

CBI response to Office of Manpower Economics call for evidence on market-facing pay in local areas

1. Levels of pay vary widely across different parts of the UK¹ – as does the cost of living. To be both fair and efficient, public sector remuneration should be responsive to local labour market conditions and able to pay differently in different areas according to need. To fully realise the benefits of truly efficient local labour markets all public sector bodies should look to make their pay structures genuinely market-facing.

 2. A transition from national to genuinely localised pay bargaining will be a gradual process. Local pay setting is vital to both long-term regional economic development and effective public service reform, but the case for it is not about deficit reduction. This measure is necessary for long-term economic rebalancing and taxpayer value, rather than to generate immediate cost savings. Addressing public sector pay premiums² benefits both public and private sectors and promotes jobs and growth. Efficient - and that means local, responsive and flexible - labour markets will help both the public and private sectors become more productive, effective and efficient and help best target reward to where it is needed.
- **Local labour markets work – the public sector should make use of them to allocate public spending efficiently and improve the quality of public services**
 - **Market-facing public sector pay creates the level-playing field needed to help serve private sector growth, while nationally bargained public sector pay can crowd out the private sector.**

Public-private wage differentials²

- Across the UK average hourly wages in the public sector are 24.3 per cent higher than those found in the private sector.
- When differences in age, experience and qualifications are controlled for, the public sector wage premium – the additional pay received by a person for working in the public rather than private sector – is 8.3 per cent.
- On average, public sector workers accrue pensions that are hugely more valuable than those found in the private sector and will continue to do so, even after the Hutton reforms. A ‘total reward’ approach which accounts for this value should be factored into considerations of public sector wages.

Region	Estimated differential	
	Men	Women
All UK	+4.6	+10.2
Wales	+18.0	+18.5
Northern Ireland	+15.5	+10.0
East	+12.2	+14.0
Yorkshire and the Humber	+10.5	+16.1
South West	+7.5	+13.3
West Midlands	+7.1	+15.2
East Midlands	+7.1	+15.7
Scotland	+5.6	+19.9
London	+4.7	+4.7
North	+4.6	+18.3
North West	+4.1	+10.2
South East	-1.4	+2.3

¹ Median gross hourly pay, work based travel to work area, ONS ASHE, 2011

² IFS – “Green budget 2012”



Local labour markets work – the public sector should make use of them

1. The recent recession showed the flexible and efficient labour market in action. One of the most striking features of the downturn was that unemployment did not rise as steeply as previous experience would have led us to expect. A major reason for this change is that businesses and employees cooperated to find ways to reduce costs and retain jobs and skills – with pay restraint, reduced overtime and flexible working all playing a part.³ Such flexibility requires pay and conditions to be managed at a local level. Public sector employers have not been similarly responsive because they lack the tools. During the recession the public sector was insulated from the effects of adjustment to economic changes, and pay decoupled from labour markets. Now a public spending squeeze is in place, public sector employers do not have the ability to cope in the way private sector firms did because they do not ‘own’ the pay and conditions of their staff.
2. During the recession, average pay growth in the private sector slowed to almost zero, only slowly recovered, and is now standing at around two per cent.⁴ Public sector pay continued to grow through the recession at pre-recession rates⁵ and, although most public sector workers are now facing a basic pay award freeze, the data suggests annual total public sector pay continues to grow – averaging one and a half per cent.⁶ As a result the public sector pay freeze which came into force in 2011 has not reduced the public sector pay premium substantially yet.⁷ In truth, the full two years of pay freeze and two years of pay restraint that have been announced will be required just to eliminate the increase in the pay differential that has grown since 2007-08.⁸
3. Little of this has anything to do with the labour market. General freezes are blunt tools which may have positive overall effects but significant negative effects for certain roles. The same can be true for general rises. National wage bargaining prevents the kind of responsiveness and flexible use of resources that worked for the private sector during the recession – and preserved jobs and skills – from taking place in the public sector, as individual employers are prevented from implementing local changes. At a time when budgets are increasingly devolved to the local level it seems perverse that control over the biggest element of a budget – pay – is not similarly devolved.
4. The substantial changes in the relationship between employers and employees that have taken place in the private sector in the last two decades are manifested in a more flexible individual package of work and reward in the private sector.⁹ Rigid pay structures are incompatible with the modern employment relationship – it remains the case that in many parts of the public sector pay structures remain inflexible, leaving pay largely dependent on factors such as grade and length of service rather than performance. Harnessing the benefits of an individualised employment relationship – employee engagement, choice and flexibility - benefits both employers and employees, and helps the UK best compete in the global economy. But these benefits are lost when national pay structures prevent individual agreements at a local level. Since the early 1990s Sweden has decentralised public sector pay, operating without national determinations of individuals’ wages, allowing for managers to be genuinely flexible in creating posts and roles and allowing wages to reflect local circumstances and

³ CBI/Hays – “Thinking positive: the 21st century employment relationship”

⁴ ONS – Labour market statistics: March 2012

⁵ IFS – “Green budget 2012”

⁶ OBR – “Economic and fiscal outlook”

⁷ Policy Exchange – “Further analysis on the public sector pay premium”

⁸ OBR – “Economic and fiscal outlook”

⁹ CBI/Hays – “Thinking positive: the 21st century employment relationship”

priorities.¹⁰ Although local pay negotiations involve some trade-off in terms of administration, expense and time taken to negotiate at an individual level, these costs have been more than offset by benefits of allowing local managers to decide what is most efficient and effective.

5. A move to responsive, market-facing public sector pay will create a more efficient, effective and responsive public sector where making the most appropriate decisions on pay at a local level is not hindered by rigid and old fashioned national pay bargaining structures. More flexible and localised pay offers significant benefits for the public sector – as a tool for performance management, reward and retention, to reduce deadweight costs and allowing for more efficient public spending, and improving public service delivery in those areas where there public sector is not currently competitive.

Utilising market-facing pay helps to allocate public spending efficiently...

6. In a competitive labour market pay should largely be a function of supply and demand, with pay structures responsive to the relevant labour markets in which they operate. To reflect local markets private sector employers might look to variables such as local pay rates, local levels of unemployment, employee turnover, response rates to advertised jobs, number of local competitors, premiums to attract people to a less convenient or attractive location and so on – with this data collected from various sources. Such data allows employers to establish efficient market-facing pay structures which meet their needs with regards to recruitment, retention and employee motivation.
7. Where there are national pay structures in place the public sector instead imposes a one-size-fits-all pay policy regardless of local labour market pressures. As a result the public sector faces deadweight costs from paying high cost public sector salaries in low pay areas, while simultaneously facing recruitment and retention challenges in areas where pay rates are not competitive. These costs also illustrate why, to be truly responsive, reforms should allow for genuinely local deals, as opposed to regionally set structures which will continue to impose barriers in some local labour markets.
8. Bargaining must be local, not regional or national, as differences in earnings are more often found within regions than between them. To minimise inefficiencies pay should be devolved to the lowest possible level – the employer. In the highest paying area of Scotland, for example, median gross hourly pay is 70 per cent higher than in the lowest paying area, while in Wales this figure is 44 per cent.¹¹ So although the average public-private wage differential across Wales is 18 per cent for men and 18.5 per cent for women these figures hide further differences at local levels.
9. Freedom to set pay rates at a genuinely local level is also necessary to truly allow public sector pay structures to respond to fluctuating patterns of recruitment and retention flows. For example, supply-side crowding out effects will vary according to the relative size of the public sector across localities. The ratio of private to public sector employment varies from a high 4.6 in Swindon to lows of 0.9 in Oxford, 1.4 in Dundee and 1.5 in Hastings and Swansea.¹² And although cities might face labour markets more similar to one another than to the outlying areas surrounding them, the urban areas that experience particularly high rates of unemployment are generally those with ‘post-industrial’ economies. Such differences mean that while unemployment is high in Glasgow it is low in Edinburgh,¹³ with each city facing a very different labour market and levels of pay, but neither is without success and challenges – they are just different ones.

¹⁰ Alison Wolf, CentreForum – “More than we bargained for: the social and economic costs of national wage bargaining”

¹¹ Median gross hourly pay, work based travel to work area: Edinburgh - £12.67, Newton Stewart and Wigtown - £7.44; Chester & Flint - £11.15, Newtown & Welshpool - £7.73. ONS ASHE, 2011

¹² Centre for Cities - Cities Outlook – Ratio private to public sector employment

¹³ CBI – “Mapping the route to growth - rebalancing employment”

10. Where public sector pay is not allowed to fall to its optimum level due to nationally set pay rates public money is not allocated effectively and the economy suffers a deadweight loss. These damages are manifested in both those areas where local market-facing pay is higher and lower than pay levels in the public sector. Moving away from a one-size-fits-all approach will reduce the deadweight costs of unnecessarily high cost public sector pay.

...and improves the quality of public services

11. By reducing deadweight losses, locally-allocated pay rates can increase the affordability of public sector provision – allowing for the remaining budget to be more effectively allocated to more efficient or productive public spending, preserving or increasing public sector jobs at no additional paybill cost, or generating savings. Conversely where public sector pay rates are not attractive in comparison with those offered in the private sector it is more difficult to attract and retain high quality public sector workers. For example teacher vacancy rates in and around London are far higher than those found elsewhere across the UK.¹⁴ These challenges can directly translate into damaging impacts on public service delivery. Research has found that in those areas where private sector wages were high there were associated recruitment problems leading to lower quality and productivity, and higher death rates in hospitals.¹⁵ Public services should not have to face these artificial barriers to improving services and outcomes because of inflexible, national agreements and restrictions.

12. Standardised rates of pay also prevent higher levels of compensation to incentivise people to work in particularly challenging areas. Public bodies should be free to target pay awards to where they are most needed to address particular problems or issues. For example rural areas may have recruitment difficulties – so whilst there is little variation in pay levels of pharmacists throughout the UK premiums are often paid in isolated areas such as the South West of England which have low earning levels and insufficient numbers of qualified candidates.¹⁶ Challenging roles may also need to offer a premium to attract staff. Schools in deprived neighbourhoods, for example, struggle to recruit the staff they need. Research has found that schools that educated the poorest children received almost thirty per cent more funding per pupil than the tenth of schools with the most affluent intake. But average teachers' pay at the most challenging schools was less than two per cent higher than at the schools with the wealthiest pupils, and teacher-pupil ratios were almost identical.¹⁷ Targeted and flexible pay rewards performance, promotes competition, and allows poorly performing services or difficult to recruit locations or fields to attract better workers to improve public service outcomes.

Local pay creates the level-playing field needed to help serve private sector to growth...

13. As well as reforming the public sector the introduction of market-facing pay will assist the private sector in the challenge of rebalancing the economy and offsetting the decline in public sector jobs and investment. Genuinely competitive and local labour markets best allocate resources, achieve fairness between the public and private sectors and encourage growth, job creation and prosperity.

14. Business investment is needed to offset declining government spending, and regions must be able to utilise their comparative advantages in order to attract this investment. Over recent years investment growth has been dominated by the government – with government investment growing at more than twice the rate of business investment between 1990 and 2010. This trend was always unsustainable

¹⁴ Office of Manpower Economics – “Local pay differences and vacancy rates for school teachers in England and Wales: Regional Differences in teachers’ rates of pay and teacher vacancy rates”

¹⁵ Centre for Economic Performance Discussion Paper No 843, January 2008. “Can Pay Regulation Kill? Panel Data Evidence on the Effect of Labour Markets on Hospital Performance”

¹⁶ IDS Pay report 1066 , February 2011

¹⁷ Chris Cook – Financial Times – “Deprived schools lose out in teacher quest”

and is set to reverse – the Office for Budget Responsibility forecasts that government investment will decline by 16% between 2009 and 2015 in real terms – a compound annual growth rate of -3.4%.¹⁸ The government is clear that supporting private sector growth is at the heart of its economic and growth strategies and that strong, sustainable and balanced growth must be more evenly shared across the country. Successful rebalancing of the economy must go hand in hand with rebalancing the UK labour market to avoid perpetuating long-standing problems of pockets of high long-term unemployment and inactivity, often in areas which suffer from multiple disadvantages. Future trends in the job market risk exacerbating current divisions, with increasing numbers of higher skill jobs in London and the south east, with other parts of the UK facing the challenge of high concentrations of low skilled jobs, large numbers of people with low-level skills and poor school attainment, and social deprivation.¹⁹ Only by firing up the private sector in regions which have had large public sector workforces and high unemployment can we resolve this issue.

...while nationally bargained public sector pay can crowd out the private sector

15. The goal of hiring in the private sector is hobbled by the public sector pay premium. National pay scales undermine the less affluent regions' major competitive advantage of lower wages.²⁰ Lower costs – in the form of lower commercial rents, lower house prices and, most importantly, lower wages and more available people to hire – are the only major source of competitive advantage for economically depressed areas. The public sector fails to utilise these benefits itself by relocating nationwide services to those areas which are able to compete on cost. But it also prevents the private sector from fully utilising these comparative advantages by essentially establishing a pay floor at public sector rates for the wages a private sector employer can offer to compete for the best staff in less economically successful areas.

16. To attract comparable quality staff, the private sector must then pay competitive salaries to those bargained nationally in the public sector. Where public sector salaries are higher than the efficient market-facing pay levels of local labour markets the private sector is crowded out and cannot compete. With, for example, men facing a public sector pay premium of over 7% in more than half the UK regions²¹, private sector employers face this elevated competition and must factor in this significant pay premium to compete for high quality staff. This impact exists across the wage distribution and for both roles where transferable jobs exist across both sectors – for examples lawyers or administrators – but also where pay differentials shape workers incentives, aspirations and longer-term career choices. Areas and communities that are currently dependent on the public sector must make the transition to private sector-led growth and prosperity. To do this, private sector work must be allowed to make itself an attractive employer through facing fair competition from public sector employers who pay market-facing rates.

Employment and Skills Directorate

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¹⁸ CBI – “A vision for rebalancing the economy – A new approach to growth”

¹⁹ CBI – “Mapping the route to growth - rebalancing employment”

²⁰ Alison Wolf, CentreForum – “More than we bargained for: the social and economic costs of national wage bargaining”

²¹ IFS “Green budget 2012” – Male public sector pay premium: Wales – 18%, Northern Ireland – 15.5%, East – 12.2%, Yorkshire and the Humber – 10.5%, South West – 7.5%, West Midlands – 7.1%, East Midlands – 7.1%, Scotland – 5.6%, London – 4.7%, North – 4.6%, North West – 4.1%, South East – -1.4%.