SUBMISSION TO THE OFFICE FOR MANPOWER ECONOMICS ON MARKET FACING PAY

Introduction

In the Autumn Statement 2011, the UK Government asked four of the Independent Pay Review Bodies to *"consider how public sector pay can be made more responsive to local labour market conditions".*

In parallel to the 2012 UK Budget, HM Treasury (HMT) published evidence which it considers supports its policy approach.

The Scottish Government does not support the UK Government's proposals on economic, public sector efficiency or equity grounds. We are also unconvinced with regard to the evidence base which has been used to support this proposal.

There are a number of challenges in making relevant comparisons of pay between the private and public sector both in terms of adequately reflecting differences in employee characteristics and job characteristics. Estimates based on the time period since the onset of the recession are also temporarily inflated due to differences in the timing of wage adjustments in the public and private sectors.

In our view, a move toward 'market facing pay' has the potential to be damaging to local economies and could seriously hamper the provision of public services. Furthermore, we remain to be convinced that regional pay awards will in practice lead to savings to the taxpayer or promote growth. Indeed, we would consider that the establishment of regional pay bargaining machinery would be relatively expensive and inefficient compared to other methods.

The Scottish Government is also concerned that such a policy may be used as a vehicle to cut spending in certain parts of the UK with a negative impact on many areas in Scotland. There are already significant variations in pay; data from the Annual Survey of Hours and Earnings finds that the average hourly pay for public sector workers in London is approximately 28% higher than in Scotland. Extending this further would not be economically efficient or assist efforts to promote shared growth across the country. This submission outlines some of the key points that inform the Scottish Government's position. It covers –

- Scottish Government's approach to pay;
- Evidence base for public-private pay differentials; and,
- Implications for economic growth and public services;

Scottish Government Pay Policy

Since 2007, the Scottish Government has taken forward a responsible approach to setting public sector pay. In the face of unprecedented cuts to our Budget, the Scottish Government has balanced difficult decisions on tight pay constraint with the need to sustain employment opportunities across the public sector.

Now, more than ever, we need to spend the resources available in the best possible way, to have the maximum impact on delivering high quality public services for the people of Scotland.

For example, by implementing a freeze of the basic pay for all staff covered by the Scottish Government's pay policy and suspending non-consolidated bonuses we have been able to provide measures to support the lower paid by maintaining our commitment to the Scottish Living Wage and ensuring that any employee earning less than £21,000 receives a pay award of at least £250. As a result we have been able to extend our no Compulsory Redundancy agreement for the 30,000 employees covered by our pay awards and the NHS in Scotland for a further year subject to agreement with the unions about workforce flexibilities.

Evidence base for public-private pay differentials

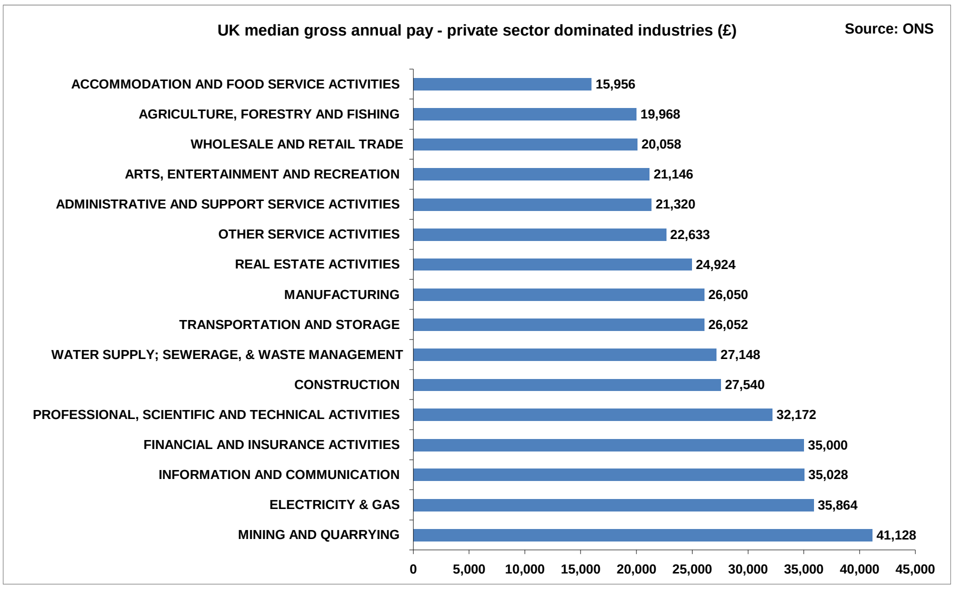
The possible introduction of market-facing pay raises a number of complex issues. The Scottish Government remains to be convinced by the evidence on public-private wage differentials.

Measuring Public-Private Wage Differentials

For example, we are aware of recent estimates – from studies by the Institute of Fiscal Studies (IFS)[1] and the Office of National Statistics (ONS) [2] – that suggest a current public/private sector pay differential of around 8% in the UK.

However, it is important to note that such studies come with a significant number of caveats. In particular, it is widely recognised that there are major methodological challenges in estimating differences in pay between jobs in the public sector and jobs in the private sector. This makes it difficult to ascertain whether there is a "like for like" premium. While attempts are made to account for variations in qualification, skills or occupation, proxies used to account for these differences may not fully reflect variations in roles or responsibilities.

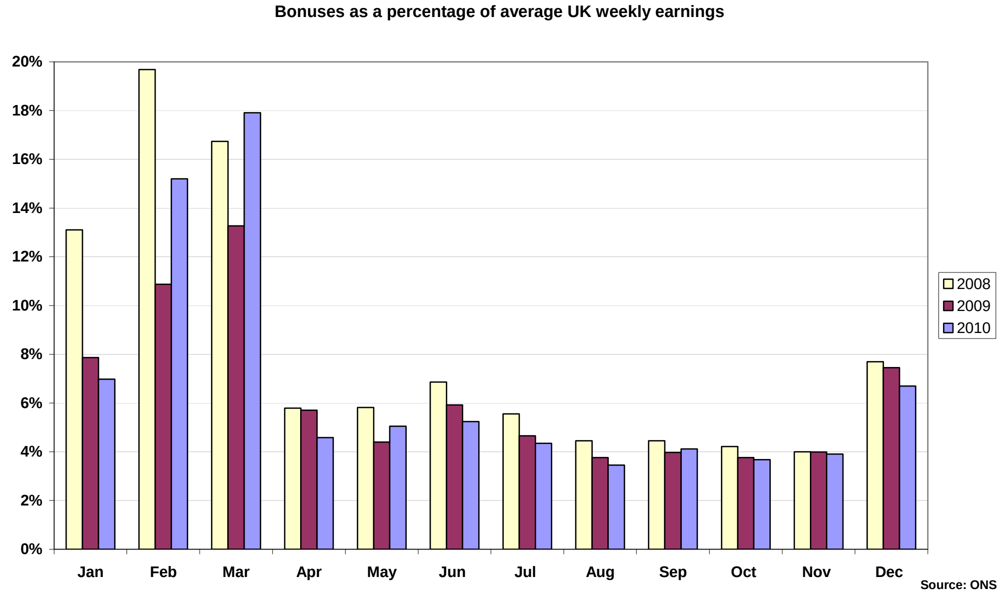
Further, pay patterns across the private sector are not uniform. Overall the distribution of earnings is wider compared to the public sector and there are also differences between sectors (ranging from hotels and retailing to financial services) and between different sized firms.



There are also limitations in the ability to draw conclusions from available pay data. For example, data from the Annual Survey of Hours and Earnings (ASHE) does not include self-employed workers, and the measures of pay do not fully take into account all forms of remuneration and benefit such as bonuses. Bonuses can be a significant element of total remuneration in the private sector however ASHE only captures some component of this.

[1] "The IFS Green Budget: February 2012": - The Institute for Fiscal Studies (2012) http://www.ifs.org.uk/budgets/gb2012/12chap5.pdf
[2] "Estimating Differences in Public and Private Sector Pay – 2012" - The Office for National Statistics (2012) http://www.ons.gov.uk/ons/dcp171776_261716.pdf

In addition the survey takes place in April of each year which is outside the main bonus season. The Monthly Wages and Salaries Survey show that bonus payments in the private sector peak between January and March. For example, bonuses accounted for 15.2% of average UK private sector weekly earnings in February 2010 and 17.9% in March 2010.



Estimates of the pay gap may also be misleading if there are factors that drive differences in labour market participation and/or choice of sector amongst the workforce. One study[3], which attempts to address this, has findings which actually suggest a positive wage differential for males in the private sector in Scotland.

These points demonstrate that care should be exercised when basing any policy conclusions on such studies.

Impact of the recession

It is also important to consider the time period over which any assessment of public and private sector pay is taken. The ONS estimate that the apparent pay premium increased from 3.0% in 2002 to 5.9% at the start of the recession in 2008 before rising further during the recession (due to falling earnings in the private sector). However, the Institute for Fiscal Studies forecast that, as a result of the policies of pay restraint in the public sector, the average public-private pay premium will fall by 4.4 percentage points between 2010-11 and 2014-15 and by 7.8 percentage points by 2016-17.

Estimates of the scale of any “pay gap” are therefore expected to decrease significantly even before any potential impact of the introduction of market facing pay is considered.

The Scottish Government will continue to take forward a realistic approach to public sector pay in this difficult climate whilst ensuring that the lowest paid are best protected. This will be balanced alongside our commitment to deliver high quality public services for the people of Scotland.

[3] A.Heitmuller, “Public-Private Sector Pay Differentials in a Devolved Scotland”, Journal of Applied Economics, Vol. 9, No.2, pp. 295-323, November 2006.

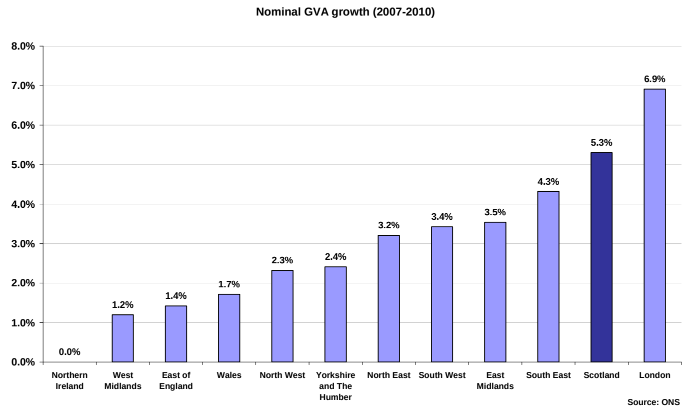
Variations by type of employee

Analysis undertaken by the IFS suggests that females are found to have a higher estimated public/private sector pay differential than males, however one limitation of this study is that it does not control for differences in occupation. For most of the period the IFS found no statistically significant differential for men. The estimated differential is also found to be higher for those at the lowest end of the income distribution.

Any general move towards locally determined pay could therefore have a disproportionate impact upon female workers and those on the lowest incomes.

It should also be noted that public sector pay already differs across the UK. For example, the Annual Survey on Hours and Earnings (ASHE) finds that median hourly public sector pay in London is 28% higher than in Scotland. Many public sector roles (e.g. central department civil servants) are not location dependent. Decentralisation out of London (where a proportionately higher number are based) could, as an alternative to regionalisation of pay, realise cost savings through a reduction in the use of London weighting.

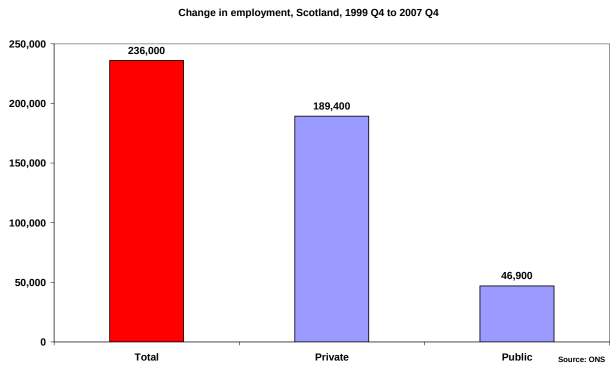
Impact on the Economy



In his letter to the Pay Review Bodies, the Chancellor argued that variation in public-private pay differentials across regions may harm private sector businesses which have to compete with higher wages.

It was also argued that variation in relative pay could lead to unequal quality of services across regions, and result in the public sector paying more than is necessary to recruit, retain and motivate staff.

However, there are a number of weaknesses with this argument. Firstly, there is little supporting evidence that such crowding out of private activity is actually occurring in Scotland. There is no obvious link between output (GVA) growth between 2007 and 2010 and the estimates of the public sector wage premium. Scotland GVA growth has been second highest in the UK, while Scottish employment rates are better than for the UK as a whole.



Since devolution – and up to the start of the recession – the public sector accounted for 19% of total employment growth in Scotland over the period 1999 to 2008 – slightly ***less*** than its pro-rata share. Public sector employment increased by just under 49,000 over the period, whilst private sector employment rose by over 210,000.

Secondly there is little evidence to suggest that crowding-out of the private sector is the key concern in most areas. In reality, growth is driven by a complex set of factors. It is unlikely that that public-private sector pay differentials are the sole barrier to unlocking economic performance.

As pointed out above, if ‘crowding-out’ is the principal concern then moving public sector posts out of relatively ‘tight’ labour markets – such as London – could be more economically efficient as it would save money and encourage growth in other parts of the country.

Thirdly, the biggest barrier to economic growth at the moment is a lack of aggregate demand. Reducing public spending in certain areas will only suppress these local economies even more. The Scottish Government does not consider that a ‘levelling down’ of wages is conducive to either the productiveness of staff or to increasing the current level of economic activity. There is a risk that this could further embed structural weaknesses and decline and lead to population shifts as people pursue more lucrative opportunities. In addition to the negative impact on the economy, this may lead to problems recruiting and retaining staff. Recent work carried out by Incomes Data Services[4] on local pay determination highlights that most large, multi site private sector companies have national pay structures. Complex local approaches can be costly.

Finally, economic theory suggests that workers should be paid their ‘marginal product’ – in effect a wage that reflects their productivity. Alongside this, there is a strong underlying principle of equal pay for equal work that has been broadly maintained in the public sector. If this was to change, it may lead to problems as local areas compete with one another for staff (perhaps even leading to increased costs) and make it more difficult to maintain morale and retain good staff. This may in turn lead to deterioration in the quality of the service provided and spatial inequalities in service provision.

Conclusion

The Scottish Government does not support proposals for market facing pay and has no intention of implementing such a policy in Scotland. However, the proposal has the potential to impact upon some 30,000 UK Government staff working in Scotland.

As outlined in this submission, there are serious methodological challenges in estimating differentials between public and private sector pay. Moreover, the public sector pay freeze is already set to reduce measures of the apparent pay gap while public sector workers are also facing significant cost pressures such as increased pension contributions.

The Scottish Government does not accept the economic or public service efficiency arguments put forward by the UK Government. In reality, we do not consider there to be evidence that crowding-out of the private sector is the key concern in most areas; rather it is often a lack of overall aggregate demand in the local economy.

Reducing public spending in certain areas will only suppress local economies even more and perhaps further embed structural weaknesses. Reducing relative wages in certain areas will make it more difficult to attract and retain high quality staff. With the UK now in a double dip recession, focus instead needs to be on genuine and productive measures to boost investment and growth in the economy.

Scottish Government

May 2012

[4] “Growing number of myths about local pay determination”, IDS, 17 January 2012 http://idseye.com/2012/01/17/growing-number-of-myths-about-local-pay-determination/