



## **The Tories have one way out of the public sector pay dilemma**

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Last week saw the Prime Minister not merely U-turn on whether to maintain a cap on public sector pay, but then U-turn on the U-turn later in the day.

Theresa May is feeling the pressure from backbench MPs, who feel a perceived lack of goodwill towards public sector workers contributed to the poor election result. Now members of the cabinet have joined in, including Michael Gove and Boris Johnson.

The problem is that the Conservatives' overall fiscal approach since 2010 got them into this mess and provides little room for manoeuvre.

The economic argument for ending the pay freeze is strong. After the financial crisis, private sector wages fell sharply in real terms. According to the Institute for Fiscal Studies, by 2011 public pay had risen to over 18 per cent above private sector pay on average, or six per cent once you control for the demographics of workers and the region in which they work.

But after pay freezes for most public sector workers in 2011 and 2012, and a one per cent annual growth cap since, that gap is now back to pre-crisis levels. Continue to squeeze pay in this environment and the recruitment and quality of public sector workers will suffer. Already there are signs of problems in attracting nurses.

Yet with as many as 5.4m employed by the public sector directly, removing the cap would be expensive. Allowing pay growth in line with the private sector would cost an extra £6.3bn a year by the end of the Parliament, according to the Office for Budget Responsibility.

Public sector pay increases must therefore result in one of either higher taxes, higher borrowing, larger spending cuts on government programmes, or a reduced public sector workforce.

### **The trouble with ringfencing**

The Conservatives should have seen this tough choice coming. You cannot reduce public sector pay in relative terms indefinitely. Daft political commitments to ringfence key departments, including all major spending on pensioners, doesn't help.

The £180bn public sector pay budget is one of the only big ticket items left. With the tax burden already at its highest level in three decades and a structural deficit remaining nine years after the crisis, the options for restraint were limited.

So what should happen now?

Ideally, the way out of this difficulty would be to change priorities and reform. The Conservatives should announce the lifting of the cap but explain that it will be financed by reducing other public spending by an equivalent amount. They should identify specific cuts and explicitly link them in a package, daring the opposition to deny public sector workers a pay rise. To take the political sting out of the new restraint, they should work with the Commons Treasury Committee on a spending review that will identify where the axe would fall with the least economic damage.

Perhaps more importantly for the longer term, they should combine the abolition of the cap with a gradual reform. Specifically, they should phase out national pay bargaining where it remains in the public sector.

Previous research by Allison Wolf has shown the high cost of having national pay scales and bargaining. Poor areas in rich regions with high living costs are hit through worse staff quality and shortages, as wages are too low. Poorer regions are likewise both denied the flexibility to vary salaries significantly to attract talented staff, while more broadly suffer as very high pay relative to the private sector crowds out private sector growth.

### **Follow Sweden**

Sweden shows the solution. There, collective bargaining was entirely replaced by individual contracts between staff and their local public sector employer, with little fuss.

If applied here, managers would then have genuine flexibility in the creation of new posts. It would liberate them to set pay to reflect more accurately local conditions, while varying wages to fulfil difficult positions.

What's more, it would not entail immediate wage changes, but would work over time. The end result would be a pay scheme determined in more market-like conditions.

The unions would of course wail, and some Conservative MPs in poorer areas would get tetchy. But all this would do is allow public sector employers to set pay using the same considerations as the private sector. Given the justification for removing the caps is this very differential, it does not seem controversial to suggest the public sector should be more like the private sector in how wages are set.

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