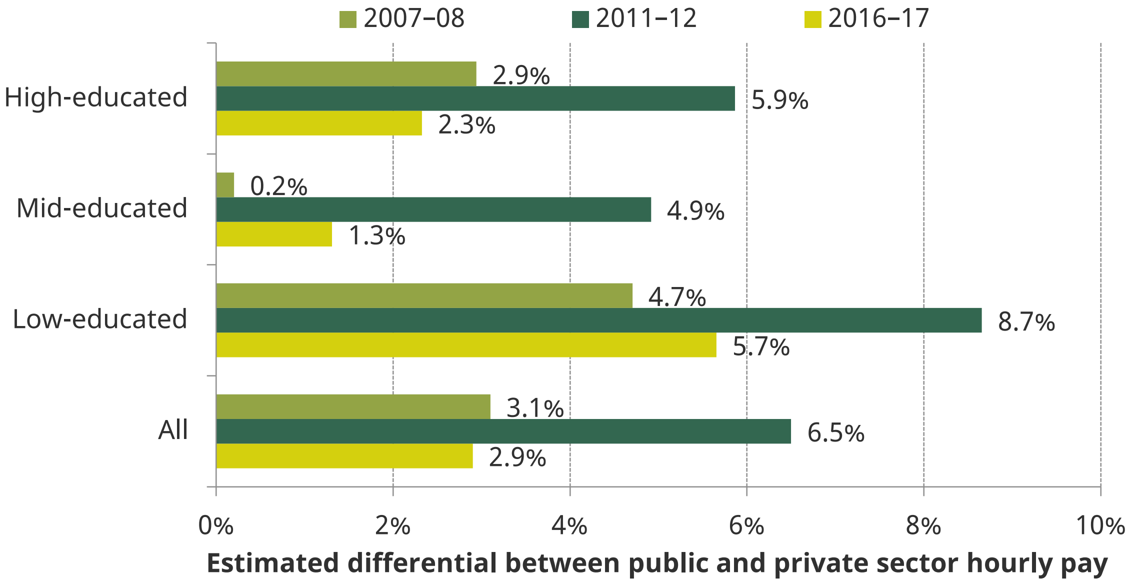
It is therefore important to remember that a significant proportion of remuneration for the public sector comes in the form of a pension, and that public sector pensions are on average worth a lot more than schemes in the private sector. Using data from 2012, Cribb and Emmerson (2016) found that including the value of workplace pensions increased the

[1] Note that the measures of pay in Figures 1 and 2 do include cash bonuses paid to employees.

public sector pay differential by 12 percentage points.[2] Although this effect will have fallen (potentially significantly) since then, given the differences in pension provision shown in Figure 3, the effect of including pensions on the public pay differential would still be to increase it substantially.

Differential between public and private sector pay lower for high-educated workers than for low-educated workers (and already below its 2007–08 level)

Figure 4. Differential between public and private sector hourly pay controlling for workers' characteristics, by education group



Note: A positive difference means that public sector pay is higher than private sector pay on average. Difference controlling for workers' characteristics controls for differences in age, sex, experience and region. 'High-educated' are those who have completed higher education. 'Mid-educated' are those with A levels or equivalents. 'Low-educated' are those who have completed at most GCSEs or equivalents, or have no qualifications.

Source: Author's calculations using the Labour Force Survey.

The pay differential between the public and private sectors is not the same across the whole public sector. On average, pay at the top end in the public sector is not as high as it is in the private sector, and at the bottom end it is not as low as it is in the private sector. This can be shown by looking at the differential for groups of workers with different educational backgrounds. Most public sector workers are highly educated, with 64% of them having completed higher education, 16% having A levels as their highest qualification and 20% having at most GCSEs.

In 2016–17, the difference between public and private sector pay was considerably higher for low-educated workers (at 5.7%) than for high-educated workers (2.3%). Moreover, while the differential was not yet back to its 2007–08 level for low- and mid-educated

[2] J. Cribb and C. Emmerson, 'Workplace pensions and remuneration in the public and private sectors in the UK', *National Institute Economic Review*, 2016, 237, R30–7.

workers – that is, they are paid slightly *more* relative to private sector workers than they were in 2007–08 – for high-educated workers it is slightly below its pre-crisis level.

Particularly if this trend continues, we would expect it to become progressively harder for the public sector to recruit highly skilled and highly educated professionals, such as teachers, doctors and senior civil servants. In addition, increases to employee pension contributions in the public sector have affected higher-educated workers more than less-educated workers. For an NHS employee earning £25,000 per year, employee pension contributions have increased from 6.5% of salary in 2010–11 to 7.1% in 2016–17. For an NHS worker earning £50,000 per year, they have increased from 7.5% to 12.5% over the same period. Similar changes have occurred in other parts of the public sector.[3] Coming alongside reforms that have reduced the value of public pensions (most obviously, the move from RPI to CPI indexation from April 2011), these increased contributions mean that remuneration for graduates in the public sector has fallen by more relative to the private sector than is implied by looking at pay alone, as is done in Figure 4.

While the trends on remuneration point to there being a good case to relax pay restraint for high skill workers in the public sector, there are also examples of where less well paid occupations that are struggling with recruitment and staff quality problems. This may particularly be the case where working conditions have changed and made certain jobs less attractive. For example, the 2017 Report of the Prison Service Pay Review body said,

"Staff motivation, morale and confidence in the Service are undoubtedly very low. Published figures on assaults and other forms of violence in establishments show that these are at the highest levels since 2000… In our view, the present state of the prison system means that all frontline prison staff currently face significantly greater, and growing, challenges, and this should be recognised in the pay award."[4]

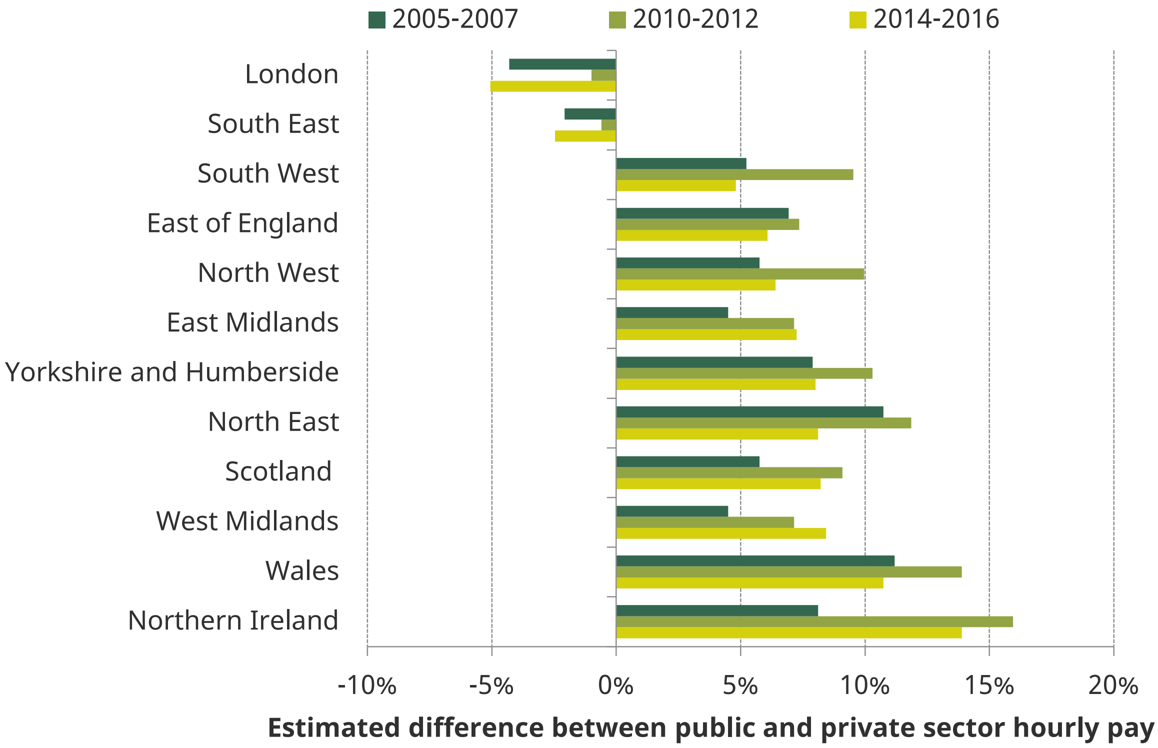
It is therefore likely that for some relatively low paid occupations, such as within prisons, higher pay could help to mitigate some of the current problems.

3 'Take-home' pay will also have been reduced for many public sector workers by the ending of contracting out of National Insurance contributions for those contributing to defined benefit pension schemes in April 2016.

4 See pages xi-xiii of the Prison Service Pay Review Body Sixteenth Report on England and Wales 2017 Executive Summary (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/644121/60009_Exec_Summary_v0.2.pdf)

Public pay differential substantially lower in London and southern England, and below level seen prior to the recession

Figure 5. Differential between public and private sector hourly pay controlling for workers' characteristics, by region and nation of the UK



Note: A positive difference means that public sector pay is higher than private sector pay on average. Difference controlling for workers' characteristics controls for differences in age, sex, experience and education. Years are pooled together to ensure adequate sample size. Years are financial years.

Source: Author's calculations using the Labour Force Survey.

Public sector pay is much lower relative to private sector pay in southern England (particularly London and the South East) than it is in the other parts of the UK. Lower relative public sector pay in these areas has been shown to lead to lower-quality public services (specifically schools and hospitals).[5] Moreover, while in many other areas of the country the pay differential is still well above its pre-crisis level, in southern England it is close to or below the level seen prior to the recession.

The analysis here suggests that it is likely that recruitment and retention problems are likely to be worse in southern England and for those in professional roles. A government that prioritises public service quality would therefore want to target pay rises in particular towards these groups.

[5] See C. Propper and J. Van Reenen, 'Can pay regulation kill? Panel data evidence on the effect of labor markets on hospital performance', *Journal of Political Economy*, 2010, 118, 222–73 and J. Britton and C. Propper, 'Teacher pay and school productivity: exploiting wage regulation', *Journal of Public Economics*, 2016, 133, 75–89.

Increasing public sector pay in line with prices or private sector earnings would cost government around £6 billion per year by 2019–20, compared with keeping the 1% cap on public pay growth

There are 5.1 million employees working for the public sector (excluding nationalised corporations), employed at a total cost of £181 billion per year in 2016–17 (or 23% of all government spending). Therefore even small percentage increases in their pay imply large increases in the cost of employing these workers. Table 1 shows the increased cost to public sector employers per year in 2018–19 and 2019–10 under three scenarios, compared with if 1% pay growth remains in place. The three scenarios are: increases in public pay scales by 1.7% per year (the increase announced for the prison service on 12 September 2017); increases in line with the CPI; or for public sector pay to rise in line with private sector pay.

Increasing public pay in line with either prices or private sector earnings would imply a higher cost to employers of around £3 billion in 2018–19 rising to around £6 billion per year by 2019–20. The table also shows that, because of the size of the NHS, education and public administration (civil service and local government administration), the extra resources needed to fund pay increases for these sectors are much larger than those needed for the police or HM Forces.

Importantly, if government does increase pay faster than 1% per year but does not provide the funds to departments and local government to cover the additional costs, then the public sector employers would have to make cuts elsewhere, potentially including further reducing the number of people employed in the public sector. On the other hand, if the Treasury does provide more resources to fund higher increases in pay, then that would necessitate either higher taxes, lower spending elsewhere or higher borrowing to pay for them.

Table 1. Estimated increase in funding needed for central and local governments to increase public sector pay under different scenarios, compared with increasing pay scales by 1% per year in 2018–19 and 2019–20

Annual cost to public sector employers (£ billion)	**Public sector earnings growth per year:**		
	1.7%	**CPI inflation**	**Private sector earnings growth**
Cost for one year of easing (2018–19)	1.3	3.5	2.9
Approximate split:			
NHS	0.4	1.1	0.9
Education	0.4	1.0	0.9
Public administration	0.3	0.7	0.6
Police (including civilians)	0.1	0.2	0.1
HM Forces	0.0	0.1	0.1
Other	0.1	0.4	0.3
Cost for two years of easing (to 2019–20)	2.6	5.8	6.4
Approximate split:			
NHS	0.8	1.8	2.0
Education	0.8	1.7	1.9
Public administration	0.5	1.1	1.3
Police (including civilians)	0.1	0.3	0.3
HM Forces	0.1	0.2	0.2
Other	0.3	0.7	0.7

Note: Cost of increase in pay is split across parts of the public sector in line with the proportion of government employees working in each part.

Source: Author's calculations using ONS series NMXS (total compensation of general government employees), ONS public sector employment statistics, OBR's Economic and Fiscal Outlook March 2017 and the Consumer Prices Index.

Summary

Pay restraint in the public sector under the coalition and Conservative governments has reduced average public sector earnings by 4% since 2009–10. One justification for this pay restraint is that falls in private sector earnings during and after the recession meant that a gap had opened up between public and private sector pay. However, by 2016–17, the difference between average pay in each sector had returned to around its pre-crisis level. Some Pay Review Bodies have now begun to report problems of recruitment and retention.

If the government maintains the 1% pay restraint for most or all public sector workers, the difference between public and private sector pay would be likely to fall further. This would likely increase recruitment, retention and motivation problems in the public sector, and risk leading to lower-quality public services. Increases in line with prices (the Consumer Prices Index) or private sector earnings would be likely to mitigate some of these problems.

If pay restraint does continue, we might expect the recruitment problems to be particularly severe in areas where the equivalent pay in the private sector is now relatively higher. That is particularly the case for highly educated professionals and those in London and the South East. If these are the areas where recruitment problems are most severe, a government interested in public service quality should target any pay rises towards these areas.

Recruitment and staff quality problems may not be limited to occupations where pay is relatively low in the public sector. Particularly if working conditions have worsened in low paid occupations, reducing the attractiveness of these jobs – for example there has been increased violence in prisons – higher pay could help mitigate some of current problems too.

Increasing pay in line with prices or private sector earnings over the next two years rather than by 1% per year does imply a significant extra cost for public sector employers, at around £6 billion per year by 2019–20. If the Treasury does not provide these public sector employers with extra funds, they would need to make cuts elsewhere. If the Treasury does increase the funds available, to fund the higher pay settlements, it would need to raise taxes, reduce spending elsewhere or borrow more.