



Total Reward and pensions in the UK in the public and private sectors

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ABSTRACT

Recent controversy has surrounded the relative value of public and private sector remuneration. We propose a comprehensive measure of Total Reward (TR) which includes not just pay, but pensions and other 'benefits in kind', evaluate it as the present value of the sum of all these payments over the lifetime and compare it for the highly educated in the UK public and private sectors. Our results suggest that TR is broadly equalised over the lifecycle for highly educated men while highly educated women have a clear TR advantage in the public sector by the end of their career. We suggest that the current controversy over public–private sector pension differentials and the perennial issues of public/private sector pay gaps requires a lifetime perspective and that the concept of TR is appropriate.

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"The pension system is only an alternative to paying a higher salary to those rendering existing services and leaving them subsequently to look after their own superannuation allowance." Sir Josiah Stamp (1880–1941) "Wealth and Taxable Capacity." 1922, Ch. II, p.57.

"The true reward which an occupation offers to labour has to be calculated by deducting the money value of all its disadvantages from that of all its advantages; and we may describe this true reward as the net advantages of the occupation." Alfred Marshall (1842–1924) "Principles of Economics." 8th ed., Bk. II, Ch. IV, 2, p.73.

1. Introduction

Recent controversy has surrounded the relative value of public and private sector remuneration and pensions in the UK. In the current recession and fiscal debt crises, there has been huge pressure to cut public sector remuneration. Many countries have already done this in nominal terms (e.g. Greece and the Republic of Ireland) and most countries will be doing this in real terms over the next five years. At the same

time there has been growing concern about the ageing population and the burden of the pension obligations to public sector workers in the future. In the UK it is suggested by the Coalition government that public sector earnings and pensions are both too high relative to the private sector and therefore they both need to be cut in real terms. As any manipulation of public sector compensation (in terms of pay or pensions or other conditions of service) will have immediate consequences for fiscal budgets, workforce composition, delivery of services, inequality and relative remuneration it is necessary to carefully evaluate any proposed changes in any element of the total remuneration package. It is also important to be clear what this calculation tells us about public/private sector relative remuneration as this is a perennial comparison fraught with pitfalls.

There is almost universal agreement that any debate about remuneration should include pay and pensions and all other forms of benefits in kind. There is no agreement on how this should be calculated. Although there has been a lot of work on selected aspects of the value of pensions across sectors (e.g., Disney et al., 2009) there has been relatively little on the evaluation of broader concepts of compensation. Indeed — although the notion of 'Total Compensation' or 'Total Reward' (TR) seems to have become widespread and fashionable in Human Resource Management circles there is no consensus of specifically what TR includes and leaves out. Often (see Greenhill, 1990; Balsam, 2002) 'Total Remuneration' or the 'compensation package' (for executives) is said to include: salary, bonus, stock options, stock grants, pensions and other compensation. This literature tends to exclude: hours of work, holiday entitlements, job security (in terms of the probability of being made unemployed) and does not attempt to enumerate future benefits in present value terms or to adopt a life cycle perspective on this evaluation. These would all seem to be important considerations for an economic evaluation of TR.

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This paper provides a conceptual method for the measurement of TR and proceeds to estimate its structure for the private and public sectors in the UK. For the purposes of this paper we will define TR in a sector for an average career as the total financial benefits and ‘in kind’ compensation, evaluated in money terms over the life cycle. This will include conditions of work and all direct financial remuneration both now and deferred as pension payments in the future. Hence we take into account current earnings, pensions, hours of work, paid holidays, employer provided health insurance, the likelihood of unemployment and the lifetime pattern of pension contributions. We do this by pooling the largest available sources of data on public and private sector employees and examining how they differ, on average, across the life cycle. This means we use all of the following data in our analysis: the Annual Survey of Hours and Earnings (ASHE), the Labour Force Survey (LFS), the English Longitudinal Survey of Ageing (ELSA), and the British Household Panel Survey (BHPS). Each of these data sets provides different data on the various components of pensionable pay. We provide a Data Appendix to this paper which includes a list of all the available data which pertain to our evaluation of TR.

The large literature on the earnings differentials in the public and private sectors (see [Borland and Gregory, 1999](#)) has addressed the issue of self-selection into careers and more recently considered the public-private differences in earnings dynamics ([Postel-Vinay and Turon, 2007](#)) over an employment lifetime. However this literature has completely ignored the value of pensions and the issues of TR over the complete life cycle (including retirement). This omission is very important in the light of the progressive changes in pension arrangements and the mooted reform of public sector pensions.

The logical reasons for being interested in a dynamic model of sector choice are that one would wish to model: the propensity to self-select into either alternative on the basis of some unobservable characteristic (like ability or propensity to take risk), the potential for earnings variance to be different in the two sectors over the working life, and the possibility of modelling sector switching or mobility at different stages in the career. However, the price of solving the full dynamic programming model as in [Postel-Vinay and Turon \(2007\)](#) is that many simplifying assumptions have to be made – most notable of which is that individuals are assumed not to consider the non-pecuniary aspects of jobs like hours of work, the length of holidays and benefits in kind like medical insurance. But most important of all, this model cannot factor in the value of a pension into the employees’ decision. Regrettably, this does not help us address the topical and fundamentally important question of whether public sector pensions are currently too generous. Indeed the only way to consider the whole issue is to develop a concept of TR.

In the light of these considerations this paper proposes a new way forward. We take the group of highly educated who we consider can easily switch between the public and private sectors and so absolve ourselves of the self-selection issue of initial sector choice based on unobservable characteristics. (Our justification is that by restricting ourselves to graduates we can reasonably assume the individuals in our data to have a lower bound on unobserved ability and that risk in earnings profiles between the two sectors is not significantly different – as is borne out by public and private sector earnings variances over the employment lifecycle in Figs. A2 and A3). We also make the assumption that all graduates are risk neutral. Provided we make these limiting assumptions then we can get on and tackle the hugely important question of what TR looks like over the whole lifecycle and address the issue of whether pensions are too generous in the public sector. We can then also examine whether the pattern of switching sectors between the public and private sectors is consistent with what we observe about TR patterns. In other words, we ask whether there is a behavioural response to the inter-sectoral imbalance of lifetime TR in terms of the sector switching decisions that individuals make.

Hence our perspective is the very real one facing governments all over the world – namely are public sector pensions too generous for the current labour force? This is not the same as asking how individuals

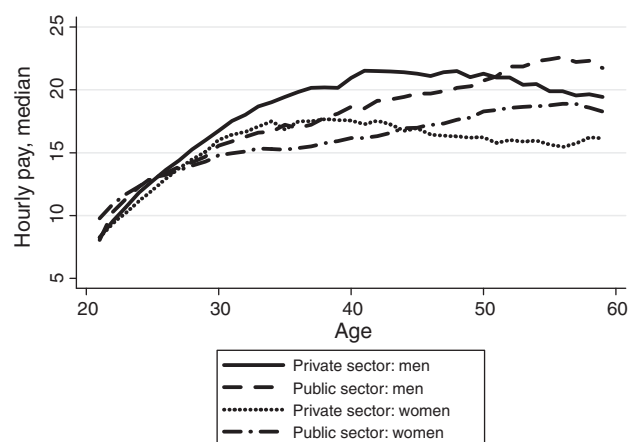


Fig. 1. Age-earnings profiles using semiparametric median quantile regression. Note: Hourly wages are employer reported as actual earnings over actual working hours (including overtime). Real values deflated to 2009 before netting out average annual growth in each sector.

Source: ASHE 1997 to 2009 (ONS), own calculations.

facing occupation choices make their decisions and whether they switch sectors in a dynamically consistent way over their employment lifetime.

The first contribution of this paper is to estimate the level of total compensation of the highly educated in the private and public sectors in the UK. The average earnings profile in the public sector depicted in [Fig. 1](#) starts off at a higher entry level than in the private sector.¹ Later in the life cycle stronger wage growth means that the private sector earnings profile rises above the public profile. While both profiles level off at later ages, the private sector profile even declines below the public profile. This shape of the private and public sector profiles has led researchers to impose a quadratic functional form on age-earnings profiles (cp. [Disney et al., 2009](#)). When performing the analysis on employer-reported earnings (ASHE data), we consistently find inverted u-shaped median age-earnings profiles ([Fig. 1](#); the age-earnings profile using LFS data can be found as [Fig. A1²](#) in the Appendix).³ Basically, the question is whether initially low but steeper private sector earnings profiles produce the same TR as public sector profiles which (on average) start off higher but progress at a slower growth rate? To answer this question we define the concept of Accumulated Lifetime TR (ALTR). Besides earnings and pension accruals, we include four non-wage and non-pension components in the valuation of TR.⁴ So, the

¹ Of course, all calculations behind this figure are in real terms and net of the sector specific growth rate in the economy.

² Median earnings are substantially lower when using LFS rather than ASHE data. While the LFS is increasingly plagued by non-response from high-income earners ([Bell et al., 2006](#)) the ASHE does not sample employees who fall below the NI contribution threshold (low income earners). As we restrict our sample to higher educated individuals, we expect the first source of bias to be stronger than the second one.

³ Two aspects of the age-earnings profiles deserve some closer attention. First, given the potentially larger variation of earnings in the private than in the public sector at each age, it would be useful to know whether the two profiles are really different from each other. In our standard analysis we reduce the problem of establishing comparability from two sample means ([Belman and Heywood, 2004](#)) by using median earnings. To detect whether the mean earnings between sectors are significantly different we construct 95% confidence intervals. While earnings differences are insignificant at the beginning and end of the working career, private sector employees do have an earnings premium at mid age (Figs. A2 and A3). Second, like the previous literature we use cross-sectional earnings data. We are aware of the fact that these profiles might potentially differ from true lifetime profiles for compositional reasons. Especially older workers who were made redundant and find it difficult to enter a new job (for reasonable pay) and who face a relatively short period until reaching the retirement age often enter early retirement ([Chan and Stevens, 2001](#)). Nevertheless, this approach mimics the perspective of the government which aims at keeping average public sector remuneration comparable to the private sector.

⁴ Evidence from the USA suggests that in-kind benefits are more common ([Heywood, 1991](#)) and more generous ([Quinn, 1982](#)) in the public sector.

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