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.

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.
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 (BHS). 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 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. 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. A1 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
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