Local Pay, Local Growth

Reforming pay setting in the public sector

Ed Holmes and Matthew Oakley

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Executive Summary

Public servants in the UK play a vital and valued role in delivering public services. Their jobs are varied and can be challenging, dangerous or require leadership of thousands of staff. In return it is right that we reward public sector staff for the contribution they make.

It is also clear both that, as a country, we are expecting more and more of our public services and that public services play a hugely important role in many local economies. In the context of limited public finances, this makes it essential that we make the most out of the funds that are available. We must ensure that the quality of public services and local growth opportunities are maximised.

The prominence of public servants in front line delivery means that the way we structure their reward is a key driver of the extent to which overall public services are delivered effectively and efficiently. Overall this means that pay, conditions and the wider benefits offered to public sector workers should reflect the value that they add to our lives; promote productivity growth; drive improvements in public services; and provide fairness for the UK taxpayer who, ultimately, both consumes and pays for the public services that public sector workers provide.

However, despite the fact that well over half the public money spent on schools, hospitals and the police is spent on remuneration – accounting for £180 billion (12.3% of GDP) across the public sector – the current system of reward for public servants falls well short of this ambition. This report outlines proposals to make the system of public sector pay fairer for vital public servants and for the taxpayer and how to use public sector pay reform to drive local growth in the parts of the UK that need it most.

How public wages are currently set

In principle, the system of pay setting in the public sector is quite diverse: a complex mix of national, sectoral, organisational, regional, local and individual pay created due to a combination of historic, political and economic factors. However, in practice, with the exception of regional weighting in London and the South-East, the propensity towards national, collectively bargained pay settlements continues to dominate.

Proponents of the current system argue that flexibilities already exist, but in practice these are rarely used. For instance, 65% of Academy Schools with flexibility to vary pay and conditions for teachers do not do so. Despite their desire for financial autonomy, the evidence suggests they feel unwilling to vary pay because of the pressures of the national pay bargaining system and trade unions. Over half of head teachers feel that current flexibilities are not sufficient to cater for the need to reward high performing teachers.

This means that, across much of the public sector, salaries are determined by nationally-set pay bands. In turn, this results in an extremely limited degree of differentiation according to the regional cost of living (outside of London), incomes, the local rate of unemployment and employee performance.

How this compares to the private sector

Trade union representatives and a number of commentators have suggested that this situation is similar to that in the private sector in the UK. However, by conducting interviews with human resources professionals across the UK's private sector we have found that, in fact, this situation is in stark contrast to arrangements in the UK's private sector.

We found that it is true that large multi-site organisations rarely have individual pay negotiation between employee and employer. However, the reward systems in larger firms aim to drive productivity by:

- Rewarding performance by linking pay increases to performance reviews, rather than length of service;
- Using Zonal pay systems to account for different costs of living in different parts of the country. These systems are often market-informed and incorporate factors such as commuting distances, economic indicators, attrition rates and benchmarking, combined with affordability; and
- Offering managers flexibility to meet local labour market conditions while not over-burdening them with negotiations and bureaucracy.

This means that, while negotiation might not be individual, rates of pay and pay progression tend to vary between individuals and between different parts of the UK. This is in stark contrast to the public sector where pay is set nationally and progression is linked to length of service and is semi-automatic. It is also a fact that around half of UK employment is in firms with less than 50 employees. For these employees, negotiation over pay will be local by default.

Within this context it is unsurprising that recent academic studies have found that the responsiveness of public sector labour markets to differences in costs and amenities is as low as 40% of that in the private sector.

How this compares to other countries

The situation in the UK's public sector is also different to that of the public sector in other countries. In fact, some countries have systems of pay negotiation that are extraordinarily different from those in the UK public sector. Many take on significant portions of the best-practice elements of remuneration policy that we highlighted exist in the private sector.

In Singapore pay is determined by a combination of ability, skills and experience, the demands of the job and prevailing labour market conditions, determined by a peg to the private sector established in the early 1990s. Wages are paid with fixed and variable components, allowing flexibility according to performance and labour market conditions. Contracts are flexible allowing underperforming employees to be dismissed.

Another country that is often highlighted as having a good example of an efficient and effective system of pay negotiation is Sweden. A number of previous reports have praised the reforms undertaken in the public sector in Sweden. These reforms took Sweden from a very centralised system of pay negotiation to one much more based on local negotiation and performance. They have been achieved with support from trade unions, workers and the government.

For this reason, our research for this report included field work in Sweden to assess their systems of public and private pay negotiation. Our visit included extensive consultations with leading economists, mediation experts and policy advisers.

We found that:

- The Swedish system is widely supported and responsive to local labour markets, performance and public service requirements;
- The structure and level of remuneration are largely comparable between the public and private sectors;
- The most differentiation and most highly individualised forms of pay setting exist in the public sector, driven by trade union desire to increase pay and a clear link between this and driving innovation and productivity; and
- Trade unions act as constructive social partners.

Overall, since Sweden has undertaken reforms taking it from a largely national pay framework similar to the UK's to this more local system, it is a useful framework for UK policymakers in creating a policy architecture to push to the UK public sector's practices in a similar direction.

What are the impacts of the UK's current system

The most commonly highlighted impact of the system of national pay bargaining in the public sector in the UK is that it creates potentially large pay differentials between the public sector and equivalent workers in the private sector. Our previous reports have highlighted that, for the typical median worker, an hourly pay gap exists between the public and private sector. The most recent data suggests that this means that the median worker in the public sector earns around 7% an hour more than the equivalent worker in the private sector. When adding in even a conservative estimate of the value of public sector pensions, this average would rise to nearly 14%.

However, these figures also hide significant variation across the country, between males and females and for workers earning different levels of wages. The analysis in this report and the Working Paper published alongside it supports the existing evidence that shows that these differentials vary dramatically both across the country and across the wage distribution. The differential for the average male public sector employee ranges between a 5.66% penalty in the South East and an 8.89% premium in Wales. For females, the differentials range from equal pay in the South East to over a 14% premium in Strathclyde and Wales.

We also show that pay differentials vary dramatically within regions. For example, while the overall London differential for the average male stands at 0.39% penalty (in effect, zero) the equivalent figure for Croydon is a 12.39% premium, whereas in Islington it is a 20.69% penalty. Similarly, if we look at females towards the top of the wage distribution, the differential in the North East stands at a 6.17% premium. However, in Middlesbrough the premium is 9.14% whereas in Stockton-on-Tees it stands at only 0.45%.

On their own, these differentials say very little except that it could be perceived as unfair that some parts of the public sector are paid more than their private sector counterparts. However, there are real problems that arise from the presence of these differentials:

- They are unfair to public sector workers, because their pay does not deliver the same living standards for the same jobs across the country. For instance nurses and teachers in high cost areas will not be able to afford the same standards of housing, childcare or even social activities as those living in relatively cheap areas, since their pay does not vary to reflect these differences in costs. For example, a typical family's cost of living is 12.6% higher in the South West than the North East, or 13.5% higher than in Wales – a distinction which is not reflected in a national pay bargaining structure.
- They damage public services because the public sector can struggle to recruit and retain the right staff in high cost areas or areas with significant disadvantages. The implications of this should not be underestimated: recent reports have shown that this can lead to high death rates in hospitals and schools in deprived neighbourhoods struggling to recruit staff, damaging educational outcomes.
- They damage local growth because regional redistribution through national pay bargaining is not the best use of public money. We estimate that the current value of the fiscal transfer to low-cost areas is at least £6.3 billion a year when both wages and pensions are considered. While we strongly support the principle that the government has a role in making fiscal transfers between relatively rich and relatively poor areas, we also believe that this money would be better spent on investment to boost local growth and jobs. This is a point also made by the IMF who have commented that in the case of the UK: '*Fiscal space for further growth-enhancing measures could be generated by… restraint of public employee compensation growth, and… used to fund higher infrastructure spending, which has a high multiplier and raises potential output.*'

More generally the system of national pay bargaining and lack of performance related pay also damages public services since it does not incentivise productivity increases. Productivity in the public sector has been, at best, flat for the last decade, but public servants often progress up pay spines regardless of performance. In short, any link between performance and pay has been all but severed and this can be linked to poor productivity.

Principles of pay reform

To tackle these issues, the Chancellor has asked the Pay Review Bodies, in charge of making recommendations on public sector pay, to consider how to make the system 'more market facing in local areas.' It seems from the evidence provided by the Treasury and public discourse, that the government is attracted to a system of pay negotiation in the public sector based on a nationally-negotiated zonal system. While this might tackle differences in living costs between relatively broad geographic areas, it would do little to tackle: differences in living costs within areas; problems with recruitment in deprived areas; or low productivity growth in the public sector. The policy would also be likely to redistribute public finances from low cost areas towards relatively high cost areas. This would be likely to damage growth and exacerbate regional inequalities. For these reasons, we believe that a change in emphasis is needed. In particular, we believe that pay reform should:

- Enhance the quality of public services by easing recruitment and retention problems, particularly in deprived areas;
- Enhance the quality of public services by boosting productivity by rewarding performance;
- Provide fairness for public and private sector workers by tackling public-private pay differentials over time;
- Ensure that money is not transferred from relatively poor areas to relatively rich areas; and
- Be a tool for driving local growth, particularly in areas currently dominated by public sector employment.

Long-term policy reforms needed

In the long-term, we believe a fundamentally different system of pay negotiation is needed in the public sector. Overall we believe that, to ensure efficiency and to target growth across all parts of the UK, reward packages across the public sector should become more closely aligned to those which are present in equivalent roles in the private sector.

We propose that:

- The system of pay negotiation in the public sector should be localist by default: the government should require all public sector employers to adopt systems of pay that reflect local labour market conditions and vary pay awards by performance of employees;

However, given the very diverse nature of public sector workforces and the evidence we have gathered from the UK's private sector and from abroad, this would not necessarily mean that all pay negotiations would happen at the employee-employer level.

- We believe that, as happens in Sweden, public sector employers should be able to choose the level at which their negotiations take place. For some this would mean negotiations between employees and employers while for others negotiations might take place at the workforce, Local Authority or even national level. The only requirement would be that they reflect local markets and are based on performance.

This increased responsibility for public sector employers will be difficult given the fact that existing data does not allow easy comparison of public and private sector. This means that:

- The government should consult on how to best measure the total reward packages of public sector employees and publish data that allows comparisons between the public sector and private sector. As a priority, the value that public sector pensions add to individual reward packages in the public sector should be analysed and published.

On an ongoing basis, we also believe that:

- The remit of the Pay Review Bodies should be amended so that it includes publishing analysis of the differentials in pay that might be expected in different parts of the country based on local labour markets and living costs, drawing on expertise from the Office of Manpower Economics and Office for National Statistics. As an interim measure, this may also include outlining suggested zonal pay differentials.

To also ensure that the system of pay in the public sector drives productivity and performance increases:

- The remits of each Pay Review Body should also include the requirement to make recommendations for how performance should be benchmarked within organisations. This might take the form of several off-the-shelf performance management/reward frameworks, which organisations could choose to use in order to meet their workforce needs.

This means that for a large portion of public sector employees, individual pay awards might be negotiated under a framework agreed between social partners (government, employers and trade unions) at a workplace, sectoral or national level depending on the nature of the workforce. This would result in a system of individual pay but not necessarily individual negotiation.

This is truly a localist policy: giving local public sector employers complete autonomy in determining the structures of pay negotiation that they believe will suit their organisations. We believe that over time, best practice will be spread across the public service and local managers will be able to pick and choose elements of the national, sectoral and local frameworks that suit their needs most effectively.

An immediate problem is that this system may loosen central government control over the public sector wage bill. For this reason, any reforms must deliver both budgetary control for the Treasury and pay flexibility for local organisations. Designing a new budgetary framework for the public sector is beyond the scope of this report, so for this reason we recommend that:

- A consultation exercise should be undertaken to design a framework and method of implementation to allow pay bill envelopes for public sector organisations at an appropriate level to be set, such that they act as a constraint on upward pay pressures and reflect equivalent costs of private sector organisations.

Short-term reforms: performance related pay

The reforms outlined above are our view of how the system of pay bargaining in the public sector should look in the future. However it is clear that, as was the case in Sweden, it will take a number of years to move to this system. As we highlighted, new budgetary frameworks are likely to be required and expertise and managerial experience will need to be developed in various parts of the public sector where it does not necessarily currently exist. As we have highlighted, where pay flexibilities do exist, they are rarely used. For these reasons, we believe it is necessary to create a more rigorous performance related pay framework for the short-term in order to catalyse a cultural shift in thinking about linking performance to pay in the longer-term.

The first problem is that within the context of current reforms in the public sector and, in particular, the announced 1% cap on pay-scale uplifts, there is relatively little room for manoeuvre in order to create differentials in pay awards in the public sector in different parts of the country. To create flexibility, we recommend that:

- A permanent nominal freeze on generalised annual pay scale uplifts should be introduced for the period of the Spending Review (up to 2015/16); and
- Automatic pay progression points should be abolished.

The introduction of these policies would provide the flexibility we need to change reward structures since on their own, they provide significant pay bill savings compared to the assumed 1% uplift in pay scales. However, we do not envisage this being a cost-saving measure. Instead:

- A system of performance related pay increases should be introduced across the public sector. From 2013/14, a temporary bell curve appraisal system (or forced ranking system) should be mandated across the public sector where this is contractually possible and alternative individual negotiation or performance-related pay systems are not already functioning.
- This would be funded through savings from pay scale freezes and the ending of automatic progression points. Any further savings should be ring-fenced for local spending on growth-enhancing investment.

These policies will allow greater differentiation in pay awards across different local areas and between individual employees with different levels of performance in the short term before more discrete means of performance related pay can be established in the longer term. In essence it is freeing up money to start a process of individualisation, without changing the total amount which is spent on public sector pay.

Short-term reforms: reflecting local labour markets

While introducing performance related pay should improve the quality of performance of public sector employees and the quality of public services, it will do little to tackle the differences in living standards for public sector employees across the country or the differentials that exist between the public and private sectors.

We believe this could be achieved through an existing system of budgetary adjustments for labour market costs for public sector organisations. Essentially, this system of Labour Cost Adjustment (LCA) factors increases budgets where labour costs are judged to be more expensive. However, the system is not currently reflected in rates of pay because of national pay bargaining. Areas with average costs are given a value of 1, while expensive areas are given a value of over 1 and low cost areas a value of less than 1.

This suggests a ready-made way in which pay bill allocations could be adjusted in the short-term. We recommend that this happens as follows:

- Where they do not already exist, the Pay Review Bodies should be required to create LCA factors for their respective workforces. These should build on existing best practices.
- In areas where the LCA is equal to or above one, the pay bill impacts of the 1% pay scale uplift should be estimated for individual public sector organisations and ring-fenced for performance-related pay (PRP) budgets.
- Where the LCA factor is less than one, the pay bill impacts of the 1% pay scale uplift should be estimated for individual public sector organisations. Half of this should be ring-fenced for PRP budgets. This means that those areas with low labour costs would see a lower PRP budget. This policy should remain in place until public sector pay in these areas is at the level considered appropriate based on LCA factors.

An immediate criticism is that this policy appears to suck money out of areas where the LCA is low. To make sure that this is not the case and that the policy does not add to regional disparities, the following should apply to the overall budgets in each area:

- In areas where the PRP budgets are reduced to reflect low LCAs, total public spending for the area should stay the same, and the amount of money saved through lower PRP budgets should be ring-fenced for expenditure in the same areas in order to stimulate local growth in a more effective way than through pay premia. Possibilities for expenditure include spending more on local infrastructure and regional growth initiatives or job creation schemes.

Impacts of reform

These policies will:

- Provide fairness to public sector workers by ensuring that public sector pay begins to reflect the differences in living costs across the country. It is right that a nurse or teacher in one part of the country should be able to enjoy the same standard of living as their colleagues is other parts of the country;
- Provide a vital boost to public services by allowing local public sector employers to flex their reward strategies in a way that allows them to recruit and retain the quality of staff that they need;
- Provide productivity improvements in the public sector by ensuring that pay is matched to performance;
- Ensure that these improvements in fairness and performance are achieved without creating fiscal transfers between different parts of the UK. These policies will not take money out of areas dominated by public sector employment.

As well as these overall benefits, the policies stand to make significant contribution to jobs and growth in local areas. In the short-term, in an illustrative low-cost area with an LCA factor of 0.97 and expenditure of £1 billion on public sector employment, based on evidence from the Regional Growth Fund we would expect that the reforms above could create at least 450 jobs each year. Replicated across the country and in each year, this would be a large boost to employment.

The longer-term impacts could be particularly large. By freeing up and reinvesting an estimated £6.3 billion of redistribution, our reforms could be used to create at least 288,000 jobs – the equivalent of just under a fifth of the number of people claiming unemployment benefit in the UK, and much more for some regions.

Other reforms needed

There is no doubt that these proposals will meet with fierce opposition from vested interests within the public sector and, in particular, from the trade unions. However, any reform that moved the public sector towards localised public sector pay would provide an opportunity for trade unions in the UK to modernise and become a productive and effective partner in the UK labour market. As we have seen in the case of Sweden, it is far from the case that high levels of unionisation necessarily mean that local pay bargaining is impossible. In fact, trade unions in Sweden tend to argue for local managers to have a bigger mandate to negotiate rather than less.

We hope that unions in the UK will take the opportunity to engage constructively in these decisions and reforms. A failure to do so will lead to higher than needed unemployment, a reduction in public service quality due to higher turnover, lower morale and retention rates, and severe underpay in some of the parts of the public sector where we vitally need highly skilled public sector workers.

A more collaborative approach will lead to more jobs, more growth and better public services. To ensure that such an approach is possible, wider reforms will be needed to the institutions involved in the current processes of pay negotiation. In particular:

- To ensure buy-in to the process, each Pay Review Body should have a permanent trade union representative as a member.
- The structure, size and membership of both the Pay Review Bodies and the OME should be consulted upon. In particular, we believe that the tripartite set up of the Low Pay Commission, where trade unions, employers and experts all have a role, should be considered for the Pay Review Bodies.
- An essential part of the implementation of a more localised system of pay negotiation must include mandating that industrial action ballots should be held for each legal public sector employer by amending TULR(C)A section 228A.

Local Pay, Local Growth

The current system of national pay bargaining across large swathes of the public sector is bad for the economy and bad for living standards. It is not a system that encourages productivity and it creates differentials in pay between private and public sector workers that lead to shortages of vital public sector workers in some areas. Both of these factors mean that the quality of public services is lower than it should be. In addition, the hard work and dedication of public sector workers is not rewarded or recognised adequately. The case for reform is clear.

The benefits of reform are also clear: increased growth across the country and more jobs in the areas that are currently most reliant on the public sector. The Coalition will face significant opposition to these reforms. But grasping the nettle now will deliver growth, jobs, fairness and ultimately better public services for us all.

Introduction

Public servants in the UK play a vital and valued role in delivering public services. Their jobs are varied and can be challenging, dangerous or require leadership of thousands of staff. In return it is right that we reward public sector staff for their efforts. Just as happens in the private sector, we should expect that pay, conditions and benefits reflect the value that they add to our lives. However, we should also expect the system that sets pay, conditions and benefits to drive improvements in public services by promoting efficiency and productivity. It should also provide fairness for the UK taxpayer who, ultimately, both consumes and pays for the public services that public sector workers provide.

This report assesses the extent to which the pay, conditions and benefits of public sector workers and the way in which they are determined, meet those goals. It builds on previous work by Policy Exchange on this issue which has highlighted that significant reforms are needed to ensure that we both properly reward public workers for their vital contribution to public services and ensure that high quality public services are efficiently delivered.

The recommendations also provide a valuable opportunity to help regenerate vulnerable communities and create jobs, at a time when the government is struggling for growth ideas.

The report is written in the context of the government's desire to make public sector pay more market facing in local areas and the remit given to the Pay Review Bodies to consider reforms to do this. It argues that, on their own, regional, zonal and individual pay setting would all be inappropriate for the UK and would fail to deliver the government's stated objectives. It makes alternative recommendations that should inform these potential reforms.

The challenge – remit of Pay Review Bodies

The Chancellor's of the Exchequer's Autumn Statement in November 2011 unveiled a remit to four Public Sector Pay Review Bodies to produce a series of recommendations to 'consider how to make pay more market facing in local areas.'[1] This remit covers the pay deals of around a fifth of the public sector.[2]

In the letters sent to the Pay Review Bodies, the Chancellor went on to outline that they should take into account:

- 'the need to recruit, retain and motivate suitably able and qualified staff across the UK;
- the difference in total reward between staff in each review body's remit group and those of similar skills working in the private sector, by location – and the impact of these differences on local labour markets;
- how private sector employers determine wages for staff in different areas of the country;

1 Specifically, this is limited to NHS workers on the 'Agenda for Change' pay scales, schoolteachers, operation prison staff, senior civil servants and very senior managers in Special Health Authorities and NHS Executive NDPBs. It explicitly excludes doctors, dentists and the Armed Forces. http://www.ome.uk.com/Article/Detail.aspx?ArticleUid=1fb5693f-71c7-4619-bf9f-79353b89925e and George Osborne, letters to the Pay Review Body Chairs, 7th December 2011, http://www.ome.uk.com/Article/Detail.aspx?ArticleUid=dfd0267d-9c7d-421b-80ba-71db9232f4b9

2 However, this should not be taken to imply the Review Bodies do not have a wider pacesetting and policy impact on a far larger proportion of the public sector.

- what the most appropriate areas or zones, by which to differentiate pay levels should be;
- the affordability of any proposals in light of the fiscal position – these should not lead to any increase in pay bill in the short or long-term;
- the need to ensure that proposals are consistent with law on equal pay;
- whether and how the new approach could be delivered within national frameworks; and
- whether proposals should apply to existing staff, or just to new entrants.'[3]

An important point to note is the focus on local, rather than regional, conditions. This is a distinction that the Chancellor fleshed out in his evidence to the Treasury Select Committee:

> *'We are asking the Pay Review Bodies to look at local markets. I have explicitly used in my letters today the word "local", not "regional"…there can be considerable disparities within regions as well.'*[4]

Clearly this is a broad remit that presents the Pay Review Bodies with a challenging set of questions. Any reforms that are implemented will impact on large numbers of public sector employees and proposals are likely to face significant challenge from the Trade Unions.

However, before we turn to consider the case for reform, it is important to lay out the context within which any changes would be made.

Context: the scale of the challenge

It should be immediately noted that the desire to introduce local markets into public sector pay is not a new thing. Most recently, while in power the current Opposition was well aware of the difficulties posed by national pay bargaining arrangements. In his April 2003 Budget Statement, the then Chancellor Gordon Brown spelt out an ambition to introduce 'measures to ensure that public service pay systems are more responsive to regional labour market conditions'.[5] The 2004 Spending Review fleshed this out further, acknowledging that 'Workforce reforms, better strategic workforce planning and more flexible use of pay are an important source of further improvement in public service performance and efficiency.'[6] It set out an ambition to:

> *'Align pay with local labour market conditions – the Government recognises that pay flexibility is an important part of achieving its objectives for efficiency and regional development. Departments will address specific recruitment and retention pressures by pursuing pay policies that reflect local labour market conditions wherever possible.'*[7]

The Chancellor's Budget Statement that year announced the goal of:

> *'Enhancing wage flexibility: by amending the remits for the Pay Review Bodies to include a stronger local and regional dimension, and working with the rest of the public sector to increase the focus on respecting local pay conditions.'*[8]

However, any firm policy reforms were not apparent outside of the continued support of the London weighting (also supported by trade unions), and the introduction of localised 'zonal' pay in the Courts Service in 2007.

3 George Osborne, letters to the Pay Review Body Chairs, 7th December 2011, http://www.ome.uk.com/Article/Detail.aspx?ArticleUid=dfd0267d-9c7d-421b-80ba-71db9232f4b9

4 George Osborne giving evidence to the Treasury Select Committee, 7th December 2011, HC 1691 Q307, http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1691/111207.htm

5 2003 Budget Statement, HM Treasury 2003

6 2004 Spending Review, Chapter 3, http://collection.europarchive.org/ea/20070705125253/http://hm-treasury.gov.uk/media/4/4/sr2004_ch3.pdf

7 2004 Spending Review, Chapter 2, http://collection.europarchive.org/ea/20070705125253/http://hm-treasury.gov.uk/media/6/0/sr2004_ch2.pdf

8 2004 Budget statement, p. 81. http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/media/1/B/Budget_2004.pdf, 'Flexibility in the UK Economy', HM Treasury, March 2004

Overall, this means that Labour made little progress on its aspiration to make public sector pay more market sensitive (though it did result in better compiling of regional price statistics). The former cabinet minister Charles Clarke has called for localised public sector pay, seeing it as a failed opportunity in advancing Labour's public service reform agenda.[9] However, while potentially supporting the regionalisation of benefits because of cost differences across the country,[10] the Shadow Chancellor has recently stated that:

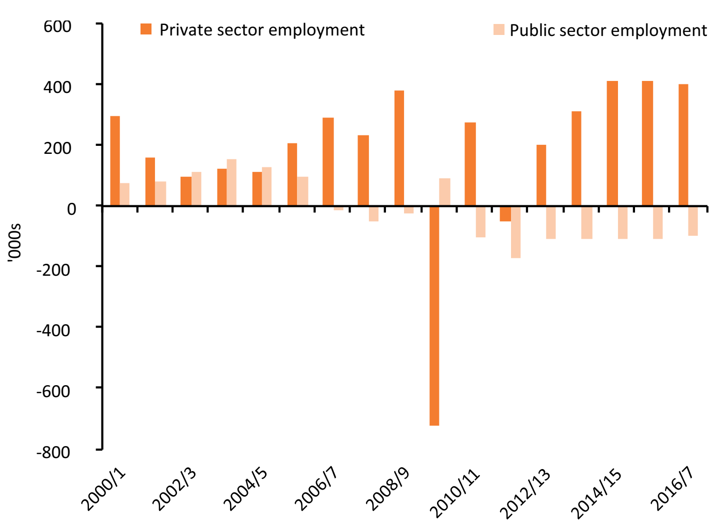
> *'Labour will oppose any moves to undermine the pay review bodies by shifting wholesale to regional and local bargaining in the public sector.'*
>
> Shadow Chancellor Ed Balls, 19th January 2012[11]

This means that any reforms are likely to face significant political opposition. This is particularly true since the attempt to consider more local-facing pay for public sector workers comes on top of large-scale reforms to the public sector workforce that are already underway. One cannot underestimate the scale of the issues involved. The total cost of public sector remuneration, including pay and pensions, accounts for some £180.4 billion a year or one pound out of every four the government spends and 12.3% of GDP. Well over half of the public money spent on schools, hospitals and the police is spent on remuneration.[12]

Reforms already announced will mean that, during the total period of the fiscal consolidation up to the end of 2016/17, the proportion of the workforce working in the public sector will have declined from one in five to one in six.[13]

Figure 1 demonstrates that total general government employment is forecast to fall by some 730,000 between 2010/11 and 2016/17 according to the Office for Budget Responsibility.[14] While a large part of these falls will come from natural staff turnover and private sector employment growth is expected to exceed losses in the public sector, this is undoubtedly a far more challenging time for the public sector than has been the case for many years.

Figure 1: Yearly change in employment, 2000–16



9 Clarke C, 'Grasping the nettle: Labour's challenge on public sector reform', Juncture, http://www.ippr.org/junctures/166/9218/grasping-the-nettle-labours-challenge-on-public-sector-reform

10 http://www.guardian.co.uk/politics/2012/jan/29/welfare-reform-liam-byrne-letter-nick-clegg

11 http://www.labour.org.uk/ed-balls-writes-to-osborne-on-delivering-fairness-on-pay

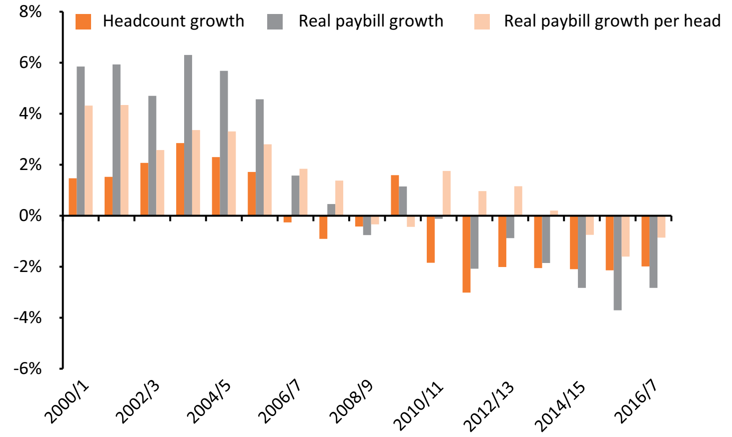
12 Figures for 2010 (including deduction of intra-government balances). Whole of Government Accounts 2009–10, HM Treasury, p. 105, http://cdn.hm-treasury.gov.uk/whole_government_accounts200910.pdf

13 Office for Budget Responsibility Economic and Fiscal Forecast 2012, http://budgetresponsibility.independent.gov.uk/wordpress/docs/March-2012-EFO1.pdf

14 Office for Budget Responsibility Economic and Fiscal Forecast 2012, p. 75, http://budgetresponsibility.independent.gov.uk/wordpress/docs/March-2012-EFO1.pdf

In turn, the public sector pay bill is projected to fall by 14.3% by 2016/17. This means year-on-year real terms reductions well into the next Parliament. As such, reforms to public sector staffing form a key element of the government's fiscal consolidation programme. Figure 2 demonstrates the year on year projected falls in the public sector pay bill.

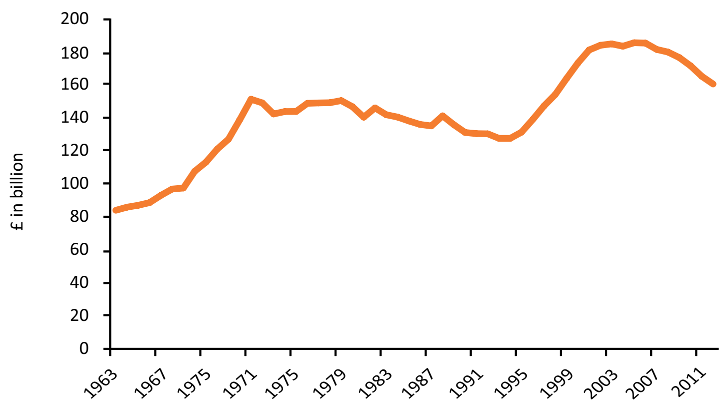
Figure 2: General government employment: key statistics, 2000–16



Source: ONS 1999–2009. OBR projections 2010–16. Treasury GDP deflator.

As well as through headcount reductions, a large part of these savings will be delivered by on-going pay restraint in the public sector. Following the payscale freeze implemented for staff not in multi-year paydeals, the Chancellor has announced that payscale increases will be an average of 1% for 2013/14 and 2014/15 (excluding some civil service departments which entered the pay

Figure 3: Public sector pay bill, 1963–2016



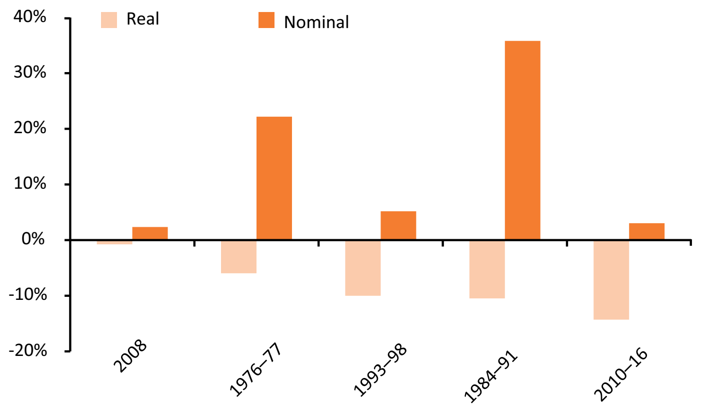
Source: UK National Accounts Blue Book; projections: Office for Budget Responsibility Economic and Fiscal Forecast, March 2012 Fiscal Supplementary Tables: 2.23 (Pay bill growth assumptions). Total compensation of employees (including public corporations).

freeze early and left it in April 2012).[15] Other policy responses have included: a graduated increase in pension contributions averaging 3% of salaries; recruitment freezes; early retirement schemes; and a mix of voluntary and compulsory redundancies.[16]

Figure 3 puts these changes to the pay bill in historical context: demonstrating that current reforms turn the tide against a decade of rapidly rising public sector pay bills.

The challenges this poses to public sector pay setting are more obviously outlined by comparing the current changes in the context of previous periods of pay bill contraction, as shown in Figure 4.

Figure 4: Periods of nominal and real falls in public sector paybill, 1964–2016



Source: UK National Accounts Blue Book; projections: Office for Budget Responsibility Economic and Fiscal Forecast, March 2012 Fiscal Supplementary Tables: 2.23 (Pay bill growth assumptions). Total compensation of employees (including public corporations).

The figure shows that the scale of the public sector pay bill reduction projected by the OBR is unprecedented in scope, speed and duration: faster than the consolidation of the 1980s and early to mid-1990s and falling even in cash terms during 2014–16 (paralleled during Ken Clarke's pay bill freeze in 1993 and 1994). Only during the financial crisis faced by the Callaghan administration in 1976 and 1977 have real term yearly cuts of comparable speed been made (and this with considerable help from high inflation).

Further difficulties are posed by the unequal dispersion of public sector employment across the UK and the centralised method of national pay bargaining that exists across much of the public sector. Figure 5 demonstrates the great variation in public sector employment by Local Authority. At the bottom of the scale, 11.2% of employment in Kensington and Chelsea comes from the public sector while at the top it is 40.7% in Eilean Siar, Orkney and Shetland.

The implication is that the differing regional impacts of the recession are likely to be exacerbated by the fiscal consolidation. Areas with the highest non-employment are often (though not always) also those most dependent on public sector employment, including Wales, Scotland and the North East.[17]

15 This step has been vigorously opposed by trade unions: http://www.unitetheunion.org/news__events/latest_news/unite_rejects__poisonous__two-.aspx

16 http://www.personneltoday.com/hrspace/blogs/ei/archive/2012/04/26/benchmarking-planned-redundancies-in-the-public-sector-in-2012.aspx

17 London, City & Regional Prospects', CEBR May 2012

Figure 5: Proportion of working age employees in public sector by Local Authority (APS, 2010/2011)

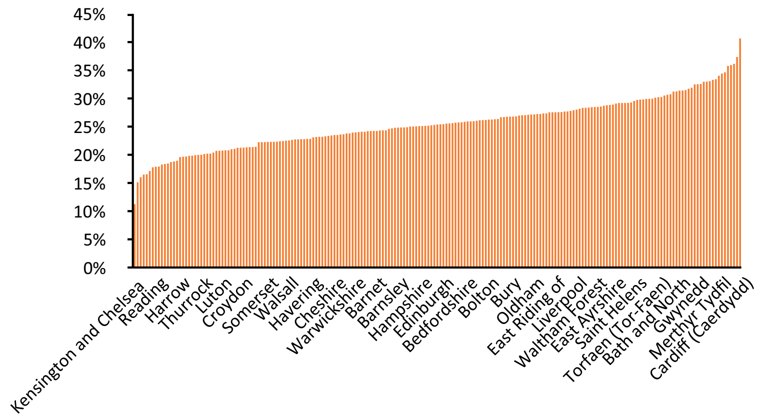
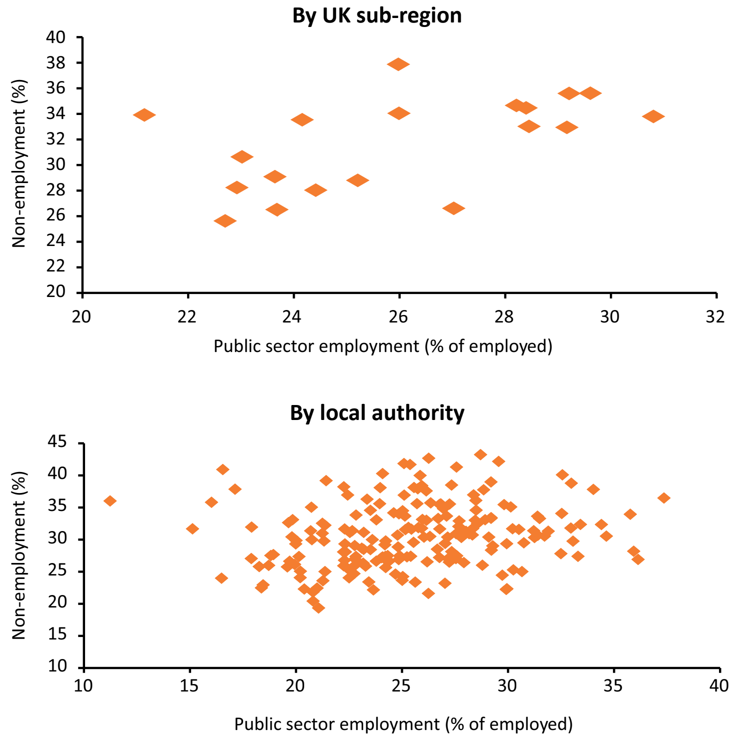


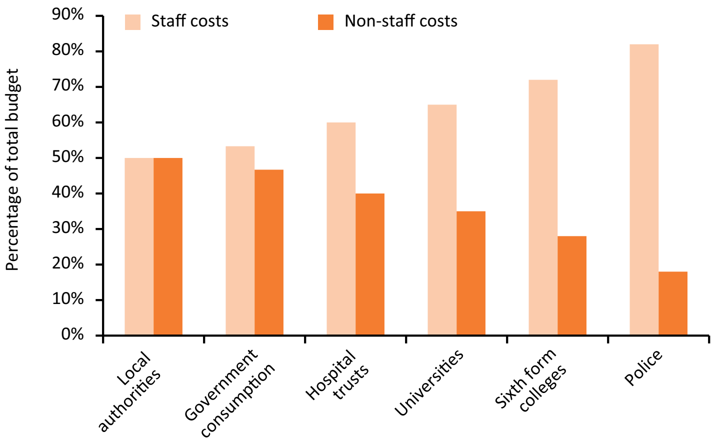
Figure 6 shows how non-employment and public sector employment rates are correlated. Any changes to wages or employment in the public sector have the possibility of being felt most in those areas most reliant on public sector employment. As we can see below, such areas also often have high unemployment and are thus vulnerable to policy changes whenever the government needs to make savings. This makes it vitally important to consider how any changes to policy might impact those areas heavily reliant on the public sector and to try to support job creation in those areas.

Figure 6: Public sector employment and rates of non-employment by area



Of course, alongside these individual and macro-economy challenges, there is also a desire to maintain and, indeed, improve the quality of public services. Most public service delivery is dependent on the quality and performance of client-facing public sector staff and, as Figure 7 demonstrates, the majority of the budget for a given public service will be taken up directly with employing staff.

Figure 7: Staff versus non-staff costs in the public sector



Source: 'Setting the scene for public sector reward: why and how', Hay Group 2012, p. 6, http://www.haygroup.com/Downloads/uk/misc/Setting_the_scene_for_public_sector_reward.pdf Higher staff cost of range estimates used where applicable. Derived from 2010/11 financial statements. Total government consumption in 2000 (OECD).

However, when it comes to pay setting, public sector managers are unused to the pay and performance responsibilities their private sector counterparts undertake: that is, they are accustomed to relying on national pay scales and minimal performance review procedures and have little experience using a system based on private sector practices. A potential shortage of management capability makes any reform difficult.

The right time

This context provides a stark backdrop to the deliberations of the Pay Review Bodies. It has also led to some commentators and politicians questioning whether this is an appropriate time to introduce further changes to public sector pay, conditions and their system of negotiation. We believe the contrary is true: the necessity of protecting and improving public services in a time of fiscal austerity means more ambitious reforms are needed.

Other MPs have expressed outright opposition to the proposals on the grounds that they would be damaging to their constituencies. For example, several Conservative MPs[18] have expressed doubts about the logistics of local pay, while several Labour and Liberal Democrat MPs[19] have argued that the policy will reduce consumer demand.[20] Unions have also argued that a move towards local pay setting would be too time consuming or expensive and many commentators have argued that removing national pay deals would drain resources away from struggling areas and lead to deeper problems.[21]

Again, we believe the contrary is true. We recognise and support the fact that an essential role of the government is to redistribute finances between relatively rich and

18 Including Guto Bebb, Guy Opperman and Andrew Percy

19 Including Russell Brown, Kelvin Hopkins and John Pugh

20 Hansard, 20th June 2012, Regional Pay debate, http://www.publications.parliament.uk/pa/cm201213/cmhansrd/cm120620/debtext/120620-0003.htm#12062086000002

21 For a useful summary, see 'Local and regional Pay in the public sector', TUC March 2012, http://www.tuc.org.uk/tucfiles/265/TUCresponsetoOME.pdf

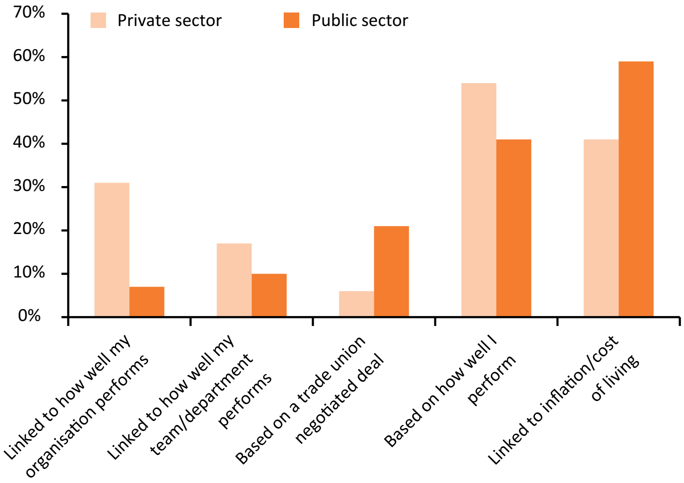
relatively poor regions as well as between rich and poor individuals. By grasping the nettle and pushing through ambitious reforms, a significant opportunity can be created to support and regenerate areas reliant on the public sector. By making better use of public sector money, job creation can be encouraged and economic growth boosted.

Both ongoing and proposed reforms also open up significant opportunities to make the public sector workforce more productive and better rewarded. Within the context of productivity in the public sector that has been, at best, flat over the last decade,[22] this again provides a vital opportunity to shape reforms to ensure that we make the most out of public expenditure: delivering the highest quality of public services most efficiently.

Critiques of a local pay system have also been put forward without a clear understanding of what the reform might look like – and indeed, before any clear picture has emerged. The proposals we will outline here are very different from those that many opponents seem to envisage. Local pay does not have to require very detailed negotiation over every point of employment, or be unnecessarily complex. It may vary widely according to the particular public service or the labour market in which the negotiations take place. We outline a strategy to ensure not only that struggling areas are not penalised, but actually helped in terms of jobs and growth.

It is also the case that, while these reforms will be politically and practically challenging, we do not believe that all parts of the public sector would be against reform. Figure 8 shows results from a recent survey by the CIPD which found that public sector staff cited trade union negotiated deals as a favoured method of setting pay in only 21% of cases; more than half – 59% – cited the cost of living. A significant proportion of respondents also favoured performance related pay of one sort or another. Another recent survey of teachers showed that 75% of teachers surveyed thought annual scale point increases should only be awarded to 'those teachers judged to have performed well' or 'all teachers, apart from those judged to have performed poorly' – only a quarter thought the increases should be awarded regardless of performance.[23]

Figure 8: Staff favoured methods of renumeration



Source: 'Employee Attitudes to Pay', CIPD 2011, Figure 4.

22 Oakley, M., (ed), (2011), *Looking to the Future of Growth. Policy Exchange*

23 *'NFER Teacher Voice Omnibus February 2012 Survey', The Sutton Trust 2012, p. 3,* http://www.suttontrust.com/public/documents/nfer-teachers-poll-report-final.pdf

Overall, it is clear that despite the current public political discourse, there is a great deal that can be gained from pushing through ambitious reforms now. Reform provides the opportunity to increase productivity, enhance public services and deliver stronger growth and more jobs across the country. These are all things that the country needs now, not in twenty years' time. Grasping the nettle now will benefit us all in the long-run. This report is aimed at achieving that outcome.

1
How Public Wages Are Currently Set

Before turning to consider the inherent problems present in the current system of setting rewards across the public sector and laying out suggestions for where reform should come, this section outlines broadly how the current system works.

Table 1: Summary of public sector remuneration by sector

Local government	National pay structures apply across nearly all administrative, clerical, technical and professional occupations across England and Wales. The most widely used of these are the National Joint Council salary scales (with a small number of councils opting out): a negotiating body composed of trade union representatives and employers. Before 1997, there was flexibility to allow local authorities to pay at different levels on pay spines. This led to significant variation, but was restricted following job evaluation in the Single Status Agreement.
Police	Police Officers: Constables, Sergeants, Inspectors and Federated ranks are nationally-set through the Police Advisory Boards and Police Negotiating Board (plus the Northern Ireland Policing Board). Some variation arises from different payments for housing and rent allowances in different regions and additional payments for London weighting. Non-officer police staff terms are negotiated through the Police Staff Council but have pay set locally with some variation.
Education	Teachers are paid on national salary scales (with slightly different arrangements for Scotland) with limited room for differentiation through allowances, London Allowance and payments to address particular skills shortages (though these are infrequently used). There are no pay scales for support staff but LEA schools generally use local government scales. Flexibility is theoretically allowed for Academies and Free Schools but is rarely used.
NHS	NHS Trusts and Foundation Trusts have theoretical autonomy over rates of pay, but these are rarely ever used. National Scales are negotiated between employers, government and the professional bodies. Since 2004, the 'Agenda for Change' has theoretically allowed high-cost area supplements, alongside recruitment and retention premia but the latter are rarely used. Before 2004 there were more additional payments to staff working in London and more local variation occurred. NHS Trusts have some freedom to set their own rates for senior managers.
Civil Service and non-departmental public bodies	Since 1996, remuneration has been devolved to the Departmental level, with each deciding its own reward and grading structures within parameters defined by the Treasury. Agencies with significant numbers of staff outside London (three of the four biggest) have separate London pay scales and allowances, while some have zonal additional payments (though again these are largely confined to London and the South East).
Fire and rescue	National rates and uplift are agreed by two National Joint Councils: the Local Authority Fire and Rescue Services and the Brigade Managers, with small additional allowances for local circumstances.

Source: Departmental websites, Whole of Government Accounts 2009–10, HM Treasury, pp. 35–36, http://cdn.hm-treasury.gov.uk/whole_government_accounts200910.pdf

It argues that current public wage negotiation is generally characterised by a rigid structure of national, collectively bargained agreements and a poor recognition of performance and local labour markets.

Table 1 gives a brief overview of the different systems in place across the public sector.

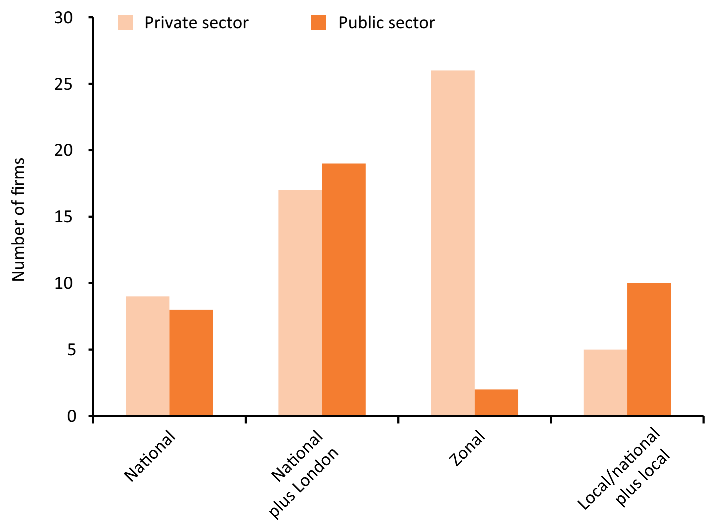
Reliance on nationally negotiated pay deals

Table 1 demonstrates that, in principle, the system of pay setting in the public sector is quite diverse: a complex mix of national, sectoral, organisational, regional, local and individual pay created for a combination of historic, political and economic factors. However, in practice, with the exception of regional weighting in London and the South-East, the propensity towards national, collectively bargained pay settlements continues to dominate.

This means that across much of the public sector, salaries are determined by nationally-set pay bands. In turn, this results in an extremely limited degree of differentiation according to the regional cost of living (outside of London), incomes, the local rate of unemployment and employee performance. Though the general criteria are that yearly pay awards should 'reflect the individual labour market position of work forces, particularly their recruitment and retention position', in practice this usually means a uniform percentage rise applied nationally across all pay scales.[24]

The key question is how much this differs from the situation in the private sector. Perhaps surprisingly, from an initial assessment it could be concluded that the situation is much the same. Figure 9 shows the split across different pay setting models in a selection of firms for the public and private sectors.

Figure 9: Instances of basic paysetting



Source: 'Local-based pay differentiation: A research report for UNISON', Income Data Services.

This has led some to argue that there is no significant difference in pay setting procedures between the public and private sectors, making reform unnecessary.[25] However, this broad-brush categorisation in raw pay setting conceals the significantly different practice between the two sectors. To take one example,

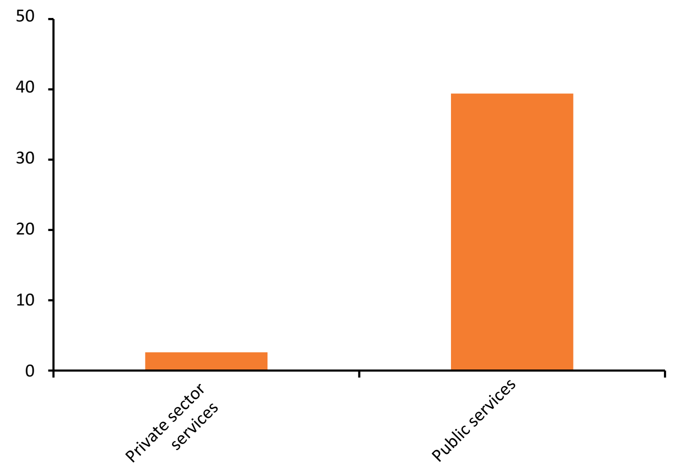
24 http://www.parliament.the-stationery-office.co.uk/pa/cm200809/cmhansrd/cm090721/wmstext/90721m0005.htm

25 'Local and regional pay in the public sector', TUC submission to OME call for evidence, p. 5, http://www.tuc.org.uk/tucfiles/265/TUCresponsetoOME.pdf

McDonalds, though technically a 'national' pay setting organisation, has annual performance reviews related to pay setting, quarterly bonuses for managers and regional weighting for certain grades.[26] Particularly at the higher levels, many of these private sector organisations have 'spot' salaries for their staff – that is, formed by individual negotiation rather than any pay scale. The widespread use of discretionary bonuses and other forms of remuneration and the absence of incremental uplift according to length of service and performance review processes linked to pay, are all more characteristic of the private sector.[27]

Thus, in practice, the private sector's pay formation process is very different to that of the public sector. In part, this is likely to be the result of significantly lower trade union density, which means that the predominance of collective bargaining in the public sector is not seen in the private sector. This is demonstrated in Figure 10.

Figure 10: Factors determining base pay (% of respondents citing collective bargaining)



Source: CIPD Reward Management Annual Survey 2011

There is also a degree of uncertainty over the true extent of reliance on national negotiations in the public sector. For instance, while Table 1 demonstrates that many areas of the public sector do have theoretical pay flexibility, other reports have found that this flexibility is not used in practice. One recent estimate is that '...roughly 70% of employees will, in practice, have their pay, terms and conditions determined nationally.'[28] The same source goes on to argue that this is because many public sector employers have 'failed to embrace localism.' This lack of flexibility and the lack of scope to adjust pay for local or regional conditions is a recurring theme.[29]

If correct, these findings suggest that Figure 10 is likely to be an underestimate of the overall scale of reliance on national, collectively agreed pay setting. Other estimates suggest that two-thirds of staff are subject to collective agreements against just 17% in the private sector.[30] Another recent report has estimated that around five million public sector employees are covered by nationally-set pay deals.[31]

26 See http://www.mcdonalds.co.uk/ukhome/People/Join-the-team/Pick-your-role/Trainee-business-manager.html; http://www.mcdonalds.co.uk/content/dam/McDonaldsUK/People/Schools-and-students/mcd_recruitment_training.pdf

27 Kim P, 'Performance Management and Performance Appraisal in the Public Sector', CEPA 2011

28 Chris Johnson, UK human capital leader, Mercer. 'Highway to Local Pay', People Management, March 2012

29 Bell D, Elliott R, Scott A, Roberts E 'The pattern and evolution of geographical wage differentials in the public and private sectors in Great Britain', The Manchester School Vol. 75 No. 4, 2007, p. 390

30 'Trade Union Membership', BIS 2010

31 'Wolf, A, 'More than we bargained for', Centre Forum 2010, http://www.centreforum.org/assets/pubs/more-than-we-bargained-for.pdf'

Too little recognition of individual performance

The other defining feature of the system of pay setting in the public sector is the rigid structure in terms of progression, performance and non-pay benefits. Again, this is quite distinct from the private sector.

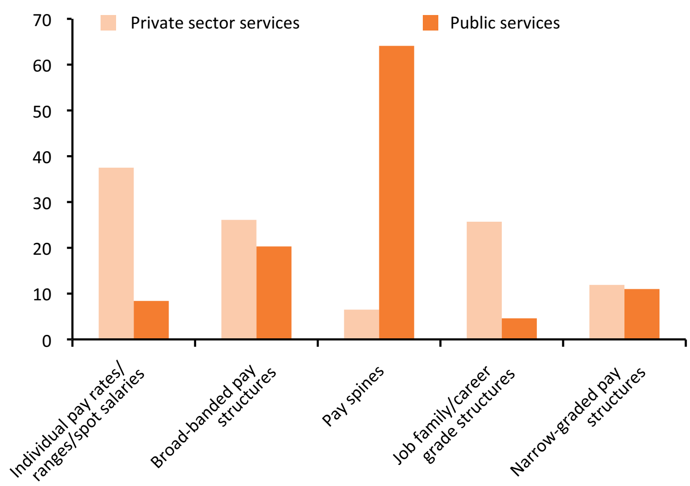
Public sector pay as a whole can be characterised as a series of graded pyramid hierarchies, each representing a particular type of occupation with pay largely negotiated at a national level. In practice this means that public sector employees are organised according to skill level and knowledge appropriate for each particular grade and allocated to 'pay spines' within them, according to experience or length of service within that grade.

Progression up the pay spine is then largely automatic (and, indeed, is often necessitated by contractual obligation) and this can apply equally to promotion to a higher grade. A typical example is that of prison officers. Their national minimum starting salary in 2010 (£17,319) is increased incrementally through length of service up a national 'pay spine' to a maximum of £25,490, followed by additional long service increments up to £26,433 (plus allowances and supplemented by regional weighting). Overall, this means that pay and position are largely determined by length of service. This is a point made effectively by John Hutton in his review of fair pay:

> *'Traditionally, the public sector's pay schemes have been based on the concept of pay-for-grade: all staff of a certain grade are paid the same or within a narrow band. Any variability in pay is based on service-based increments: pay increasing with length of service.'*[32]

Figure 11 compares the structures of base pay between the private and public sectors and clearly demonstrates the strong reliance on pay spines in public services. It demonstrates that length of service is routinely cited as a key factor determining wages by around 70% of public sector employers compared to less than 20% in private sector services or manufacturing.[33]

Figure 11: Base pay structures (% of respondents)



Source: CIPD Reward Management Annual Survey 2011

32 Hutton Review on Fair Pay, HM Treasury 2011, p. 41, http://www.hm-treasury.gov.uk/d/hutton_fairpay_review.pdf

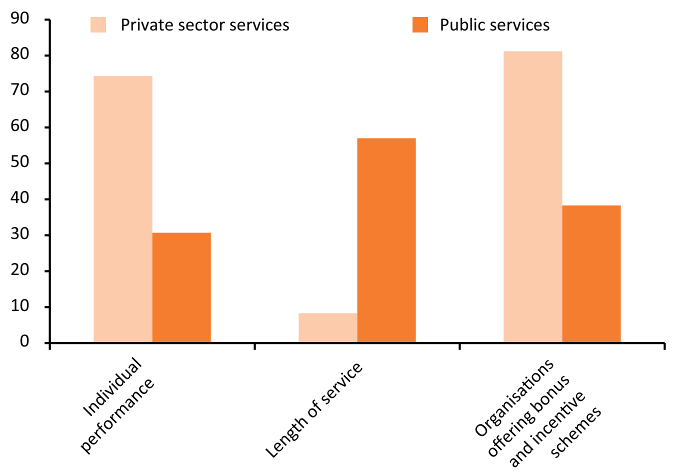
33 'Public/Private Approaches to Pay Progression', Office of Manpower Economics, p. 5

There also seems to be inflexibility in non-pay forms of remuneration used in the public sector. Here, aside from generous holiday and pension entitlements, when compared with the private sector, fewer forms of individual recognition such as bonuses are used.

Consequently, individual performance is little rewarded and, as Figure 12 shows, length of service is mentioned on average as a means of progression typically five to six times more frequently than in the private sector.[34] The impact of this lack of flexibility on incentives, recruitment and, consequently, the quality of public services should not be underestimated. The Hutton Review on Fair Pay concluded that:

> *'The public sector may be missing out on high calibre individuals because it does not offer sufficient opportunities and incentives to perform.'*[35]

Figure 12: Basis for base pay progression, availability of bonus schemes (% of respondents)



Source: CIPD Reward Management Annual Survey 2011

Are things changing?

The last few decades have seen significant reform of both the labour market generally and, specifically, the public sector. For instance, outsourcing of public service delivery has become more widespread and the level of unionisation has fallen dramatically in both the public and private sectors. With this in mind there is the possibility that the lack of flexibility outlined above might be being addressed already. However, that seems not to be the case. The evidence suggests that the scope of these systems to account for differences in the cost of living and personal performance has been further eroded in recent years. A recent report summarises that:

> *'A general feature of public sector pay arrangements in the last few years has been the drive to shorten the length of pay scales. Shorter pay scales offer fewer opportunities to use accelerated incremental progression to respond to tight labour markets… developments have reduced the*

34 'Reward Management', CIPD Annual Survey Report 2010

35 Hutton Review on Fair Pay, HM Treasury 2011, p. 41, http://www.hm-treasury.gov.uk/d/hutton_fairpay_review.pdf

scope for geographical differentiation of pay outside London. Although this scope was limited prior to the most recent round of reforms, it is likely to have reduced still further.'[36]

A key driver of these changes has been a series of reforms since the 1990s focused around equal pay, such as Single Status Agreements in local authorities, the National Framework Agreement for universities and the NHS' new reward programme Agenda for Change. Box 1 outlines the example of the NHS where, although some reforms have been implemented, the system of pay is still largely rigid and inflexible.

Box 1: Public sector pay flexibilities: common in theory, unused in practice

Example: The NHS

For NHS staff on the Agenda for Change pay system[37]: including doctors, and dentists[38] (though not GPs who are in effect private practitioners), there is routine negotiation of pay and conditions on a national basis between employers, staff and trade unions.

Agenda for Change was a new pay system introduced in the NHS in 2004. It cut out the old arrangements based on occupational groups (psychologists, scientific officers, nurses etc.) and replaced them with nine paybands with incremental progression. There is uplift from the penultimate pay point on a payband, theoretically only if performance is satisfactory: demonstrating knowledge, skills and application, through a Knowledge and Skills Framework. In practice, however, progression tends to be automatic. An assessment of the framework remarked that 'the most frequently-cited reasons given for non-appraisal were that appraisals were not taken seriously in their department and that managers were not interested in completing them', and found that some 90 per cent of staff did not even think they had had an appraisal in the previous year.[39]

The benchmarking process, putting occupations into different bands, was introduced partly to provide protection from equal pay disputes (before 2004, there were many equal pay claims through the 1983 Equal Pay Act). Recruitment and retention premia can be applied, but there has to be a written 'objective justification'.

This usually means higher pay for London. It can be used to allow the NHS to compete with the private sector for certain jobs (preventing losing a lot of clerical staff simultaneously because a call centre has just opened locally with better pay, for example). However, London has more vacancies, recruitment, retention problems and also takes on more expensive agency staff than other regions.[40] Vacancy rates for nurses are some four times higher in London than in the North East.[41]

Foundation Trusts can also opt out of the national salary structures. However, in practice, none do (Southend used to but it was very similar to the national terms, and was enacted principally for the purposes of increasing wages above the existing payscales.) Some trusts are considering using the greater flexibility available in the system but it is difficult – if trade unions do not agree, they have to fire and rehire people to introduce new terms.

The overall impact of these changes has tended to be to drive up pay in roles where female employment is high, in order to head off equal pay claims.[42] While

36 Bell D, Elliott R, Scott A, Roberts E 'The pattern and evolution of geographical wage differentials in the public and private sectors in Great Britain', The Manchester School Vol. 75 No. 4, 2007, p. 392

37 See http://www.nhsemployers.org/PayAndContracts/AgendaForChange/Pages/Afc-AtAGlanceRP.aspx

38 N.B. these stand outside the pay review body regional pay remit (perhaps because they form more of a national labour market). See http://www.hm-treasury.gov.uk/d/chx_letter_doctors_dentist_pay_review_body_071211.pdf

39 Brown D, Mercer M et al., 'Review of the NHS Knowledge and Skills Framework', NHS Staff Council, Institute for Employment Studies 2010, p. 32, 36, http://www.employment-studies.co.uk/pdflibrary/nhse_0410.pdf

40 'Controlling the use of temporary staff through large scale workforce change', NHS Employers, p. 10, http://www.nhsemployers.org/SiteCollectionDocuments/Controlling_the_use_of_temporary_staff_through_large_scale_workforce_change.pdf

41 The NHS Information Centre for health and social care Vacancies Survey March 2011

42 'NHS Pay Modernisation in England: Agenda for Change', National Audit Office 2009, http://www.nao.org.uk/publications/0809/nhs_pay_modernisation.aspx

targeting gender equality is the right thing to do, it has had the consequence of eliminating differentials in pay levels between groups in the public sector. A recent report by the Hay Group concluded:

> *'Many saw this Agenda for Change as an enforced change they had to go along with – one which came with a substantial price tag but no major benefits. The gains which organisations generally look for from reward improvements, such as better cost control, talent management, productivity or performance, were missing. Typically, they did not even lead to higher employee engagement.'*[43]

This outlines a major problem that, within the current system of pay setting in the public sector, local managers have little say in the whole process and, in turn, this impacts on decision making at a local and, by implication, a national level:

> *'Employers have little or no control over the pay increases set for their staff…The consequences of that are quite dramatic. In local government our budgets are usually set in January/February, and sometimes the pay award isn't agreed until as late as July or September. So local politicians have no idea what to include in their budget for the year, and we're not talking small numbers here – this could be £3–4 million.'*[44]

This results in a highly inflexible labour market: academic studies have put the responsiveness of public sector labour markets to differences in costs and amenities as low as 40% of their private sector counterparts.[45] This restricts managers from using pay as a tool to incentivise better performance and these problems even exist where managers have widespread flexibilities.

To take the example of Academy schools, who have autonomy to set their own pay and conditions, a recent study found that some 65% of them had not used this flexibility at all and had no intention of doing so, while 60% said nationally-set pay and terms of employment made it 'culturally difficult for them to vary pay and conditions in their school'.[46] Even where more flexible arrangements are introduced, significant legacy obligations often prevent their being used: for example, Academy schools who have transferred existing teachers who have been employed for more than four years are entitled to 100 days of sick leave on full pay, followed by 100 days on half day: in other words, a full school year, protected through TUPE regulations.[47]

Conclusion

This chapter has demonstrated the large reliance on nationally agreed and collectively bargained agreements in determining public sector pay and that this is different to the private sector. It has also shown that public sector structures tend to be rigid in terms of their ability to match pay to local labour market conditions and individual performance, even where flexibilities theoretically exist. The next chapter outlines the impact of relying on these structures, in terms of fairness, costs and the quality of public services.

43 'Setting the scene for public sector reward: why and how', Hay Group 2012, p. 5, http://www.haygroup.com/Downloads/uk/misc/Setting_the_scene_for_public_sector_reward.pdf

44 Gillian Hibberd, strategic director for resources and business transformation, Buckinghamshire County Council. 'Highway to Local Pay', People Management, March 2012

45 Bell D, Elliott R, Scott A, Roberts E 'The pattern and evolution of geographical wage differentials in the public and private sectors in Great Britain', The Manchester School Vol. 75 No. 4, 2007, p. 386

46 Bassett D, Lyon G, Tanner W, Watkin B, 'Plan A+: Unleashing the potential of academies', Reform, 2012, p. 5, http://reform.co.uk/resources/0000/0385/Plan_A__FINAL.pdf

47 Teachers' sick pay and sick leave entitlements, http://www.teachers.org.uk/node/1584

2

Why Change is Needed

Problems with national pay setting: damaging growth and public services

The main problem with the system of national pay setting is that it leads to potentially large differentials between public and private sector pay for similar individuals in similar areas. In the abstract, this is not necessarily a problem. However, in reality it can lead to three major economic and social problems.

Firstly, it has a negative impact on the quality of public services. Secondly, it has been detrimental to the growth prospects of areas where public sector employment is high and costs of living relatively low. Finally, there are strong arguments surrounding fairness both between public sector workers in different localities and between public sector employees and private sector employees.

This chapter outlines the existing evidence around the pay differentials that arise from the system of nationally negotiated pay and presents new detailed evidence on the extent of these. It then presents evidence on the impact that these differentials have had on each of the three areas outlined above.

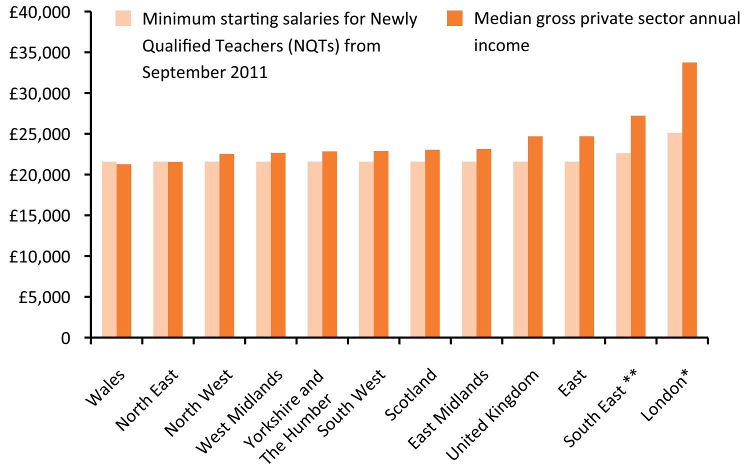
National pay rates mean under-payment in some areas and over-payment in others

A major cause of the problems outlined above is that national pay rates lead to individuals being paid in a fashion that does not reflect local labour market conditions. In the private sector, salaries – subject to the national minimum wage – are much more closely tied to supply and demand. If there is a shortage of welders on Teesside, for example, pay goes up. In the shorter-term this might attract more people with the right skills to the area and in the longer-term might attract more people to learn the trade, resulting in a levelling off of wages, and so on: the market ensures that workers and pay are kept broadly in equilibrium.

Conversely, in the public sector, the rigid setting of equal pay across the UK – with the only significant weighting given for London and its surrounding area – largely eliminates the market mechanism as a means of regulating scarcity in the public labour market.

To take the example of classroom teachers, virtually all newly qualified teachers in maintained schools will start on point M1 on the pay scale in England and Wales (though it may be higher in light of previous experience or exceptional shortages). The value of these point scales is greater in London and its surrounding area. Figure 13 compares its value to regional median incomes.

Figure 13: New teachers' minimum starting salaries and average income by region in maintained schools, England and Wales, 2011



Source: Annual Survey of Hours and Earnings, 2011.

* Figure given is for Outer London (Inner London is £27,000).

** The salary figure is for the 'Fringe' area around London (e.g. Surrey, Dartford, Crawley etc.) Outlying regions in the South East are paid at the lower rate of £21,588.

Simply, the existing system of regional variation is not enough to stop teachers being relatively underpaid in London and overpaid in less expensive regions. In effect, any new teacher in Wales is guaranteed a minimum starting salary of 101.5% of the regional private sector median, while a new teacher starting in Outer London will be paid just 74.4% of the regional average. This major disparity has been linked to serious labour shortages in high income areas and oversubscription in lower ones.[48] It also makes it more difficult for private firms in low-wage areas to compete with the public sector salaries on offer, increasing their costs and discouraging private sector firms from locating there.

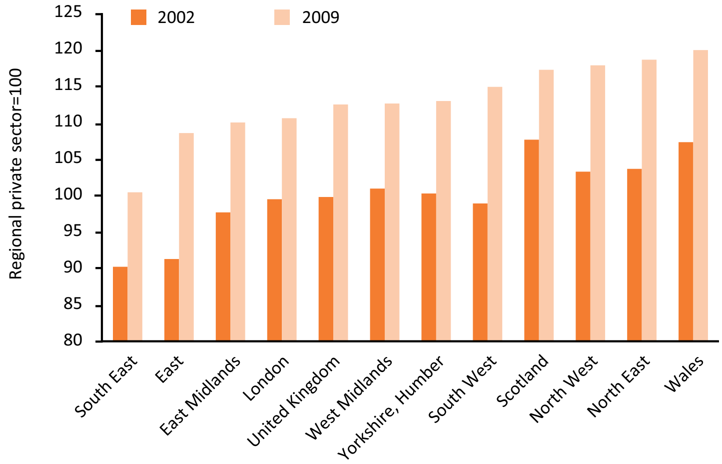
Of course, just comparing teachers starting salaries to regional averages is a simplistic assessment of the true situation. However, numerous reports have found these kinds of problems to exist right across the public sector. The overwhelming conclusion from these reports is that public sector workers in the UK see potentially large wage differentials compared to the private sector depending on where they are located. In some areas the public sector is relatively well paid and in others it is poorly paid.

The most straightforward analysis extends that above to look at regional median wages across the two sectors. Figure 14 shows that public sector employees tend to have pay premiums in regions where private incomes are lower. In Wales median public sector wages are 20% higher than in the private sector. In the South East, median wages are broadly similar and over the whole of the UK, median weekly wages for public sector workers are around 12% higher than in the private sector.

Again, this is a relatively straightforward analysis and the best of the reports on this subject have tried to account for the differences in the composition of workers in the public and private sectors. On average, public sector workers are

48 For example, see Gomes P, 'Fiscal Policy and the Labour Market: the effects of public sector employment and wages', European Commission Economics Papers 439, February 2011. http://ec.europa.eu/economy_finance/publications/economic_paper/2011/pdf/ecp439_en.pdf

Figure 14: Public sector median gross weekly salary by region, 2002 and 2009



Source: Annual Survey of Hours and Earnings supplementary data, Office for National Statistics.

older, have higher qualifications and have spent longer in employment. Each of these factors will have an impact on the pay that someone might expect and so they need to be accounted for when comparing wages across the two sectors.

Reports that have adopted this approach include those by the Office for National Statistics, IFS and HM Treasury, all in 2012, which all find sizeable wage differentials across different regions of the UK. The average UK differential in these reports tends to stand at between an 8% and a 10% premium in the public sector. The average differential was found to be greater for females and at the bottom of the wage distribution. Some areas (London, the North and North West) were also found not to have a statistically significant pay differential for males. [49]

Previous Policy Exchange reports have found similar results.[50] A new Working Paper, Mind the Gap, published alongside this report outlines new research that Policy Exchange has conducted to extend the existing UK evidence. It analyses the scale of pay differentials across Local Authorities and how they vary by gender and where individuals sit on the wage distribution. The importance of this new analysis is that it demonstrates the large variations in wage differentials that exist within different regions and across the wage distribution.

For example, previous reports have found that average pay differentials in London are either close to zero, not statistically significantly different from zero, or slightly negative. However, our research finds that large pay premiums exist for those employed at the bottom of the wage distribution in London. Wages in London for both males and females employed at around the tenth percentile of the wage distribution are around 20% higher than their private sector counterparts.[51] A potential reason for this is the fact that the public sector tends to pay a London weighting, while this is not uniformly given in private sector firms. At the other

49 Emmerson, C., & Jin, W., (2012), 'Public sector pensions and pay', in Emmerson, C., Johnson, P., and Miller, H., (eds), *The IFS Green Budget: February 2012* (http://www.ifs.org.uk/budgets/gb2012/12chap5.pdf); ONS (2012), *Estimating differences in public and private pay – 2012*. http://www.ons.gov.uk/ons/dcp171776_261716.pdf; HM Treasury, (2012). *Government Evidence to the Pay Review Bodies: Economics of Local Pay*. Available on http://www.ome.uk.com/

50 Holmes, E., and Oakley, M., (2011), *Public and private sector terms, conditions and the issue of fairness*. Policy Exchange, London. Oakley, M., (2011) *Further analysis on the public sector pay premium*. Policy Exchange, London

51 After controlling for age, gender, region, length of employment, qualification levels, permanence of employment (temporary or permanent) and whether the job is full or part time.

end of the scale, males and females at the top of the wage distribution see pay penalties of as much as 30% compared to private sector equivalents.

Table 2 shows the estimated differentials by sub-region for males and females.[52]

Table 2: Estimates of public sector hourly wage differentials by sub-region, gender and point in the wage distribution (% difference in hourly pay in public sector)

	MALE					FEMALE				
	Percentile of the wage distribution					Percentile of the wage distribution				
Region	**10**	**25**	**50**	**75**	**90**	**10**	**25**	**50**	**75**	**90**
Tyne and Wear	10.93	7.87	4.93	0.69	-2.73	10.68	10.37	10.33	5.89	0.65
Rest of North East	13.51	8.75	6.78	1.44	-1.28	13.25	11.25	12.18	6.64	2.10
Greater Manchester	14.56	9.36	4.96	1.11	-0.36	14.31	11.85	10.36	6.31	3.02
Merseyside	14.86	10.65	4.50	3.05	-2.17	14.61	13.15	9.90	8.25	1.20
Rest of North West	13.90	9.85	4.57	-1.14	-7.06	13.65	12.35	9.97	4.06	-3.68
South Yorkshire	17.23	12.24	6.30	5.11	3.32	16.98	14.74	11.70	10.31	6.69
West Yorkshire	14.78	8.44	6.04	3.18	-6.59	14.53	10.93	11.44	8.38	-3.22
Rest of Yorkshire and Humberside	21.74	11.27	8.44	5.00	-0.06	21.49	13.76	13.84	10.20	3.32
East Midlands	14.62	10.09	5.29	-1.72	-4.60	14.37	12.59	10.69	3.48	-1.22
West Midlands Metropolitan County	12.46	8.52	5.81	1.67	-3.44	12.21	11.02	11.21	6.87	-0.07
Rest of West Midlands	10.13	7.90	6.45	0.10	2.93	9.87	10.40	11.85	5.31	6.30
East of England	12.00	7.19	-0.55	-6.48	-13.96	11.75	9.69	4.85	-1.28	-10.59
Inner London	19.05	7.02	-3.65	-19.50	-30.82	18.80	9.52	1.75	-14.30	-27.45
Outer London	22.35	15.70	1.29	-6.80	-14.60	22.10	18.20	6.69	-1.60	-11.22
South East	12.91	3.89	-5.66	-13.79	-22.68	12.65	6.38	-0.26	-8.59	-19.30
South West	13.98	8.37	3.88	-3.29	-10.28	13.73	10.87	9.28	1.91	-6.90
Wales	17.00	12.99	8.89	6.55	4.08	16.75	15.49	14.29	11.75	7.45
Strathclyde	19.08	14.94	8.67	2.71	-2.50	18.83	17.44	14.07	7.91	0.88
Rest of Scotland	18.12	12.35	5.11	-0.42	-6.76	17.87	14.85	10.51	4.78	-3.38
Northern Ireland	17.18	12.70	6.93	5.96	9.46	16.93	15.20	12.33	11.16	12.83

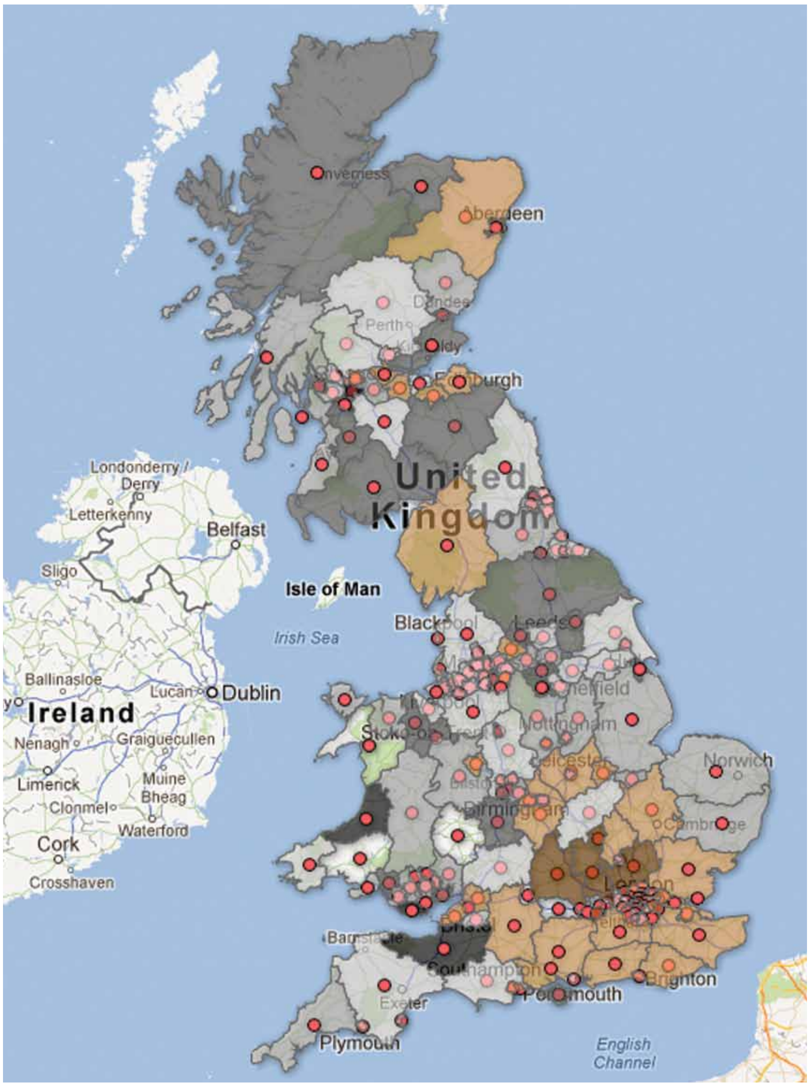
Source: Departmental websites, Whole of Government Accounts 2009–10, HM Treasury, pp. 35–36, http://cdn.hm-treasury.gov.uk/whole_government_accounts200910.pdf

Our analysis has also found that within-region variation is also extremely important. For example, while the overall London differential for the average male stands at 0.39% penalty (in effect, zero) the equivalent figure for Croydon is a 12.39% premium, whereas in Islington it is a 20.69% penalty. Similarly, if we look at females towards the top of the wage distribution, the differential in the North East stands at a 6.17% premium. However, in Middlesbrough the premium is 9.14% whereas in Stockton-on-Tees it stands at 0.45%.

52 Note that these figures have been compiled using the regression output at Annex 1. Measures of statistical significance can be found there.

Figure 15 shows estimates of the average differential estimated for each Local Authority.[53] Orange colours represent a pay penalty; dark orange is a 20% or over penalty; white represents equivalence; grey colours represent a wage premium; dark grey is a premium of over 15%.

Figure 15: Local Authority average public sector hourly wage differential



With the evidence clear that potentially large pay differentials exist between equivalent workers in the public and private sectors, the following sections outline the impacts of these differentials.

Fairness between public sector workers

A key issue in this debate has been fairness between public sector workers doing the same or similar jobs. The reasoning behind keeping national pay bargaining for this reason is summarised by the Trade Union Congress:

53 The Local Authority average is calculated by taking the average of the estimated differential for each individual in the relevant Local Authority.

> *'The TUC believes that it is unfair for a public sector worker in one area, performing the same duties and with the same skills and qualifications, to be paid less than a public sector colleague doing an equivalent job elsewhere in the country.'*[54]

In other words, fairness requires equal pay. But does this result in equal reward? Differences in the actual cost of living in different areas mean paying workers the same salary regardless results in reward being, in practice, very unequal. To demonstrate this, the Table 3 outlines an example of the after-tax family income that a typical NHS nurse with two children and a partner earning £20,000 might expect in different parts of the country:

Table 3

Median income	North East	North West	Yorkshire and Humber	East Midlands	West Midlands	East/East Anglia	London	South East	South West	Wales
Typical nurse	£28,600	£28,600	£28,600	£28,600	£28,600	£28,600	£33,700	£29,875	£28,600	£28,600
Nurse's net earnings	£24,501	£24,501	£24,501	£24,501	£24,501	£24,501	£28,581	£25,521	£24,501	£24,501
Partner's earnings	£20,000	£20,000	£20,000	£20,000	£20,000	£20,000	£20,000	£20,000	£20,000	£20,000
Partner's net earnings	£17,621	£17,621	£17,621	£17,621	£17,621	£17,621	£17,621	£17,621	£17,621	£17,621
Family after tax earnings	£42,122	£42,122	£42,122	£42,122	£42,122	£42,122	£46,202	£43,142	£42,122	£42,122
Child Benefit	£1,752	£1,752	£1,752	£1,752	£1,752	£1,752	£1,752	£1,752	£1,752	£1,752
After tax family income	£43,874	£43,874	£43,874	£43,874	£43,874	£43,874	£47,954	£44,894	£43,874	£43,874

Source: DWP Family Resources Survey, Royal College of Nursing, NHS Information Centre. Calculations by the Resolution Foundation for ITV Tonight 'Divided Britain' programme. Typical nurse is a median nurse full-time equivalent total earnings (Band 5 Agenda for Change) including London weighting.

In other words, the national pay system gives a typical family the same income regardless of location, with the exception of London and the South East. However, the costs a typical family will incur: mortgages, energy bills, council tax, transport, etc., vary widely across the country. Table 4 shows that this can result in a significant difference in the cost of living.

In other words, the cost of living means paying public sector workers regardless of where they are living results in very unequal reward. It is sometimes argued that costs only vary significantly in London and the South East and that London weighting accounts for this disparity.[55] But even excluding these two regions, Table 4 shows there are wide differences between regions where national pay rates are exactly the same.

Our typical family's cost of living is 12.6% higher in the South West than the North East, or 13.5% higher than in Wales – a distinction which is not reflected in a national pay bargaining structure. Even these broad differences do not reflect price differences at a local level (a workplace which is inaccessible by public transport in a rural area might add significantly to costs, for example). Even excluding the wider impact of national wage scales, we do not believe it is fair for public sector workers to be rewarded unequally based purely on where they live. But as Table 4 demonstrates, achieving equal reward does not mean equal pay.

54 TUC submission to OME call for evidence, 'Local and regional pay in the public sector', p. 2. http://www.tuc.org.uk/tucfiles/265/TUCresponsetoOME.pdf

55 For example, see Hatchett A 'Regional pay: top ten myths', Public Finance 17th January 2012, http://opinion.publicfinance.co.uk/2012/01/regional-pay-the-top-ten-myths/

Fairness between public sector workers, far from requiring that national pay scales remain, actually clearly demonstrates the need for reform.

Table 4: Monthly income and expenditure: Nurse with partner, two children, living in typical 3-bed home

	North East	North West	Yorkshire and Humber	East Midlands	West Midlands	East/East Anglia	London	South East	South West	Wales
After tax income	£3,656.20	£3,656.20	£3,656.20	£3,656.20	£3,656.20	£3,656.20	£3,996.20	£3,741.20	£3,656.20	£3,656.20
Mortgage and maintenance costs (typical 3-bed home)	£449.00	£483.00	£462.00	£482.00	£529.00	£579.00	£1,089.00	£811.00	£685.00	£479.00
Council tax (band D)	£127.08	£122.83	£117.58	£124.58	£118.33	£124.17	£108.67	£122.92	£125.33	£99.00
Energy costs (typical user)	£103.60	£105.70	£103.17	£102.55	£104.89	£103.73	£104.26	£103.26	£106.11	£105.55
Car (6,000 miles average a year)	£73.70	£73.48	£74.03	£73.76	£73.96	£74.07	£74.23	£75.18	£74.11	£74.21
Train (commuting ~ 15 miles)	£91.67	£128.92	£105.00	£125.67	£103.00	£210.58	£210.58	£210.58	£152.17	£87.75
Childcare (40 hours a week)	£665.32	£636.83	£662.41	£676.62	£631.21	£719.19	£879.15	£826.52	£741.52	£640.29
Food & non-alcoholic	£332.24	£332.24	£332.24	£332.24	£332.24	£332.24	£332.24	£332.24	£332.24	£332.24
Alcoholic drinks	£61.27	£61.27	£61.27	£61.27	£61.27	£61.27	£61.27	£61.27	£61.27	£61.27
Clothing and footwear	£129.74	£129.74	£129.74	£129.74	£129.74	£129.74	£129.74	£129.74	£129.74	£129.74
Housing, water, electricity	£228.47	£228.47	£228.47	£228.47	£228.47	£228.47	£228.47	£228.47	£228.47	£228.47
Furnishings, h/hold equipment	£154.10	£154.10	£154.10	£154.10	£154.10	£154.10	£154.10	£154.10	£154.10	£154.10
Health	£38.72	£38.72	£38.72	£38.72	£38.72	£38.72	£38.72	£38.72	£38.72	£38.72
Transport	£313.52	£313.52	£313.52	£313.52	£313.52	£313.52	£313.52	£313.52	£313.52	£313.52
Communication	£61.33	£61.33	£61.33	£61.33	£61.33	£61.33	£61.33	£61.33	£61.33	£61.33
Recreation	£304.31	£304.31	£304.31	£304.31	£304.31	£304.31	£304.31	£304.31	£304.31	£304.31
Education	£30.31	£30.31	£30.31	£30.31	£30.31	£30.31	£30.31	£30.31	£30.31	£30.31
Restaurants and hotels	£189.07	£189.07	£189.07	£189.07	£189.07	£189.07	£189.07	£189.07	£189.07	£189.07
Misc goods and services	£210.30	£210.30	£210.30	£210.30	£210.30	£210.30	£210.30	£210.30	£210.30	£210.30
Misc goods and services (minus childcare)	£161.86	£161.86	£161.86	£161.86	£161.86	£161.86	£161.86	£161.86	£161.86	£161.86
Total consumption	£2,053.31	£2,053.31	£2,053.31	£2,053.31	£2,053.31	£2,053.31	£2,053.31	£2,053.31	£2,053.31	£2,053.31
Total non-consumption	£523.71	£523.71	£523.71	£523.71	£523.71	£523.71	£523.71	£523.71	£523.71	£523.71
Total expenditure	£2,577.01	£2,577.01	£2,577.01	£2,577.01	£2,577.01	£2,577.01	£2,577.01	£2,577.01	£2,577.01	£2,577.01
Total spend (non-housing)	£2,524.32	£2,530.71	£2,525.14	£2,566.13	£2,494.33	£2,694.68	£2,839.83	£2,801.41	£2,662.19	£2,469.75
Total spend	£2,973.32	£3,013.71	£2,987.14	£3,048.13	£3,023.33	£3,273.68	£3,928.83	£3,612.41	£3,347.19	£2,948.75
Balance (income minus spend)	£682.88	£642.49	£669.06	£608.07	£632.87	£382.52	£67.37	£128.79	£309.01	£707.45
Spend/cost rank	9th	7th	8th	5th	6th	4th	1st	2nd	3rd	10th
Balance rank	£ 9.00	£ 7.00	£ 8.00	£ 5.00	£ 6.00	£ 4.00	£ 1.00	£ 2.00	£ 3.00	£ 10.00
Spend as % income	81.3%	82.4%	81.7%	83.4%	82.7%	89.5%	98.3%	96.6%	91.5%	80.7%

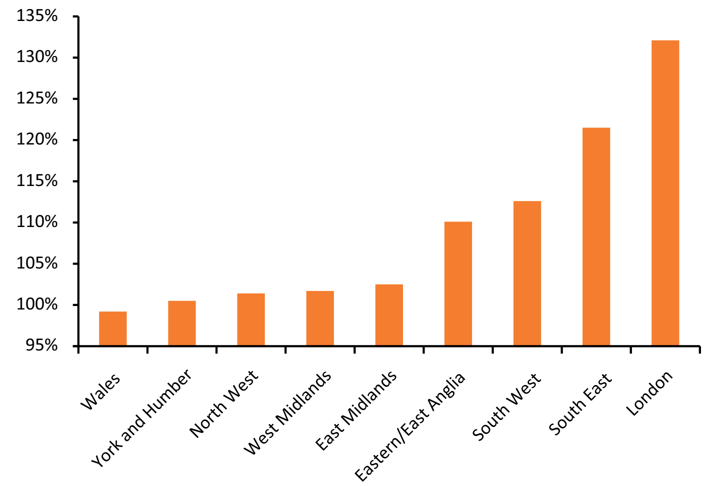
Source: Lloyds Banking Group 'Halifax House Price Index', LSL Property Services Ltd, DCLG, uSwitch, WhatGas.com, Joseph Rowntree Foundation, 'Minimum Income Standard 2012', Campaign for Better Transport, Daycare Trust. Calculations by the Resolution Foundation for ITV Tonight 'Divided Britain' programme.

Table 5: Cost of living for stylized family relative to other regions (nurse with partner, two children, living in typical 3-bed home)

	North East	North West	York and Humber	East Midlands	West Midlands	Eastern/ East Anglia	London	South East	South West	Wales
North East		98.7%	99.5%	97.5%	98.3%	90.8%	75.7%	82.3%	88.8%	100.8%
North West	101.4%		100.9%	98.9%	99.7%	92.1%	76.7%	83.4%	90.0%	102.2%
York and Humber	100.5%	99.1%		98.0%	98.8%	91.2%	76.0%	82.7%	89.2%	101.3%
East Midlands	102.5%	101.1%	102.0%		100.8%	93.1%	77.6%	84.4%	91.1%	103.4%
West Midlands	101.7%	100.3%	101.2%	99.2%		92.4%	77.0%	83.7%	90.3%	102.5%
Eastern/East Anglia	110.1%	108.6%	109.6%	107.4%	108.3%		83.3%	90.6%	97.8%	111.0%
London	132.1%	130.4%	131.5%	128.9%	130.0%	120.0%		108.8%	117.4%	133.2%
South East	121.5%	119.9%	120.9%	118.5%	119.5%	110.3%	91.9%		107.9%	122.5%
South West	112.6%	111.1%	112.1%	109.8%	110.7%	102.2%	85.2%	92.7%		113.5%
Wales	99.2%	97.8%	98.7%	96.7%	97.5%	90.1%	75.1%	81.6%	88.1%	

Source: as above.

Figure 16: Example: Cost of living in the North East versus other regions of the UK



The quality of public services

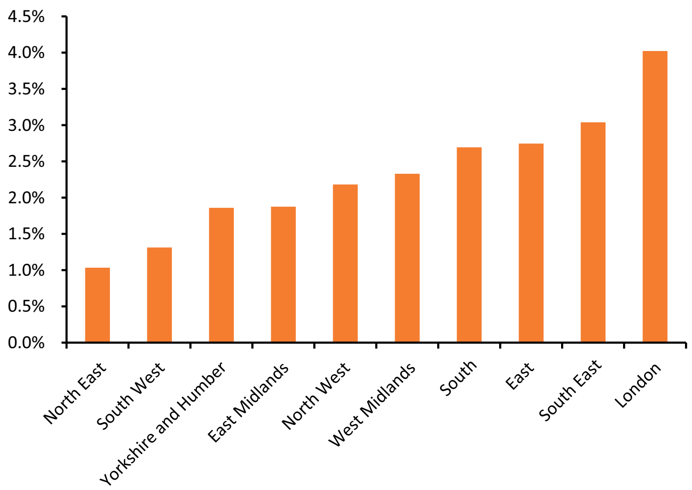
A recent report outlines another of the key problems that come from a rigid national system of pay determination and the differentials in pay between private and public sectors that chapter 2 demonstrated:

> *'Public sector pay structures as designed, in general, offer little scope for local flexibility. In contrast, there is considerable geographic variation in the rates paid in the private sector. As a result, there is*

substantial regional and geographic variation in the size of the pay gap between public and private sector employees. These pay gaps have important implications for the ability of the public sector to recruit and retain staff, and consequently for the quality of public services.'[56]

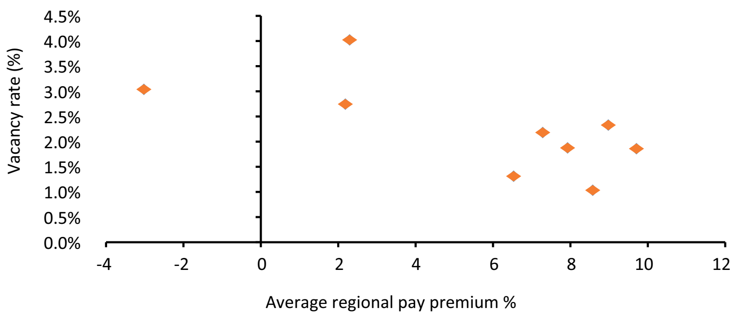
This difficultly in recruiting staff is easily shown. Figure 17 shows vacancy rates for NHS qualified nurses split by region. It demonstrates the large differences that are present, with vacancy rates nearly four times as high in London as compared to the North East.

Figure 17: Qualified nurses vacancies rates in the NHS by region, 2010



Source: The NHS Information Centre Vacancy Survey, NHS information centre, 2010.

Figure 18: Nurses vacancy rates versus public sector pay premium



Source: The NHS Information Centre Vacancy Survey, NHS information centre, 2009; and authors own calculations as per chapter 2.

Figure 18 goes on to demonstrate that those areas with lowest vacancies have the highest public sector pay premium and that those areas with the highest vacancies have a low public sector premia, or a pay penalty. In other words, in areas where the public sector is underpaid relative to the private sector, the public sector, unsurprisingly, finds it harder to fill vacancies.

56 Bell D, Elliott R, Scott A, Roberts E 'The pattern and evolution of geographical wage differentials in the public and private sectors in Great Britain', The Manchester School Vol. 75 No. 4, 2007, p. 387. Our boldening.

Table 6 outlines some of the key findings from research that has looked to estimate the impact of these problems on the quality of public services.

Table 6: Evidence of negative impact of national pay structures on public service delivery

Sector	Author, title	Description
Health	Burgess S, Gossage D, Propper C, 'Explaining Differences in Hospital Performance: Does the answer lie in the labour market?', 2003.	Found death rates in hospitals are higher where public sector pay is proportionately lower than the private sector in the region.
Nurses	Elliot R, McDonald D, MacIver R, 'Local Government Finance: Review of the Area Cost Adjustment', Waverley Press, 1996.	Includes analysis of difficulties of attracting and retaining nurses where pay does not reflect non-labour costs and labour market demand.
Teachers	Wolf, A, 'More than we bargained for', Centre Forum 2010.	Shows significant recruitment problems for teachers in deprived neighbourhoods.
Educational outcomes	Propper C, Britton B, 'Does Wage Regulation Harm Kids? Evidence from English Schools', Centre for Market and Public Organisation, Bristol University 2012	Found that, controlling for a wide range of factors, a 10 per cent increase in an area's average wages leads to a one exam grade loss at GCSE level.

Source: as above.

A potential cause of some of these problems is that budgets for public sector organisations in different geographical areas already tend to account for potential differences in staff costs, but are not able to change pay in response to this, since pay is negotiated nationally. Box 2 outlines more details of this system.

Box 2: How government budgets (try) to account for labour costs

Given the dominance of national pay bargaining, it is perhaps frequently misunderstood that government spending formula often try to account for distinctions in labour markets, despite the strictures of national pay scales largely preventing their reflection in public sector wages.

In fact, adjustments due to local labour markets are reflected in many areas of government budgeting. For example through:

- An Area Cost Adjustment for local government finance (mostly composed of a Labour Cost Adjustment);
- Market Forces Factors for the health service; and
- Area-costs Uplifts for the Learning and Skills Council.

> These formula tend to operate on the basis of a multiplicative scaling factor: that is, the labour cost element of a given budget grant will be multiplied by a factor dependent on a calculation of the relative cost of the labour market (a labour cost adjustment). A simplified example would be that if an area is judged to have labour costs 10% higher than the average, it will receive 10% more relative funding for staff costs (though a 'floor' on this system limits its effects).[57]
>
> However, because of the system of national pay bargaining, it is not generally possible to reflect this higher level of funding in individual staff pay.

Box 2 outlines that, in the context of national pay scales, this system has had unintended consequences. In particular, increasing budgets without the ability to increase pay has meant that the non-pay budget in certain areas has grown disproportionately, resulting in a 'postcode lottery' directly flowing from the restrictions of national pay bargaining'. For example, the Area Cost Adjustment for schools was 1.28 for Inner London; 1.15 for Outer London West and 1.09 for Outer London East. This contributed to a situation where, as of 2010, schools in Newham received £5,071 per child, while Tower Hamlets got £6,170, despite being neighbouring boroughs.[58]

In short, even where this formula resulted in increased funding for high labour cost areas, it has not necessarily resulted in better public service outcomes. Since public services are unable to reflect higher labour market costs with more pay, these areas also suffer from higher vacancy rates and lower retention of staff, resulting in understaffing or more temporary and agency workers to fill the gaps in provision.[59]

Another important finding highlighted by Alison Wolf is that these problems exist within regions, since deprived neighbourhoods can struggle to recruit the right public servants. Where public sector salaries do not rise to reflect local labour markets, there are also problems: a recent report by Propper and Britton, using data from 3,285 schools in the Pupil Level Annual School Census found that a 10 per cent increase in average wages results in an area led to a one exam grade loss per pupil at GCSE level, controlling for a wide range of specifications.[60] Given the findings above that pay differentials can vary significantly between different Local Authorities, this finding is of real importance. It demonstrates that a failure to recognise locally differentiated labour markets can have a real impact on public service delivery.

Productivity: National pay setting means pay reflects length of service, not performance

Another problem which could impact on public service delivery and increased costs to the taxpayer is that the current system of national pay setting tends to result in pay that reflects length of service, rather than performance.

Chapter 1 highlighted that national pay setting requires 'pay spines', based on levels of experience and that progression up the pay spine is largely automatic. In effect, many public workers get two pay rises a year – one based on the negotiated settlement and another based on moving up the point scale as a consequence of being in their job for another year.

57 http://www.local.communities.gov.uk/finance/0809/methaca.pdf

58 'The Future Distribution of School Funding', 4in10 Consultation Response, April 2010, http://www.endchildpoverty.org.uk/images/ecp/4in10_School_Funding_Consultation_Submission.pdf

59 For the case of London, see 'Local pay differences and vacancy rates for school teachers in England and Wales: Regional Differences in teachers' rates of pay and teacher vacancy rates', Office of Manpower Economics, July 2010.

60 Propper C, Britton B, 'Does Wage Regulation Harm Kids? Evidence from English Schools', Centre for Market and Public Organisation, Bristol University 2012, http://www.bristol.ac.uk/cmpo/publications/papers/2012/wp293.pdf

For example, state school teachers will generally move up to a higher scale point each year. While technically this can be denied for unsatisfactory performance (and promotion by two grades can be granted for exceptional teachers), in practice the overwhelming majority of teachers increase by one grade each year (in Scotland, the progression is fully automatic).[61] This point is supported by the Department for Education evidence for the School Teacher's Pay Review Body which shows that 'virtually all teachers on the main pay scale progressed to the next point' in the pay scale from one year to the next. For example, the proportion of teachers progressing up the main payscale each year (M1 to M6) is almost 100% across England and Wales, despite its theoretical dependence on satisfactory performance. The success rate for accessing the higher payscale (U1 to U3) is 97%.[62]

Of course, most private sector workers will increase their salaries as they become more experienced and productive. The difference with teachers and many other public workers is the scale of the rise and the fact that it is semi-automatic – indeed, the union NASUWT describes the scales on its website simply as 'six annual increase points'.[63]

Since this means progression occurs largely irrespective of performance, any link between performance and pay increases is largely broken. Critics see this as a key factor in lower public sector productivity.[64]

Productivity in the public sector is stagnant… at best

While precise figures on levels of public sector productivity are difficult to ascertain due to lack of easily verifiable metrics such as profit or turnover, official statistics have made great strides towards accurate qualitative assessment in the public sector – and the overall trend is striking. Of 22 estimates of productivity in the public sector since 2004, 18 show falls in productivity – ranging from a modest 2% yearly increase by one ONS estimate to a remarkable 15–20% decrease in education and NHS productivity between 1997 and 2003.[65] An Office for National Statistics estimate in June 2009 – based on General Government Final Consumption Expenditure and even including generous upward revisions for qualitative improvements in health and education – shows a 3.4% fall between 1997 and 2007 or about 0.3% per year. Since private sector productivity improved by 27.9% over the same period, we are left with the remarkable total of a 31.3% gap in productivity relative to the private sector or, in terms of unit labour costs, a rise of 30.5% relative to the private sector – even this, we should recall, starting from much lower levels of productivity and unit labour cost efficiency.[66] This leaves a £58.4 billion shortfall from what an equivalent level of public service would have cost had productivity gains matched that of the private sector.[67] As the CBI's then Director General put it:

> *'If the public sector had matched the private sector's productivity performance over that period, then we could now have 11% more public services for the same money.'*[68]

Apart from the cost in public money and reduction in public service outcomes, this lack of productivity reduces the sustainable growth rate of the economy. Particularly given the economic difficulties the UK faces, a continuation of low public sector productivity is no longer an option. Reforms to public sector pay

61 TES Connect article, December 2008. http://www.tes.co.uk/article.aspx?storycode=6000224

62 'Evidence to the STRB: the case for change', Department for Education 2012, http://media.education.gov.uk/assets/files/pdf/e/evidence%20to%20the%20strb%20the%20case%20for%20change.pdf

63 http://www.nasuwt.org.uk/PayPensionsandConditions/England/Pay/MaintainedSchools/index.htm

64 See Lavy, V 'Performance Pay and Teachers' Effort, Productivity and Grading Ethics', NBER Working Paper No. 10622, National Bureau of Economic Research, 2004

65 'The public sector productivity challenge', Big Picture, Quarter 4 2009 No. 5, p. 28

66 Centre for Economics and Business Research, The UK's public sector productivity shortfall is costing taxpayers £58,4 billion a year, 23rd August 2009. http://www.cebr.com/Resources/CEBR/Public%20sector%20costs.pdf

67 'Total Public Service Output and Productivity', Office for National Statistics, June 2009

68 Richard Lambert speech, 16th June 2009

– the majority of public service spending – which links staff reward to their productivity, rewarding service improvements and innovation is key to achieving this.

Wasted money and fairness

We have shown that a lack of flexibility in pay means that some public sector workers are underpaid, meaning that recruitment and retention can be a problem and that public services suffer. At the other end of the scale, we believe that where public sector premiums exist and public sector employees receive more pay than their private sector equivalents, this is money badly spent. We recognise and support the fact that an essential role of the government is to redistribute finances between relatively rich and relatively poor regions as well as between rich and poor individuals. However, we do not believe that National Pay Scales are an efficient way of doing this.

At the most basic level, as our previous reports have argued, there is an inherent trade-off between pay and employment.[69] For example, in areas where significant pay premiums exist, if pay premiums were to reduce over time, more people could be employed within any given budget. The recession provided a stark example, where, if real wages were to have fallen faster in the public sector, it is likely that redundancies could have been limited further. Given the large personal and social costs of unemployment,[70] we believe that cutting pay premiums and reinvesting in more jobs would be a better model for regional redistribution. In this respect, high public sector pay premiums introduce an inherent unfairness between those currently employed and receiving the high pay and those who are unemployed in those areas.[71]

Direct increases in employment are only one way in which fiscal transfers might be better spent. Others include boosting regional infrastructure spend, increased support for education or childcare in local areas or wider measures to support private sector growth. In this respect, there is also unfairness for the taxpayer as the current policy is not an efficient use of taxpayer's money. Chapter 8 gives more detail of how fiscal transfers between regions might be better spent.

Local area growth

The final point raised by the Chancellor and the Treasury's evidence to the pay review bodies is that national pay bargaining and the pay differentials it creates could lead to crowding out of the private sector. In turn, this could have a significant negative impact on growth in local areas dominated by the public sector.

This is a contentious debate, often based on little evidence. However, recent reports have argued that it may well be the case in the UK. The IFS have recently stated that:

> *'if remuneration in the public sector is too high, then all else equal, it might lead to excessive crowding out of skills for the private sector, wage inflation and an inappropriately higher burden for the taxpayer. This may be a problem now, in particular in regions outside London and the South-East.'*[72]

Another recent report by Gomes[73] found that optimal wages for the public sector should be 3% lower than the private sector in order to ensure a disproportionate

69 Holmes, E., and Oakley, M., (2011), *Public and private sector terms, conditions and the issue of fairness*. Policy Exchange, London

70 For example, we recently published an analysis of scarring effects of unemployment on older workers. Tinsley M, 'Too Much to Lose: Understanding and Supporting Britain's Older Workers', Policy Exchange 2012, http://www.policyexchange.org.uk/publications/category/item/too-much-to-lose-understanding-and-supporting-britain-s-older-workers

71 An unsurprising conclusion given the trade unions have an interest in protecting their employed members, rather than considering those out of work.

72 IFS Green Budget 2010, Ch 9, p. 219, http://www.ifs.org.uk/budgets/gb2010/10chap9.pdf

73 Gomes P, 'Fiscal Policy and the Labour Market: the effects of public sector employment and wages', *European Commission Economics Papers 439*, February 2011. http://ec.europa.eu/economy_finance/publications/economic_paper/2011/pdf/ecp439_en.pdf Dynamic stochastic general equilibrium model with search and matching frictions in the labour market and with both public and private sectors.

number of unemployed are not seeking work in the public sector. Where public wage premiums are significant, people disproportionately seek public sector jobs. This has the effect of increasing unemployment by driving up private sector wages and 'crowding out' its job creation. However, if the public wage penalty is too large, people do not seek the jobs, leading to problems of recruitment and retention. Both these problems are present in the current system.

Alison Wolf has also argued that there may be significant negative impacts on economies in local areas dominated by public sector employment:

> *'England's poorer regions often have poor transport communications and a legacy of defunct industry, but they should have one major competitive advantage – lower wages. The inflated pay imposed on poor regions via national wage bargaining is, in effect, a direct assault on that asset.'*[74]

The most rigorous report considering this question was published recently by Faggio and Overman.[75] While this does not consider the effect of public sector wages specifically, it does look at the impact of high levels of public sector employment. It finds that in the short-term, increases in public sector employment boost overall employment (increases in employment in service and construction sectors outweigh crowding out effects in the manufacturing sector). However, over the longer-term, increases in public sector employment lead to an aggregate fall in employment which are consistent with 'crowding out for total private sector employment.'

However, there are other papers that argue that crowding out effects are not likely. For instance, the evidence presented by the Welsh Government to the pay review bodies explicitly challenges the idea that crowding out has been a problem in Wales.[76] Recent papers by the New Economics Foundation[77] and Income Data Services[78] commissioned by the TUC, also argue this point more generally.

Overall, on the basis of the existing evidence, it is difficult to argue that high levels of public sector employment focussed in particular areas has no impact on the private sector in those areas. However, what is less clear, is the route through which these impacts take place. In short, while it makes intuitive sense, we cannot be certain that the removal of public sector pay differentials, in the context of constant public sector employment levels, would reduce crowding out effects.

This means that, if the case for reform hung on this argument alone, there would be questions over the need for reform now. However, this is not the case. The sections above outline clear arguments over the impact of national pay bargaining on the quality of public services and on the efficient use of public money. Commenting on his recent paper, Overman summarises the case well. A key reason we should look to reform the existing system:

> *'…is because of the implications for the quality of public good provision in high cost areas. And on that front, what evidence we have, strongly favours more localised pay.*[79]

Previous sections have also highlighted the unfairness of national pay bargaining in the context of budgetary decisions and that more effective means can be found to transfer public spending between regions. These arguments make a strong case that reform of pay negotiation would increase the quality of public services, deliver fairness for those working within the public sector and through the better use of fiscal transfers, drive growth and inclusion across the country.

74 Wolf, A, 'More than we bargained for', Centre Forum 2010, http://www.centreforum.org/assets/pubs/more-than-we-bargained-for.pdf

75 Faggio, G., & Overman, H.G., (2012), *The effect of public sector employment on local labour markets.* http://www.spatialeconomics.ac.uk/textonly/serc/publications/download/sercdp0111.pdf

76 Welsh Government, (2012), *Regional and local market pay in Wales: Evidence summary submitted for the consideration by the pay review bodies.* http://wales.gov.uk/docs/caecd/research/regionalandlocalparketpayinwales120508.pdf?lang=en

77 NEF, (2012), *The economic impact of local and regional pay in the public sector: a report by the New Economics Foundation for the Trade Union Congress.* http://www.tuc.org.uk/tucfiles/345/EconImpactPublicSector.pdf

78 'Crowding out : fact or fiction?', Income Data Services, 2012, http://www.unison.org.uk/file/IDS%20research%20report%20for%20UNISON%20on%20crowding%20out%20July%202012%20(2).pdf

79 http://spatial-economics.blogspot.co.uk/2012/06/public-sector-pay-and-local-employment.html

3
How Much Might Fair Pay in the Public Sector Save – or Cost?

The previous chapters have laid out the impacts of national pay negotiation in the public sector and made the case for ensuring that pay differentials between the private and public sector are reduced. This raises the obvious question of what the fiscal impact of moving to equal pay between the public and private sector might be.

A full costing of the budgetary implications of removing pay differentials between the public and private sectors would require a significant benchmarking exercise across the whole public sector. This would be both costly and time consuming. However, it is important that we begin to understand the potential scale of budgetary changes involved.

To do this, the Working Paper accompanying this report,[80] sets out a methodology to examine the scale of the potential budgetary implications of this policy. It uses the differentials estimated by sub-region and point in the wage distribution to calculate individual level pay differentials. These are then aggregated to form a view of the UK-level budgetary impacts. More detail can be found in the Working Paper.

Perhaps surprisingly, we estimate that the cost of simply equalising pay differentials to within 1% of the private sector equivalent as £3.79 billion. This is in large part due to significant underpayment of highly-skilled public sector workers, predominantly in the South East.

Table 5 sets out estimates of the total budgetary impact of pay alignment along with estimates of the costs of increasing (decreasing) pay where there are pay penalties (premiums). It also outlines estimates of the proportions of public sector employees that might be affected.

The table demonstrates the sheer scale of the task that might be involved. In some regions, we estimate that all employees in the public sector are paid more than their private sector counterparts. In others, we estimate nearly all of the public sector to be underpaid. If we look at what this means in terms of the fiscal transfers between regions we can see the size of redistribution across the country. The total redistribution to sub-regions where we estimate an overpayment is nearly £3 billion. The total redistribution away from sub-regions where we estimate an underpayment is £6.7 billion. Taking the two together implies a total fiscal transfer in the order of £9.7 billion.

There are also distinct differences between males and females, with a greater proportion of females being overpaid compared to their (female) private sector

80 Oakley M, 'Mind the Gap: the size and costs of pay differentials between the public and private sectors in the UK', Policy Exchange 2012

counterparts. In part, this is likely to be a result of equal pay legislation which is more strongly enforced in the public sector in response to equal pay claims. The Working Paper puts forward estimates which attempt to control for this (and finds that significant premiums still exist), but it is difficult to do so satisfactorily. It is clear that any attempts to reform the system will need to take this into account.

Table 7: Costs of pay differentials broken down by region and percent of workforce paid more/less than private sector counterparts

	Overall costs of pay premia/ penalties	Costs of over-payments	Costs of under-payments	PERCENT OF PUBLIC SECTOR EMPLOYEES: Within 1% band of private sector equivalent		Overpaid		Underpaid	
	Yearly £ ,000's	Yearly £ ,000's	Yearly £ ,000's	Male	Female	Male	Female	Male	Female
Tyne and Wear	42,692	105,435	-62,765	0	0	66	77	34	23
Rest of North East	183,092	183,100	0	38	0	62	100	0	0
Greater Manchester	241,516	267,421	-25,905	0	0	62	100	38	0
Merseyside	150,640	167,032	-16,392	0	0	61	100	39	0
Rest of North West	49,893	189,377	-139,484	30	0	35	75	35	25
South Yorkshire	264,761	264,761	0	0	0	100	100	0	0
West Yorkshire	82,148	170,784	-88,636	0	0	60	76	40	24
Rest of Yorkshire and Humberside	261,995	261,995	0	0	0	100	100	0	0
East Midlands	130,426	251,224	-120,798	31	26	28	74	41	0
West Midlands Metropolitan County	115,263	157,740	-42,477	0	22	55	78	45	0
Rest of West Midlands	289,402	289,402	0	31	0	69	100	0	0
East of England	-703,935	91,802	-795,737	18	30	6	42	76	28
Inner London	-1,880,785	19,157	-1,899,942	0	0	6	22	94	78
Outer London	-1,305,964	77,464	-1,383,428	11	0	4	28	84	72
South East	-2,830,647	47,927	-2,878,574	0	25	7	15	93	60
South West	-44,280	289,755	-334,035	32	0	26	72	42	28
Wales	699,102	699,102	0	0	0	100	100	0	0
Strathclyde	179,937	215,014	-35,078	33	0	27	100	40	0
Rest of Scotland	31,992	237,291	-205,299	33	0	26	68	41	32
Northern Ireland	253,551	253,551	0	0	0	100	68	0	0
UK	-3,789,201	4,239,334	-8,028,550	15	6	44	73	41	20

Source: as above.
Note: all £ figures are rounded to nearest 1,000

This picture is also incomplete since it does not account for other aspects of remuneration – particularly pensions. Box 3 considers some of these other aspects.

Box 3: Considering the whole package

A major limitation to the analysis of pay differentials is that pay is only one aspect of total reward. Private sector workers, particularly towards the top of the income distribution often have remuneration packages where bonuses and other fringe benefits, such as private health care, form a large part of their overall package. Of course, pension contributions form an important part of any reward package and these are not accounted for in this analysis. An example of some of the possible non-wage benefits and the difference in the likely coverage in the public sector compared to private sector is given in Table 6.[81]

Table 6: Stylised differences in reward package between public and private sector

	Low pay public	High pay public
Holidays (including privilege days)	+	+
Pensions	+	+
Bonus payments	-	-
Flexible working	+	+
Intrinsic satisfaction/public service motives	+	+
Other fringe benefits	+	-

Where **+** means public sector package more generous)

Accounting for the differences in the non-wage differentials laid out in Box 3 is vitally important as, once accounted for, they could lead to equivalence in total reward packages when we had previously estimated a wage differential.

However, relatively little analysis has been undertaken on the value of many of these different aspects of total reward packages. One exception is the value of pensions between the public and private sectors, which was considered by Disney, Emmerson and Tetlow (2009).[82] Summarising their findings they state:

> *'...public sector workers are more likely to be covered by DB defined benefit plans than private sector workers but also that as a percentage of salary the incremental accruals of pension wealth for DB covered public sector workers on average exceed those for DB covered private sector workers...there is no clear compensatory relationship between current pay and pension entitlements: there is no statistically significant evidence from any of our groups that, on average, either pay or pensions are lower in the public sector than in the private sector.'*

In terms of value, they find that '...One-period accruals in the public sector are, on average, worth 6.6% of salary more in a public sector DB plan than in a private sector DB plan.'

For reasons we note below, this is a very low estimate of the degree to which wage premiums in the public sector are augmented by more generous pension arrangements. However, in short, where this paper estimates a pay premium for workers in the public sector, this would be larger when accounting for the

81 For an overview of total remuneration, see CIPD Reward Management Annual Survey 2011; IFS Green Budget 2012, Chapter 5, http://www.ifs.org.uk/budgets/gb2012/12chap5.pdf

82 Disney R, Emmerson C, Tetlow G, 'What is a Public Sector Pension Worth?', Economic Journal Vol 119, Issue 541, pp. 517–535, 2009

pensions premium. Conversely, where a penalty for workers in the public sector is estimated (notably at the top of the wage distribution and, in particular, in London and the South East of England) this would be lower after accounting for the more generous public sector pension arrangements.

To try to estimate the impact of this on the costs we highlight above, the Working Paper re-estimates pay differentials accounting for the value of pension accrual, with estimates which vary across the education distribution, from the Disney, Emmerson and Tetlow (2009) paper. While unsatisfactory (in the sense that it is confined to defined benefit pensions and assumes equivalence between the two sectors), it does at least provide a method to partially account for accrual of pension rights.

Table 8: Costs of pay differentials broken down by region and percent of workforce paid more/less than private sector counterparts after adjusting for pensions

	Overall costs of pay premia/ penalties	Costs of over-payments	Costs of under-payments	PERCENT OF PUBLIC SECTOR EMPLOYEES: Within 1% band of private sector equivalent		Overpaid		Underpaid	
	Yearly £ ,000's	Yearly £ ,000's	Yearly £ ,000's	Male	Female	Male	Female	Male	Female
Tyne and Wear	251,612	253,237	-1,625	31	0	67	99	1	1
Rest of North East	433,439	433,439	-	0	0	100	100	0	0
Greater Manchester	681,464	681,464		1	0	99	100	0	0
Merseyside	374,687	374,687	-	2	0	98	100	0	0
Rest of North West	531,713	532,906	-1,193	36	0	63	100	1	0
South Yorkshire	486,444	486,444	-	0	0	100	100	0	0
West Yorkshire	419,533	421,106	-1,573	37	0	61	100	2	0
Rest of Yorkshire and Humberside	561,106	561,106	-	0	0	100	100	0	0
East Midlands	771,564	775,004	-3,440	38	0	60	100	2	0
West Midlands Metropolitan County	458,973	459,396	-423	0	0	99	100	1	0
Rest of West Midlands	679,518	679,518	-	0	0	100	100	0	0
East of England	206,765	436,496	-229,730	29	19	25	81	45	0
Inner London	-1,341,798	50,532	-1,392,330	0	0	15	20	85	80
Outer London	-446,890	254,440	-701,330	0	0	17	57	83	43
South East	-1,404,128	296,582	-1,700,710	0	14	21	55	79	32
South West	769,043	820,494	-51,451	0	0	57	99	43	1
Wales	1,254,449	1,254,449	-	0	0	100	100	0	0
Strathclyde	587,398	587,398	-	1	0	99	100	0	0
Rest of Scotland	612,781	635,732	-22,951	0	0	61	100	39	0
Northern Ireland	420,806	420,806	-	0	0	100	100	0	0
UK	6,308,480	10,415,237	-4,106,757	9	4	59	86	32	10

Note: all £ figures are rounded to nearest 1,000

Table 8 outlines the results from this analysis and demonstrates that, even with this under-estimate of the additional value of public sector pensions, the cost of equalising remuneration is eliminated.

In fact, instead of a £3.79 billion cost, after accounting for the superior value of public sector pensions even with this very modest estimate, equalising the total reward-package (i.e. including pay and pensions) would realise a saving of £6.31 billion a year.

As we have noted, however, this is a low estimate. It puts the average additional value of public over private sector pensions at 6.6% of earnings. It contrasts public and private defined benefit pensions, despite the fact that they have been largely phased out in the private sector. In addition, most private sector workers do not have a pension, while most public sector staff are auto-enrolled in defined-benefit pensions – in 2011, 83% of public sector workers belong to an occupational pension scheme against just 33% in the private sector,[83] and of those with such pensions, an Office for National Statistics estimate of the median value for 2008–10 was £40,000 for the private sector but £90,100 for the public sector.[84]

Other estimates have put the pensions' differential higher: one estimate put the nominal average public sector salary at 15.6% more than the same nominal amount in the private sector[85]; other estimates have put the figure at around 12%.[86] Research by the IFS concluded that the mean value of pension accrual is 9.3% of salary for a private sector defined-contribution pension compared to 30.5% for a defined-benefit public pension.[87]

Overall, the results above highlighted how significant the potential savings equalising public and private sector reward packages could be. However, it seems likely that the potential cost reductions we outline are extremely cautious. Further work will be needed to calculate a fair pension value comparison between the two sectors, and in the long-term this should be factored in to the budgetary adjustment reforms we outline later.

Similar arguments can be made over longer holidays (plus privilege days), the increased use of flexible working and over the presence of intrinsic job satisfaction or 'interest' which could be associated with public service roles. These points are particularly true for those towards the top of the wage distribution, where overall it seems likely that once non-wage reward is taken into account, the overall level of the differential (penalty) would be reduced.

The lack of reliable data on these aspects of reward packages in the public sector acts as a limit to the degree we can make accurate estimates of the extent to which public sector workers are better-rewarded than their private sector counterparts. For this reason we recommend that:

- The government should consult on how to best measure the total reward packages of public sector employees and publish data that allows comparisons between the public sector and private sector. As a priority, the value that public sector pensions add to individual reward packages in the public sector should be analysed and published.

83 2011 Annual Survey of Hours and Earnings: Summary of Pension Results, Office for National Statistics, http://www.ons.gov.uk/ons/rel/ashe/annual-survey-of-hours-and-earnings-pension-tables/2011-provisional-results/stb-ashe-pensions2011.html

84 'Wealth in Britain Wave 2, 2008/10, Part 2 Chapter 4, http://www.ons.gov.uk/ons/rel/was/wealth-in-great-britain-wave-2/2008-2010--part-2-/report--chapter-4--pension-wealth.html

85 Calculation of mean value of total pension accrual across all employees in 2005. Institute for Fiscal Studies, 'Occupational Pension Value in the Public and Private Sectors', p. 15. http://www.ifs.org.uk/wps/wp1003.pdf

86 The IFS Green Budget 2008, p. 172. http://www.ifs.org.uk/budgets/gb2008/08chap8.pdf

87 Institute for Fiscal Studies, 'Occupational Pension Value in the Public and Private Sectors', p. 13. http://www.ifs.org.uk/wps/wp1003.pdf

4

Alternative Models of Pay Determination

The previous chapters have outlined the need to reform the model of pay determination in the public sector in the UK so that we reward vital public sector workers in an appropriate and fair manner, drive productivity increases to deliver better public services and help to boost growth across the country. This chapter uses evidence of existing regimes of pay determination in the private and public sectors of the UK to inform the debate over what reform might look like.

Evidence from the UK

Learning from experiences of pay setting that reflects local labour markets is key to making recommendations for the future of public sector pay setting. For this reason, as part of the process of writing this report, Policy Exchange interviewed a wide variety of Human Resources professionals in the private sector to assess how their pay negotiations operated. We also interviewed a number of Human Resources professionals in public sector organisations which have significantly diverged from national pay setting.

The discussions revealed very diverse pay setting arrangements which have evolved significantly over time. Perhaps surprisingly, few larger organisations place significant emphasis on the regional cost of living and, although private sector employers are able to pay widely varying salaries for the same roles in different parts of the country, truly local paysetting rarely exists in larger firms. As has been highlighted by Unison, Income Data Services and others,[88] those private sector businesses with a presence in many different localities across the UK do not necessarily set pay locally (particularly for non-manager, semi-skilled and unskilled employees).

In part this is a reflection of the high transaction costs that can result from duplicating similar negotiations individually with all employees. It is also a reflection of the potential lack of negotiating experience of many local managers and thereby a comparative advantage that unions could use in order to raise wages.

As a result, large private sector firms establish rules or guidelines at the national level, and the rules identify the conditions under which higher pay is offered in different areas of the UK.

> *'Typically these rules require 'evidence of the rates paid by local competitors, of the local cost of living, and perhaps of local unemployment rates or turnover rates as evidence of market tightness.'*[89]

88 'Local-based pay differentiation: A research report for UNISON', Income Data Services

89 Bell D, Elliott R, Scott A, Roberts E 'The pattern and evolution of geographical wage differentials in the public and private sectors in Great Britain', The Manchester School Vol. 75 No. 4, 2007, p. 390

Alongside this, they may also use other methods to ensure that pay adjusts to local markets.

We provide more complete details of the case studies used in this report in the appendix. These explore some of the most interesting models for ensuring that local pay reflects local conditions for larger organisations, without being onerous on employees and managers. However, we can summarise that private sector pay setting can be characterised by:

- Pay based on performance or contribution to the organisation, with no reflection on length of service;
- Market-informed pay-setting incorporating factors such as commuting distances, economic indicators, attrition rates and benchmarking, combined with affordability;
- Pay settlements often being tied to business units rather than across the organisation;
- A more flexible pay system for professional roles based on comparisons to national (or even international) labour markets, with uprating often conducted on a discretionary basis through annual review;
- Transparency of salary setting processes and clear communication and consultation with staff;
- The use of job evaluation methodology and a pay progression framework, so the best performing people are given the highest pay increases based on assessment of factors such as competencies, delivery of results, experience, level of responsibility etc., with a benchmarking process between managers to ensure consistency;
- Discretionary bonuses, rarely awarded and mostly for exceptional performance, usually at more senior levels according to identifiable metrics, often conditional on meeting specific unit or organisation-wide minimum performance;
- Tailored pay systems to particular workforces with individual line managers given some discretion over how particular pay budgets are spent, in-line with organisation-wide budget setting.

These findings are very much in line with the Hay Group's review of the remuneration practices of what it views as the world's most successful companies, summarised in Box 4.

Box 4: Best practice in the private sector

The Hay Group's annual reviews of the world's best companies found they shared several things in common with their remuneration practices:[90]

- Aligning reward with the organisation's overall strategy and maintaining it over time;
- Use a total reward approach, making staff appreciate non-monetary rewards;
- Full engagement of managers in making use of reward programmes;
- Transparent reward policies which are well communicated;
- Effectively executing the policy;
- Closely linking reward to performance and greater variation in pay, including paying lower base salaries than average but higher than average salaries to their top performers.

90 'Setting the scene for public sector reward: why and how', Hay Group 2012, p. 7, http://www.haygroup.com/Downloads/uk/misc/Setting_the_scene_for_public_sector_reward.pdf

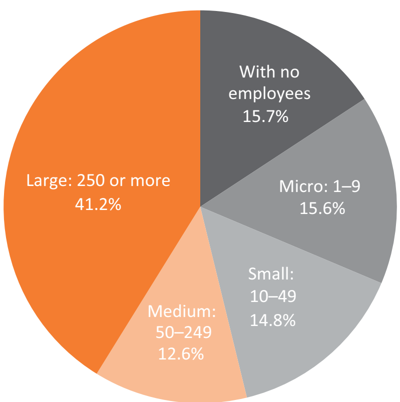
For those public sector organisations which have departed from national pay scales (mostly local authorities), this has been characterised by:

- Removal of incremental pay progression;
- Accelerated promotion through pay scales based on personal performance reviews;
- The use of existing national salary scales as a reference point for the cost of the new, more locally facing, pay systems;
- Phasing out bonuses as 'custom and practice' and becoming discretionary if an employee has done an exceptional job;
- Market premiums being paid in response to particular labour markets, skills shortages and whether the competition for a particular role is local or national (generally for more senior staff);
- Tracking of regional labour markets, turnover, retention, recruitment and other data and its incorporation in the reward process;
- Minimal variation from national frameworks in terms of pension and other terms and conditions outside pay;
- Consideration of Total Reward (i.e. including remuneration outside pay) and paydrift;
- Opposition to any change from national pay bargaining by local trade unionists, often orchestrated by national union organisations;
- New systems to replace preceding performance review and competency frameworks which proved ineffective.

The case of small firms

The evidence above demonstrated that not many large multi-site firms have truly local pay setting. However, while this is true of larger firms, it is inaccurate to characterise this as typical of the UK private sector labour market. 58.8% of UK employment is in firms with less than 250 employees; just under half (46.2%) are employed in firms with less than 50 employees.[91]

Figure 19: Distribution of UK private sector employment by size of firm, 2011



Source: 'Business population estimates for the UK and regions 2011', Department for Business Innovation & Skills 2011.

91 'Business population estimates for the UK and regions 2011', Department for Business Innovation & Skills 2011, p. 2, http://www.fsb.org.uk/pressroom/assets/statistical%20release%20bpe%202011%20edition.pdf

For these employees, pay setting is likely to be a very localised process. This is particularly true for employees in the smallest firms. Since trading is likely to occur at only one location (or a few locations within a particular area) paysetting will, by definition, be distinct to that local area – and equally, by definition, distinct from other firms in other parts of the country (subject to the minimum wage). Consequently, for the majority of workers in the private sector who work for non-large firms, pay is likely to be 'local pay by default' and thus highly dependent on the local labour market and trading environment they operate in.

This is likely to be more pronounced for the smallest firms: for example, the 3.4 million firms which are sole trader or partnerships could be characterised as 'individual pay by default' – that is, their pay is determined entirely by their own performance and unique circumstances. Thus, while larger firms may find it more practical to operate with more limited local pay bargaining than their smaller peers, the majority of private sector employees, working in smaller firms, will usually have pay determined at a largely local (if not individual) level. This contributes to the more responsive characteristics of private sector paysetting we outlined earlier.

Conclusion

Many of those who argue against reform of the system of national pay bargaining in the public sector use the argument that the private sector does not use a system of local bargaining. 'Large multi-site private sector firms have the closest parallels with the public sector given their size and the fact that they operate in multiple local areas.'[92] Our discussions with HR professionals, who deliver systems of pay determination across the private and public sectors, have shown that this is true. However, they have also shown that reward strategies in the private sector are very different to the system of collectively agreed national pay bargaining in the public sector. Smaller firms that account for nearly two thirds of employment in the UK also have paysetting systems that are 'local by default'.

The systems in larger firms aim to drive productivity by rewarding performance and offer managers flexibility to meet local labour market conditions while not over-burdening them with negotiations and bureaucracy. In particular, pay increases in the private sector are frequently determined by performance review and are unlinked to length of service. This is often the case even where overall paysetting is theoretically national or zonal, rather than local. In contrast, in the public sector pay increases or progression are usually semi-automatic even where it is notionally dependent on successful performance.

Overall it is clear that pay-setting in the public sector diverges significantly from what is seen as the best practice in the private sector. Reforms to public sector pay negotiation structures that look to learn from best practice in the private sector could deliver a fairer system that motivates staff and drives public service improvements.

92 TUC submission to OME call for evidence, 'Local and regional pay in the public sector', p. 4. http://www.tuc.org.uk/tucfiles/265/TUCresponsetoOME.pdf

5

Evidence From Abroad

As well as drawing evidence from the private sector in the UK, it is also informative to look at how other countries structure pay negotiation. There are several diverse means of pay setting which vary widely across countries and that have changed over time:[93]

Description	Country, dates applicable
Uncoordinated wage bargaining conducted at the individual firm or workplace level.	Canada, Ireland 1960–69 and 1981–87, New Zealand since 1988, United States, UK private sector since 1980.
Some industry and company bargaining with weak pattern-setting and government coordination through minimum wage/indexation policy.	Australia, 1992–, France, Italy intermittently.
Industry-wide bargaining with some pattern-setting and moderate unionisation.	Denmark, since 1981, Finland intermittently, Sweden since 1994, Australia prior to 1981, New Zealand prior to 1988.
Central bargaining at industry or firm level informally or explicitly driven by government agencies, with extensive pattern-setting roles and high unionisation.	Belgium, Finland mostly, Ireland 1970–8 and 1987–93, Italy since 1993, Netherlands since 1983, Norway mostly, Switzerland, Germany, Austria since 1983.
Central government agency imposition of pay increases or freezes, including high-level co-ordination with small number of unions with informal centralisation of industry-level bargaining, and/or extensive pattern-setting and co-ordination by private sector firms.	Denmark 1960 to 80, Ireland since 1994, Norway intermittently, Sweden 1960–82, Austria prior to 1983, Japan, UK public sector.

What is clear from this table is that relatively few countries have run pay negotiation structures like those that currently exist across large swathes of the UK public sector. Some countries have systems of pay negotiation that are extraordinarily different from those in the UK public sector. Many take on significant portions of the best-practice elements of remuneration policy that we highlighted exist in the private sector. Box 5 highlights the case of Singapore.

Box 5: Case study – Singapore's Civil Service

Pay in Singapore's civil service is determined by a combination of ability, skills and experience, the demands of the job and prevailing labour market conditions, determined by a peg to the private sector established in the early 1990s.[94] Wages are paid with fixed and variable components, allowing flexibility according to performance and labour market conditions, including an Annual Variable Component, Merit

93 Kenworthy L, 'Wage-Setting Coordination Scores' Emory University 2001, http://www.u.arizona.edu/~lkenwor/WageCoorScores.pdf

94 See http://www.ifaq.gov.sg/psd/apps/fcd_faqmain.aspx

Increment and Performance Bonus. Contracts are flexible allowing underperforming employees to be dismissed. Pay is heavily stratified with those at the top earning in excess of £1.25 million.

It aims to employ the best in the labour market, with high levels of entry from the private sector. It also gives generous scholarships for undergraduates in return for six years of service after graduation, who can be fast tracked to senior management by their early 30s.[95] Additional training continues throughout a civil servant's career, including a dedicated Civil Service College and postgraduate training for more senior roles. This ethos is reflected throughout the public sector:

'Meritocracy reigns all the way down the system. Teachers, for instance, need to have finished in the top third of their class (as they do in Finland and South Korea, which also shine in the education rankings). Headmasters are often appointed in their 30s and rewarded with merit pay if they do well but moved on quickly if their schools underperform.'[96]

Another country that is often highlighted as having a good example of an efficient and effective system of pay negotiation is Sweden. A number of previous reports have praised the reforms undertaken in the public sector in Sweden. These reforms took Sweden from a very centralised system of pay negotiation to one much more based on local negotiation and performance.[97] They have been achieved with support from trade unions, workers and the government.

For this reason, our research for this report included a visit to Sweden to assess their systems of public and private pay negotiation. Our visit included extensive consultations with leading economists, mediation experts and policy advisers.

Case study: Sweden

Overall, while many key stakeholders conceded that the local and personalised system that now exists in Sweden has higher transaction costs than the UK's system of national pay bargaining, that did not weaken their support. As one expert put it to us, while national pay bargaining 'may be efficient, it is not effective' and that 'pay should not be fair, pay should be productive.'

The majority of people we spoke to were also critical of the previous, nationalised system and welcomed the reforms over the last few decades. The result is a pay setting system that is not only responsive to labour market forces, but enjoys widespread support – from employers, trade unions and the public at large. While Sweden and the UK's economies differ significantly in several respects, we believe Sweden's experience of implementing these reforms and its end result hold many key lessons as to how such policies might be implemented in the UK.

The pay bargaining system

Sweden's system of public sector remuneration combines collective bargaining and high unionisation with a complex, differentiated system of pay bargaining. Collective bargaining covers the whole Swedish public sector and remains the norm throughout the economy, covering some 92% of the workforce. Employees at all levels are heavily involved with the pay setting process, either directly negotiating for themselves, or as trade union representatives.

95 Cappelli M, 'Talent Management in the 21st Century: Lessons from Singapore', Wharton-SMU Research Center, https://mercury.smu.edu.sg/rsrchpubupload/1911/CappelliP_TalentMgt21Spore.pdf

96 Go East, young bureaucrat', Economist, March 17th 2011. http://www.economist.com/node/18359852

97 Wolf, A, 'More than we bargained for', Centre Forum 2010, http://www.centreforum.org/assets/pubs/more-than-we-bargained-for.pdf

Some 60 trade unions, split mainly by skill level and sector, and 50 employer organisations are involved in negotiating around 650 nationwide collective agreements, whose terms can change during each bargaining round. The Swedish Enterprise Confederation and the Swedish Trade Union Confederation both play an important role in negotiating national agreements. There are three main confederations of unions: for white-collar, blue collar and graduate-level professionals which play a leading role in sectoral negotiations as well as regulating competition between unions. Table 9 outlines the major parties involved in these negotiations.

Table 9: Stakeholders in the Swedish pay bargaining system

Name	Description
SN (Svenskt Näringsliv)	The Swedish Enterprise Confederation, Sweden's CBI, is the main employer's trade association, representing some 55,000 member companies (around 80 per cent of the total) and the 50 employer organisations.
TCO (Tjänstemännens Centralorganisation)	The Swedish Confederation of Professional Employees represents around 1.3 million white-collar employees and has 15 member unions.
LO (Landsorganisationen i Sverige)	The Swedish Trade Union Confederation represents 1.5 million blue-collar employees and has 15 member unions. Its largest union is the Municipal Workers' Union (Kommunal), principally representing local government workers, followed by the Union of Metalworkers (IF Metall), following a merger of two unions in 2006.
SACO (Sveriges Akademikers Centralorganisation)	The Swedish Confederation of Professional Associations, represents 556,000 employees educated to graduate-level or above and has 22 member unions.
SALAR	The Swedish Association of Local Authorities and Regions represents local government employers, covering 290 municipalities and 20 county councils, negotiating some 20 local-level agreement and 6 national agreements.
SAGE	The Swedish Agency for Government Employers represents central government employers, covering 250 government agencies.
National Mediation Office	The central government mediation service, tasked with resolving labour disputes as well as promoting a wage formation process and national statistics relating to wages and salaries.
Swedish Association of Local Authorities and Regions (Sveriges Kommuner och landsting, SKL).	Representative association of local government employers: 290 municipal, 18 county councils and two regions.
Swedish Agency for Government Employers (Arbetsgivarverket)	Representative association for national public sector employers, negotiating for 270 public authorities.

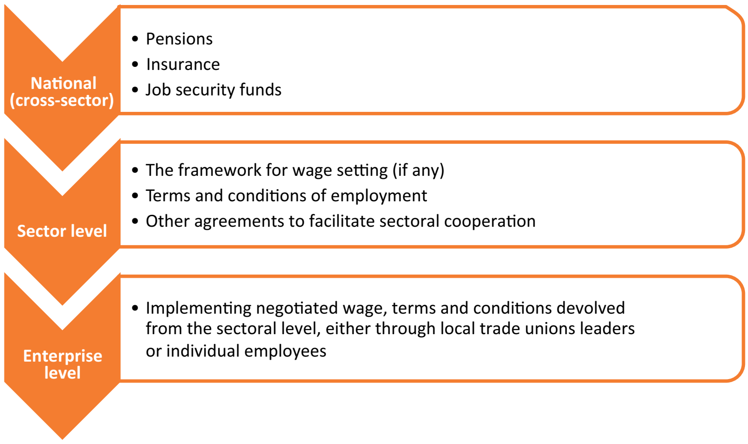
Source: Eurofound, National Mediation Office

Negotiation of collective agreements is undertaken at three levels: national, sectoral/industry-wide and at firm level. Agreements at the national and sectoral level often have little or no bearing on pay setting: instead they tend to discuss the formation of a general framework and other aspects of remuneration such as pensions and job security. A stylised version of the system is given in Figure 20.

What this means for pay setting in practice

Given the importance of exports for the Swedish economy it is unsurprising that the main emphasis in the system is that wages should largely reflect international

Figure 20: Tiers of collective bargaining agreement in Sweden



Source: 'Business population estimates for the UK and regions 2011', Department for Business Innovation & Skills 2011.

levels in order to drive competitiveness. In practice, certain sectors act as pace-setters – particularly export-orientated major industries such as metalworking and the paper industry, which puts a cap on increases, generally via a labour cost index in these sectors following an industrial agreement in 1997. A 2% inflation target, agreed with the social partners and whose implications for pay have been supervised by the National Mediation Office since 2000, further assisted in holding down costs.

Underpinning this emphasis on competitiveness is the principle, particularly in the public sector, that wages should be negotiated locally so that the specific organisation the employee works for can find the right solution. This means that final negotiations over pay tend to either take place individually between employer and employee, or between the employer and the employee's trade union representative (the former is more common for white-collar and graduate-level employees who prefer to negotiate for themselves;[98] the latter for blue-collar workers).

However, this does not mean that individually negotiated contracts between employees and employers are necessarily the norm. In fact, a number of different models exist in different parts of the economy. There are seven main models for how pay is set (in increasing order of centralisation):

- *Local wage formation without nationally determined margin* – pay is negotiated entirely by local stakeholders without any guarantees as to the percentage increase.
- *Local wage formation with a fall-back, regulating the size of the increase* – pay is set locally, but if this negotiation fails a percentage pay bill guarantee is applied via the sectoral agreement, which is then distributed by local agreement.
- *Local wage formation with a fall-back, regulating the size of the increase, plus some form of individual guarantee* – as above, but with a minimum guarantee such as a set money pay increase per worker in additional to a percentage pay bill guarantee should no agreement be reached.

98 Strath, A, 'Teacher Policy Reforms in Sweden: The Case of Individualised Pay', (2004), Swedish Ministry of Education and Science, 2004

- *Local wage frame without an individual guarantee* – a local pay bill framework is applied specifying the pay bill limits within which pay negotiation can be negotiated, but without a set guarantee for each worker.
- *Local wage frame with an individual guarantee or alternatively a fall-back regulating the individual guarantee* – as above but with a guaranteed increase for each worker, such as a set money amount, set at the sectoral level, or with such a guarantee if no agreement is reached.
- *General pay increase and local wage frame* – a general pay increase is negotiated through the sectoral agreement which can then be added to by local negotiation.
- *General pay increase* – pay is negotiated uniformally at the sectoral agreement level without local negotiation.

Table 10: Main models of agreement in the Swedish pay bargaining system

	PERCENTAGE OF EMPLOYEES, BY SECTOR			
Agreement model	**Private**	**Central government**	**Municipal and county council**	**All sectors**
1. Local wage formation without nationally determined margin	6	38	5	8
2. Local wage formation with a fall-back regulating the size of the increase	9	62	40	25
3. Local wage formation with a fall-back, regulating the size of the increase, plus some form of individual guarantee	1			1
4. Local wage frame without an individual guarantee	12		54	7
5. Local wage frame with an individual guarantee or alternatively a fall-back regulating the individual guarantee	43			43
6. General pay increase and local wage frame	18			10
7. General pay increase	11		1	6

Source: National Mediation Office Sweden, Annual Report 2010, p. 6, http://www.medlingsinstitutet.se/pdfs/pdfs_2011/eng_smftn_feb2011.pdf

Table 10 demonstrates that the use of these different models varies significantly between the public and private sectors in Sweden.

As will be apparent, this system is complex. Notably, the private sector has greater reliance on a more structured pay frame and minimum guarantees (models 5 to 7) than the public sector, which has more local and personalised pay setting (models 1 to 4) – almost the opposite situation to the UK. However, the consequence is a system which is not only supported by employers and unions, but results in a much more granular and sophisticated approach to pay negotiation. The system has also functioned with relatively little industrial action in either the public or private sector.

Remarkably, trade unions in Sweden tend to argue for local managers to have a bigger mandate to negotiate rather than less, whereas private sector employers often like to 'pass the blame' to the external wage framework. In particular, the flexibility of the Swedish private sector to distribute the increase in the pay bill available according to negotiation is frequently restricted by minimum increase guarantees, but this is less common in the public sector, where 'local parties are allowed to decide the wage margin and its distribution in almost all cases.'[99] Indeed, trade unions see individual negotiation as an effective way to ensure public sector pay keeps up with the private sector, with some groups who stuck to the old processes seeing their wages fall behind.

Once a collective agreement has been reached between employer organisations and trade unions (with negotiation for the new pay round preceding the previous ones' expiration), both member employer and local trade union representatives are bound by its terms (if the employer is not an employer organisation member, the trade union negotiates directly).

Similar systems in Finland and Denmark have a hybrid system of general pay increases plus local supplements (around 65% of increases by generic average, 35% locally determined, for example). The systems have generally become more flexible over time (for example, a fixed minimum increase plus a locally determined top-up, with the latter gradually becoming a greater proportion of the total increase).

A consensus?

An interesting feature is that the process of pay negotiation is now widely supported among Swedish trade unions.[100] It has also gained wider support over time: for example, pay reforms for Sweden's teachers had less than a third of their largest union members' support four years after their introduction in 1996, compared to over 60 per cent ten years later.[101]

A peace clause which has been in force since 1928 prevents unions from striking during the period of the collective agreement (though they made do so if no agreement is reached), except under exceptional circumstances such as employer breach of contract. Despite this peace agreement, strikes were common in the 1970s but following the reforms instigated in the 1980s, strikes have become far less frequent.

This is in stark contrast to many of the negotiations that take place in the UK, where industrial action has become heavily concentrated in the public sector. In fact, in Sweden, trade unions work on a much more collaborative footing with employers. A key example are trade unions in the export-orientated sectors, who tend to be very cooperative since they see productivity gains as essential to getting greater pay increases for their members (not dissimilar to the role played by some British trade unions in the private sector, such as deals made with Nissan or Hitachi.[102]) The relationship between innovation, productivity and pay is well established in the Swedish trade union movement and this leads to a collaborative approach.

Public sector wage negotiations are then usually conducted on the basis of comparability with the private sector, but only to be competitive rather than market leading. Education, age and time in service are not directly reflected in pay at all. Instead performance and skills are rewarded and pay reflects the market.

Political involvement is also largely divorced from the pay setting process. Indeed, political intervention is looked upon as a potential source of harm by stakeholder groups. The largest influences that government has are through pay envelope setting and through the National Mediation Office (Medlingsinstitutet), a central government agency. It is used to promote efficient wage formation,

99 National Mediation Office Sweden, Annual Report 2010, p. 6, http://www.medlingsinstitutet.se/pdfs/pdfs_2011/eng_smftn_feb2011.pdf

100 Wolf, A, 'More than we bargained for', Centre Forum 2010, p. 79

101 'Evidence to the STRB: the case for change', Department for Education 2012, p. 65, http://media.education.gov.uk/assets/files/pdf/e/evidence%20to%20the%20strb%20the%20case%20for%20change.pdf

102 http://www.bbc.co.uk/news/business-18979836

compile wage statistics and has been successful in mediating in disputes and avoiding strike action.

Pay envelope setting from central government is also a key element of the system, which limits wage inflation and pay bill risks to the government. In practice, scope for wage increases in the public sector is decided through a national budget process, giving each manager a local budget pay envelope, which defines the scope for pay increases that exists. They can then distribute subject to negotiation and the pay setting frameworks outlined above.

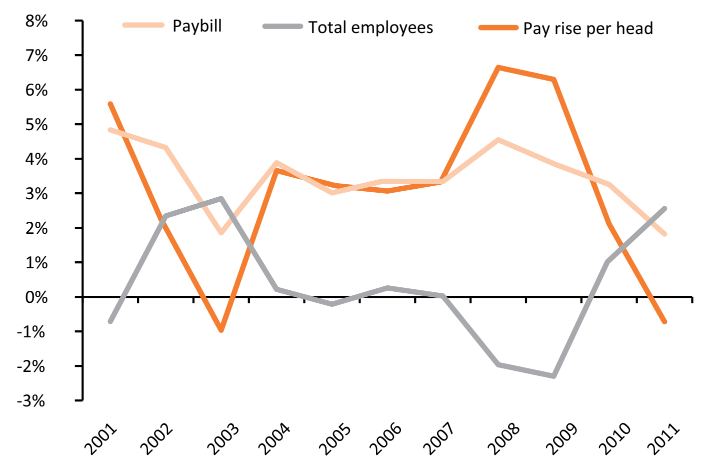
Crucially, however, the size of the pay bill budget is not subject to negotiation with trade unions and other stakeholders, but is set by local and central government. This ensures the separation of the pay setting process from politics, in which trade unions are not allowed to interfere. There are few complaints about the time taken to negotiate, but occasionally there are complaints that the pay envelope set by Departments is simply pushed down to local actors, leading to flat increases.

The key actors in the negotiations also seem to be able to come to agreement in the vast majority of cases without industrial conflict. The series of 'fallback' arrangements alongside arbitration, such as a set increase with additional distribution taking place at the local level, or simply a flat increase specified in the sectoral agreement, come into force if bosses and employees or their representatives cannot agree on a deal (though this very rarely happens – around 2% of the time). This did not occur overnight, but is the result of a series of incremental reforms stemming from problems not dissimilar to those in the UK's public sector today.

Increased competitiveness

Overall the consensus was that the reforms to pay negotiation in Sweden have been positive. In particular, they have resulted in a system of pay negotiation which ensures international competitiveness for Sweden. In particular, as demonstrated in Figure 21 the wage formation process has resulted in pay restraint.

Figure 21: Swedish government sector annual pay and paybill growth, 2001–2011



Source: Statistics Sweden, Average monthly salary (mo4) and number of employees in the governmental sector.

Nominal paybill growth has averaged just 3.5% over the last decade against a mean pay rise of 3.1% per worker and has been flexible enough to allow pay settlements to fall rapidly after the global financial crisis began. The experts we interviewed argued strongly that this had been vital in delivering a more internationally competitive economy. Studies of the effects have shown positive results for public services – for example, individualised pay has reduced teacher shortages by allowing areas where recruitment has been historically difficult to pay more and improved mobility within the sector.[103] This has a strong read-across to parts of the UK where wage levels and pay-bill growth outstrip what might be expected based on market characteristics: wage moderation compared to competitors (in this case, other regions in the UK) can lead to greater competitiveness and growth.

Conclusions

There are many different models of public sector pay negotiation across the world. But few rely so heavily on collectively bargained national pay-setting as the UK and this has become more so over time as countries have reformed their systems to become more effective. There are many lessons we can learn from abroad, both in terms of the need to move away from our existing system and also in terms of how transition might be managed.

The Swedish system is of particular interest. It is complex but widely supported and responsive to local labour markets, performance and public service requirements. Its structure and level of remuneration are largely comparable between the public and private sectors. Perhaps surprisingly, the most differentiation and most highly individualised forms of pay setting exist in the public sector, driven by trade union desire to increase pay and a clear link between this and driving innovation and productivity. Since Sweden has undertaken a path from a largely national pay framework similar to the UK's to this more local system, it is a useful framework for UK policymakers in creating a policy architecture to push the UK public sector's practices in a similar direction.

103 Ladd, H, 'Teacher Labour Markets in Developed Countries', 2007

6

Principles of Reform of the UK System

> *'A crisis can provide an opportunity to review out-dated structures and inflexible staff terms and conditions. Changes should be sustainable and reflect the future aims and objectives of the organisation. Although many of the planned changes are a response to the current budget pressures, fixing these structures with short term 'freezes' will not solve the problem in the longer term.'*[104]

The previous chapters have outlined the problems with the current system of pay bargaining in the UK's public sector and highlighted alternative models of pay setting from across the public and private sectors both in the UK and abroad.

This chapter assesses what these findings mean for reform of public sector pay negotiation. It argues that, on their own, regional, zonal and individual pay setting would all be inappropriate for the UK and would fail to deliver the government's stated objectives. To tackle this, it goes on to outline criteria which a new model should meet. Chapter 7 suggests a potential model that would deliver better results.

Objectives of reform

Chapter 1 outlined the remit that the Chancellor set the Pay Review Bodies. The key objectives can be summarised as:

- public sector pay determination becomes more market facing in local areas;
- public sector organisations are better able to recruit, retain and motivate suitably able staff across the UK;
- total reward packages between public workforces and those of similar skills working in the private sector become more closely aligned by location;[105]
- any proposals should not lead to an increase in pay bill in the short or long-term; and
- proposals are consistent with the law on equal pay.

To these objectives, it seems important to add two further objectives:

- reforms are practical and can be delivered without prohibitive delivery costs; and
- reforms do not lead to a redistribution of wealth, capital (physical or human) or income from relatively poor regions to relatively rich regions.

The options

As outlined in Table 10, the Swedish system of pay bargaining has a number of different models within it. These range from the most localised bargaining

104 'Facing up to the challenge: Developing a new employment offer for the public sector', Hay Group 2011, p. 3, http://www.haygroup.com/downloads/uk/facing_up_to_the_challenge_final.pdf

105 Note that the Pay Review Bodies were asked to take this into account, but from speeches and the Government evidence, it is clear that closer alignment is an objective (George Osborne's letter to the Pay Review Body Chairs, 20th March 2012)

between employer and employee, to nationally-set and collectively agreed negotiations. The existing UK commentary argues that the government broadly has a choice along this same spectrum. Some of the broad models for reform that have been discussed so far in the UK are outlined below.

Regional pay

At one end of the spectrum is a movement to regionally varied wages. These would be centrally set and collectively bargained, but include variation to account for regional differences in labour markets. This variation could either look to reflect differences in the costs of living in each large region or could target a reduction in the public – private pay differentials. However, there are significant problems with each of these options.

If regional variation were based on differences in costs of living, this would do nothing to account for differences in, for instance, the costs of housing in different parts of relatively large geographical areas. For example, different pay rates for areas the size of Yorkshire and Humberside, the West Midlands or the South West of England would do nothing to address the differences in costs between high-cost city centres and rural areas. There is also a significant lack of information on costs of living across the country, since the Office for National Statistics have struggled to produce robust and meaningful estimates on a timely basis.[106]

Given these problems, it might make more sense to peg wages to the private sector: effectively free-riding on the ability of the private sector to match wages to regional labour markets. However, this approach would do nothing to tackle the large within-region variation in local labour markets. For instance, our results above showed large within-region variation in public – private wage differentials, which would not be addressed by this approach.

Overall, it seems unlikely that this approach would prove a distinct improvement on the system we currently have.

Zonal pay

A more promising reform might be to introduce a system of zonal pay, perhaps following the Courts Service model.[107] The basis of this system is to have several bands of pay, which different areas are assigned to, based on local labour market conditions and living costs.

This would involve specifying different pay rates in different areas at a lower level than large regions (for example, a major provincial city, such as Birmingham or Salford, which are designated under the 'hotspot' paybands in the Courts Service, as distinct from the lower rate set in surrounding regions like Sutton Coldfield and Oldham). This would allow higher labour cost areas outside London to be in a different pay zone to other areas surrounding it and, as such, there is the ability to consider some aspects of within region variation.

Such a system has been the basis of the Treasury's evidence on local pay and has featured prominently in the government's discussion of the issue.[108] Leaked plans for the civil service moot four geographical zones with Inner London pay the highest, Outer London second, 'hotspot' areas like Manchester and Birmingham third and the rest receiving least.[109] Thus, based on the evidence presented to them, it seems likely that at least some of the Pay Review Bodies will recommend such 'zonal' pay structures.

However, there are two key problems with this system. Firstly, it will do very little to target improved provision of public services. To recruit the best public

106 See Fenwick D, O'Donoghue J, 'Developing estimates of relative regional consumer price levels', Office for National Statistics

107 Chloe Smith, the Economic Secretary, the Chancellor George Osborne and others have used this as an example in Select Committee hearings

108 http://www.ome.uk.com/Article/Detail.aspx?ArticleUid=a782b32d-b08b-423b-8061-361211188711

109 http://www.guardian.co.uk/politics/2012/may/20/civil-service-pay-cut-whitehall

servants to the most deprived areas (for instance the best teachers to the worst performing schools in the most deprived areas), pay needs to be flexible enough to allow increases for these areas. However, they may be located very close to other affluent areas within the same zone, meaning that these two areas are likely to be placed into the same pay band.

The second problem is one both of principle and practice. The principle problem is that zonal pay bands may sound like a localist policy, but pay rates will still be set centrally through the existing systems. This means that, in practice, the system would not be locally facing at all. It would be a system that tried to deliver local policies through Whitehall, rather than trusting local managers. In terms of practicalities, it seems unlikely that such a system could work effectively across all of the public sector. Demand and supply for different public servant roles will vary greatly both between and within regions and it would be difficult for central planners to assess these differences effectively enough to assign the correct pay bands. In addition, without adjustment in budgets, the policy would in effect reduce non-pay bill budgets in the new 'hotspot' regions, having a potentially damaging effect on public services there.

As we have noted, the Courts Service is frequently taken as an example of zonal pay, including by the Chancellor.[110] Yet the significance of this reform is limited. The reform was in fact a move towards more national pay bargaining rather than less: consolidating around 42 different pay systems into four zones.[111] The structure in effect is simply an extension of London weighting with an additional 'hotspot' band, largely applicable to the South East of England.[112] It fails to deal with the weak link between pay progression and performance, intra-regional differences and the complexities of particular local labour markets.

Overall, while zonal pay would likely be an improvement on the existing system, it seems unlikely to be able to drive the improvement in public services we need. A lack of involvement of local decision makers would mean that it is unable to capture the fluidity and varied nature of local labour markets.

Full localisation and individual contracts/management

At the other end of the scale would be a system of truly local negotiation, which asked each public sector employee to negotiate their pay and conditions with their manager on each site. Such a system has been heavily criticised by trade unions:

> *'There isn't a model or blueprint… In large multi-site private-sector employers – particularly those that deal with unions – national pay frameworks are a part of life. They are the norm… potentially devolving responsibility around pay and conditions down to 20,000 individual schools, for example is frankly ludicrous.'*[113]

Our findings from a survey of the pay-setting process within the private sector confirms these findings for larger firms and we agree that it would be uneconomical for public sector organisations at the local level to negotiate each and every term and condition of employment. However, paysetting at an individual level is more commonly associated with highly skilled or specialised professions and it is also true that the public sector has a more skilled workforce than the private sector.[114] In fact, given that the private sector generally finds it more efficient to pay 'spot' salaries for more specialised or highly skilled workers, this would suggest that more individualised paysetting for these grades would be

110 Autumn Statement 2011

111 Pay and Allowances manual, Ministry of Justice, 2012

112 'Government Evidence to the Pay Review Bodies: Economics of Local Pay', HM Treasury Submission to the Office of Manpower Economics

113 Paul Nowak, TUC head of public services, 'Highway to Local Pay', People Management, March 2012

114 For example, see the TUC's response to the ONS' public/private sector pay data: http://www.tuc.org.uk/industrial/tuc-20830-f0.cfm

preferable. However, a purely individualised process for all aspects of employees' pay would clearly be both cumbersome to managers and difficult to submit to budgetary control. It would also not be reflective of private sector best practice.

Changing the emphasis

Table 11 summarises our analysis of the extent to which the options above might be expected to meet the Chancellor's objectives. It makes it clear that none of the options generally considered in public discussion seem to meet the Chancellor's goals while being deliverable and practical. To implement an efficient system of pay bargaining in the public sector that truly reflects local labour markets it is clear that a change of emphasis is needed.

Table 11: Overview assessment of pay bargaining options in the public sector

Objective	Regional pay	Zonal pay	Individualised pay
Public sector pay determination becomes more market facing in local areas.	Very poor: centrally set regional variation would do little to reflect diverse within-region circumstances.	Poor: centrally set zonal variation could address differences in living costs, but not supply and demand conditions in local areas.	Good: would be able to reflect local labour market conditions.
Public sector organisations are able to recruit, retain and motivate suitably able staff across the UK.	Poor: no opportunities to adjust pay to local needs and supply variations.	Poor: no opportunities to adjust pay to local needs and supply variations.	Excellent: able to reflect supply constraints and design packages to reward and motivate staff individually.
Total reward packages between public workforces and those of similar skills working in the private sector become more closely aligned by location.	Average: possibility of moving toward equivalisation in broad regional areas. Will not address within-region variations. Will not address non-pay differentials.	Average: possibility of moving toward equivalisation in broad zonal areas. Will not address within-region variations. Will not address non-pay differentials.	Excellent: would be able to benchmark individual roles to private sector counterparts.
Any proposals should not lead to an increase in pay bill in the short or long-term.	Excellent: Treasury retains control of pay bill, with little risk.	Average: Treasury retains most of the control of pay bill, with slight risk that zones will compete and some lobby for larger pay envelopes/to be uprated.	Average: would represent a significant risk to pay bill management for the Treasury if not constrained.This could only be mitigated by setting tight paybill envelopes using at present unavailable data.
Proposals are consistent with the law on equal pay.	Little/no risk.	Little/no risk.	Potential impact – risks would need to be managed (e.g. robust pay framework/benchmarking systems).
Proposals are deliverable and practical.	Good: easy change to current process. Slight practical problems might be apparent with gaming around regional boundaries.	Good: relatively easy change to current process and can build on Courts Service experience. Slight practical problems might be apparent with gaming around regional boundaries.	Poor: impractical to negotiate terms and conditions for all individuals. Not a model followed by the private sector except for senior staff and could be costly to implement (e.g. training costs for managers).
Reforms do not lead to a redistribution of wealth, capital (physical or human) or income from relatively poor regions to relatively rich regions.	Poor: implication is lower wages in regions where pay premia are currently high (e.g. North East and Wales) and higher wages in pay penalty areas (e.g. London and South East).	Poor: implication is lower wages in regions where pay premia are currently high (e.g. rural North East and Wales) and higher wages in pay penalty areas (e.g. urban South East).	Average: Potential for some redistribution across regions, but would also raise incomes in some poor areas within rich regions (in order to drive public service delivery improvements).
Overall assessment.	Poor: little gain over existing practice.	Average: slight gain over existing practice and relatively straight forward to implement.	Average: would meet most of the objectives but impractical and potentially costly without several caveats.

Performance

The first area where a change of emphasis is needed is in the use of performance related pay (PRP). Our survey of private sector employers showed that many use performance related pay to improve productivity and quality of services. Academic research also supports its use;[115] a brief summary can be found in a recent publication by the Office of Manpower Economics.[116] Private companies often favour corporate standardisation and consistency of HR and reward processes, such as appraisal and performance-related pay, rather than localisation. A recent CIPD publication commented that: 'PRP has grown in prominence since the 1980s as employers have increasingly sought effective ways of driving high performance levels by linking employee reward to business objectives.'[117]

The effects of performance related pay in the private sector are well established in the academic literature. By linking workers' productivity more effectively to their financial reward, they will expend more effort, improving the quality and quantity of their work, encouraging them to pursue professional development they may not have otherwise not have.[118]

Reports looking at the public sector show that public servants are responsive to financial incentives.[119] Unfortunately, there is scant evidence on the effects of a well designed system of PRP in the case of the UK public sector. One of the main reasons for this is that the UK public sector has only seen performance related pay on a very small scale. For example, the Defence Aviation Repair Agency paid awards of between just £50 and £150 for excellent performance. Top performers in the Home Office received just 2% of their base salary.[120] In some instances, the results have been complex – for example, a system of team-based reward in Jobcentre Plus for job entry, varying by the difficulty of placing a claimant, showed incentives aimed at smaller teams produced 10% greater output than larger teams.[121] Schemes are often pilots which last for less than a year.[122] Though well established elsewhere, this makes evidence on the efficacy or otherwise of PRP in the UK public sector alone, sparse.

Evidence on performance related pay is more extensive in other countries, however. For example, performance pay scheme for the Brazilian Tax Collection Authority led to a 75% increase in the rate of growth of fines per inspection.[123] A financial incentive scheme based on American hospital rankings successively raised standards – initially most significantly for the poorest rated, despite bonuses only being paid to the top fifth of those ranked.[124] Merit based pay is correlated with stronger test scores in American schools.[125] These effects can become more pronounced over time.[126] Several states continue to push toward more performance related pay systems for schools.[127] A recent study by Lavy showed significant improvement in pass rates and test scores for maths and English following the introduction of cash incentives.[128]

This does not mean that all types of PRP will be effective if they are not well targeted and designed, however.[129] Different levels and types of performance related pay (at individual, small or large team level for example) are required for different workforces. For example, jobs with less easily definable targets and where intrinsic motivation may play a significant role such as the judiciary or military, may need qualitative rather than quantitative performance systems to be most effective.[130] This may be done alongside a framework of promotion and non-pay privileges that act as a proxy for performance related pay.[131]

115 For instance see: Schleicher, A., (2011), *Building a high-quality teaching profession: lessons from around the world. OECD*

116 *Prentice G, Burgess S, Propper C*, 'Performance pay in the public sector: a review of the issues and evidence', OME 2007

117 Performance Related Pay Factsheet, CIPD 2012, http://www.cipd.co.uk/hr-resources/factsheets/performance-related-pay.aspx

118 A more technical reader should refer to Malcomson, J.M., (1999) 'Individual Employment Contracts' in Ashenfelter, O., & Card, D., (eds) (1999), *Handbook of Labor Economics, Volume 3b*

119 *Prendergast, C., (2007), 'The Motivation and Bias of Bureaucrats'. American Economic Review, Vol. 97, No.1, 180–196*

120 *ibid* p. 6

121 Burgess S, Ratto M et al., 'Incentives in the Public Sector: Evidence from a Government Agency', CMPO Working Paper 04/103, 2004

122 *ibid* p. 15

123 Kahn C, Ziliak J et al., 'Performance-based Wages in Tax Collection: The Brazilian Tax Collection Reform and its Effects', Economic Journal Vol. 111 No. 468, pp. 188–205

124 Lindenauer P, et al, 'Public Report and Pay for Performance in Hospital Quality Improvement', New England Journal of Medicine 2007, http://rds.epi-ucsf.org/ticr/syllabus/courses/66/2011/04/21/Lecture/readings/Lindenauer.pdf

125 Figlio D, Kenny L, 'Individual Teacher Incentives and Student Performance', NBER Working Paper No. 12627, 2006

126 Ladd H, 'The Dallas school accountability and incentive program: an evaluation of its impacts on student outcomes', Economics of Education Review 18, pp. 1–16, February 1999

127 For example, see Colorado Senate Bill 191 'Great Teachers and Leaders', http://www.cde.state.co.us/EducatorEffectiveness/downloads/EESummit3_2012/CDE_EE_TransitionToolkit.pdf

128 Lavy, V. (2009) 'Performance Pay and Teachers Effort, Productivity and Grading Ethics, American Economic Review Volume 99, Number 5 December 2009, pp. 1979–2021(43)

129 Courty, Pascal, Marschke, G, 'An empirical Investigation of Gaming Responses to Explicit Performance Incentives', Journal

As we have spelt out above, by linking compensation to performance, employees should work more productively, improving the quality of their contribution. Since so many public sector services are delivered by front-line staff, this has a direct implication for improving public sector performance. In short, if staff see the value in improving their skills and performance, this has a positive effect on the long-term development of their organisation.[132] Developing the right incentives also motivates staff to concentrate their efforts on things deemed most important, improving efficiency overall. Rewards that are tightly linked to performance also produce a better quality of applicants, producing further productivity gains through selection effects.[133] Such systems are also associated with the retention of high performers and low performers leaving the organisation over time, as the latter refuse to accept lower salaries than their peers.[134]

Limited efforts to introduce elements of performance related pay have been ongoing for several years. Some team-based bonuses (rather than individual) were introduced in the Civil Service following the Makinson report in 2000,[135] with significant impact.[136] Where PRP is introduced, several studies show a discernible effect on public service outcomes,[137] primarily achieved by prompting workers to focus more effectively on important objectives. A recent study by the World Bank found that, across 110 case studies of public and relevant private sector jobs in various countries, 65 of 110 found a clearly positive effect for performance-related pay.[138] Bonuses linked to specific service outcomes were found to be especially effective.

It remains the case that pay is largely unrelated to performance in large swathes of the UK public sector and that where financial incentives have occasionally been introduced, the effect on performance is limited because of the limitations of the incentive[139] relative to other drivers of pay – in particular, pay increments largely dependent on length of service. The Department for Education evidence to the Pay Review Body outlined that '...progression in the current system is very much linked to teacher length of experience and age' and may limit the impact of high performing and innovative teachers. Research from the Office of Manpower Economics also found that over half of head teachers do not believe that 'existing allowances sufficiently cater for the need to reward high performance.'[140]

This creates the wrong incentives both for high flyers (who are not rewarded) and low performers (who are rewarded simply for staying in the same post over time). It can also lead to the best public servants being moved away from where they are needed most. Since the only way to reward performance is often to promote people, this can take them away from public service delivery on the front line and toward management and leadership that they may neither be suited to nor desire. To tackle this, one head teacher commented that they would like to have the ability 'to reward performance in the classroom so that they want to remain in the classroom'.[141] Overall, this structure, we believe, creates a culture which is inflexible and not conducive to innovation and accountability.

Creating appropriate frameworks and structures for a fully performance related pay system will not be easy. These systems take time to be successfully communicated, for incentives to be recognised and behaviours to change.[142] Nevertheless, given the clear evidence on the efficacy of a well designed PRP system, laying out the intention to implement a rigorous system linking pay to performance across the public sector should be a high priority in any programme

of Labour Economics, Vol. 22, no. 1, pp. 23–56, 2004

130 Prentice G, Burgess S, Propper C, 'Performance pay in the public sector: a review of the issues and evidence', OME 2007, p. 21

131 Kosiak, S, 'Military Compensation: Requirements, Tredns and Options', Centre for Strategic and Budgetary Assessments, 2005

132 Lavy V, 'Evaluating the Effect of Teachers' Group Performance Incentives on Pupil Achievement', Journal of Political Economy volume 110(6), 2002

133 Lazear E, 'Performance Pay and Productivity', American Economic Review volume 90(5), 2000

134 Besley T, Machin S, 'Are Public Sector CEOs Different? Leadership Wages and Performance in Schools', LSE 2008, http://econ.lse.ac.uk/~tbesley/papers/pubsecceo.pdf

135 Makinson J, 'Incentives for change: rewarding performance in national government networks', 2000

136 Burgess S et al, 'Evaluation of the Introduction of the Makinson Incentive Scheme in HM Customs and Excise', 2005, http://www.bristol.ac.uk/cmpo/events/2005/markinson/hmcustoms.pdf

137 Atkinson A. et al, 'Evaluating the impact of performance-related pay for teachers in England.', 2004, http://www.bristol.ac.uk/cmpo/publications/papers/2004/abstract113.html

138 Zahid Hasnain Z, Nick Manning N, Pierskalla J, 'Performance-related Pay in the Public Sector: A Review of Theory and Evidence', World Bank Working Paper 6043

139 Prentice G, Burgess S, Propper C, 'Performance pay in the public sector: a review of the issues and evidence', OME 2007

140 'Evidence to the STRB: the case for change', Department for Education 2012, p. 7, http://media.education.gov.uk/assets/files/pdf/e/evidence%20to%20the%20strb%20the%20case%20for%20change.pdf

141 OME, (2011), *Teachers Pay Issues: research findings 2011. Accessed at* http://www.ome.uk.com/STRB_Research_Documents.aspx

142 Pollitt, C, Dan S, 'The Impacts of the New Public Management in Europe: A Meta-Analysis', 2011, p. 46

of pay reform. We believe this will help engineer a culture shift in behaviours across the public sector, improving innovation and productivity. The impact of this change would be far greater than simply changing the means of pay bargaining.

The best of both worlds

The second reason that a change of emphasis is needed is because the government has tied its own hands by the way it has approached the problem. In essence, by asking the Pay Review Bodies to consider how to tackle the problem, the government has tied itself to the current system of pay negotiation at a national level. It seems unlikely that the Pay Review Bodies would suggest a complete devolution of pay negotiation, since that would make them redundant. Thus, while we might see more variation in wage rates across the country, this will not be set locally, it will be set nationally.

Such a system would leave local managers with none of the responsibility, flexibility or control that we demonstrated are present in the best practices in the private sector in the UK and, for instance, in the Swedish public sector.

In particular, such reforms would not allow the introduction of characteristics prevalent in the private sector, such as:

- Ensuring the pay matches performance by tying annual performance reviews directly to pay formation and ending links between length of service and pay.
- Tying pay formation to organisational units or individuals rather than across the whole service.
- Using discretionary pay for specialised and senior roles and flexibility in employee benefits (e.g. a 'menu' of potential options).
- Using staff transparency for salary opportunities (rather than payscales) within their role.
- Weighting pay increases by explicit budgetary pay bill envelopes.
- Differentiating treatment of occupations with local or national labour market competition.

To tackle this, we believe that a hybrid model of pay negotiation is needed, such that it makes the most of the economies of scale of a centrally negotiated pay settlement while allowing local flexibility to meet differences in supply and demand and living costs in local areas and to reward performance effectively. The following chapter outlines our detailed proposals to deliver this.

7
Detail of Proposals – Short and Long-term

This chapter outlines our high-level proposals for how pay should be set in the public sector. It lays out both the long-term goal for how pay should be set and short-term measures targeted at closing wage differentials and introducing a workable system of pay negotiation before expertise and data exist such that local managers are able to negotiate more locally.

Setting pay – long run

Local by default

Previous chapters have outlined evidence from the private sector, from international experience and from innovations in the UK's public sector that suggest a key part of any framework for pay negotiation is flexibility. For instance, in Sweden different parts of the public and private sectors have pay negotiation that varies from a centralised bargaining system to a very localised pay setting system.

Introducing a system such as this in the UK would be attractive. It would allow pay setting processes to flex to fit different structures of employment and different workforces (for instance, those competing in national labour markets versus those operating more locally). It would also allow those areas of the public sector where innovation in pay setting has already taken place to retain the features of their processes that have been proven to be effective. The key thing is that we do not replace one centralised and inflexible system with another that is equally centralised and inflexible. For this reason we recommend that:

- The government must make it clear that local managers must take into account both local labour market conditions and individual performance when setting pay. In essence, this would require that pay setting would be mandated to be localist by default.

This twin requirement to base pay on local conditions and individual performance is essential to delivering a system that reflects both local variations in the costs of living and delivers an improvement in productivity and the quality of public service provision. It would also allow local managers to flex pay in order to ensure that they recruit suitably trained and experienced employees.

However, we are not arguing that all pay negotiation should be undertaken at the local level. As we have highlighted, this does not tend to occur in the private sector, particularly for lower-skill groups and would be costly to implement. Instead, it will be up to individual organisations to decide the exact level to which negotiations are devolved in order to fit in with their workforce needs, guided by Departmental frameworks.

Just as the case in Sweden, some may choose to negotiate locally whereas others may choose to negotiate at a higher level (for instance, sectorally or regionally). As long as these negotiations take account of local labour markets and use a system of performance-related reward, they would fit with our proposals. Where this does not happen (particularly in the short-term), stronger mandation will be necessary (we explore this below).

This might mean, for instance, that a particular school or hospital chose to negotiate at the workplace level. They could introduce their own framework of performance related pay and flex pay deals to reflect local labour market conditions and the needs of their organisation. On the other hand, it might make sense for other public sector organisations, for instance those fulfilling back-office functions of large departments, to choose to use pay setting framework that is sectorally agreed.

We outline later our belief that trade unions will have a strong role to play in this devolved process of negotiation and we hope that they will take up the challenge to engage constructively in a system that has been proven to improve productivity and fairly reward public sector employees.

Within this system we also recognise a number of constraints: transaction costs might be high, particularly where managers do not have experience of negotiations; and some aspects of employment might be better negotiated at a higher level. Both of these areas are addressed below.

Facilitating links to performance and local areas

A typical argument against individualised pay negotiation is that the transaction costs of repeating negotiations across many individuals are prohibitively high. We agree with this analysis, which is why we believe that the majority of negotiations in a localised system would take place at a higher level (e.g. at the workforce level) and could be informed by collective agreements across broader sectors.

We also recognise that many current managers within the public sector could be ill-prepared to take on new responsibilities around pay negotiation and, in particular, effective performance assessment. For this reason, we believe that organisations should be given significant levels of support to implement a system of pay that reflects performance and local area labour market conditions. This will require that guidance is given over the appropriate use of Performance Related Pay frameworks and information on how labour market trends vary across the country.

To implement this we recommend that:

- The remit of the Pay Review Bodies should be amended to include that they publish analysis of the differentials in pay that might be expected in different parts of the country based on local labour markets and living costs, drawing on expertise from the Office of Manpower Economics and Office for National Statistics. As an interim measure, this may also include outlining suggested zonal pay differentials.

- This remit should also include that the Pay Review Bodies make recommendations for how performance should be benchmarked within organisations. This might take the form of several off-the-shelf performance management/reward frameworks, which organisations could choose to use in order to meet their workforce needs.

Both of these aspects should be developed in collaboration with HR professionals and experts in benchmarking and performance management. They could then be collectively agreed between the government and trade unions.

Local or collective?

By allowing organisations to use off-the-shelf frameworks, there is a risk that all organisations will use this option rather than developing their own frameworks and practices. However, this is a risk worth taking for a number of reasons.

Firstly, even if all organisations did choose this option, a system for geographically differentiated and performance related pay would still be introduced across the public sector. This would represent a major advance from the current situation.

Secondly, such an approach would allow those organisations already embracing local and performance related pay to keep the elements of their models that are currently working well. We would expect that, over time, other organisations would learn from these experiences and mix best practice methods with the nationally negotiated framework. This would allow organisations to combine local flexibility with economies of scale from national negotiation.

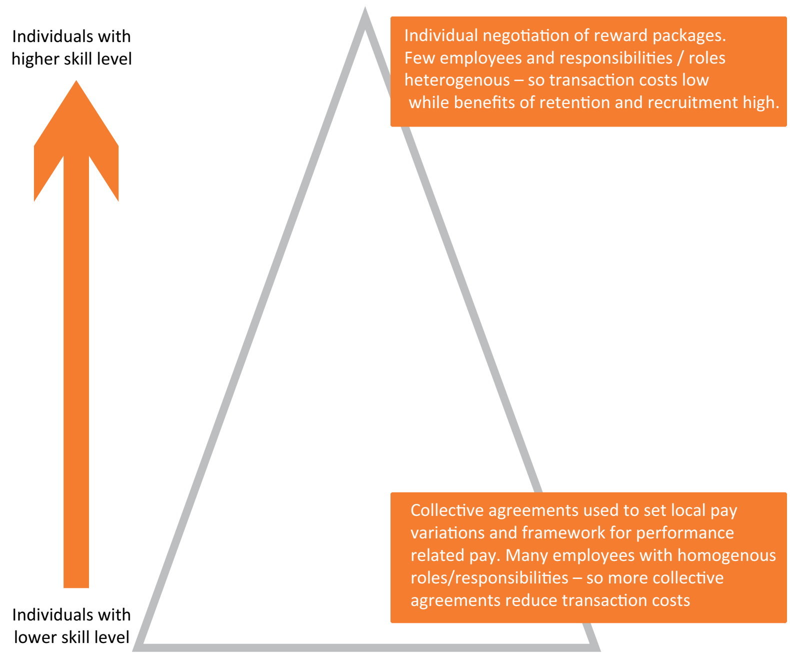
For example, following practice in the private sector, pay negotiation for higher skilled or key workers might be based on locally-determined and individualised pay setting. Since these employees are relatively few in number, transaction costs would be relatively low and the potential benefits very high: the need to recruit such staff for specialist or niche positions mean it may be necessary to vary the level of remuneration widely from employee to employee. Such an approach would ensure that the right people can be recruited, retained and motivated, without wholesale application of individual bargaining across the public sector.

In contrast, those workers with lower skills tend to be less mobile and may be unable (because of the fixed costs) to travel to get the best pay. In the private sector, their pay may be more generic (a standard hourly rate within a zonal system, for example). Pay progression may be negotiated around more formal structures rather than the employee themselves (through a trade union and performance evaluation processes, for example).

Following this example in the public sector would mean that pay negotiation for non-key/lower-skilled workers could follow a collectively agreed framework for sectorally differentiated pay. This would also broadly match the system in place in Sweden where, as we have seen, fall-back arrangements stipulating the size of minimum increase are prevalent in the public sector, often negotiated at a sectoral level.

As Figure 22 highlights, the key aspect of this system is that it would allow local flexibility to combine local and centralised decision making in a way that best meets the needs of their organisation.

Figure 22: Flexibility in pay determination – example of different pay systems for higher and lower skilled workers



Finally, the system will still require significant levels of localised decision making. The objective will be to ensure that negotiations take place at the level best suited to that organisation's and particular workforces' needs. This would require performance management/reward frameworks suited to making decisions on the relative performance of that particular workforce. This would provide much greater flexibility for managers to trade off pay increases for existing staff with the recruitment of new or replacement staff.

What should stay national

Evidence from abroad and from the private sector in the UK suggests that, even where pay is devolved to a local level, broader agreements around pensions and terms and conditions are still negotiated collectively at a higher level, often nationally. This reflects the standardised structures of the majority of these elements of reward packages across broad occupational groups and workforces and the economies of scale that combining these complex negotiations brings. While it may be appropriate to flex some small elements to suit particular circumstances, in the round, the complexity of pension obligations, legacy liabilities and the potential that varying terms and conditions across organisations would have to undermine job mobility, mean that such negotiations could become difficult were the variation significant. These issues and the economies of scale associated with existing systems inform our recommendation that:

- Negotiations over pensions and broader terms and conditions, excluding pay, should not form parts of these reforms and should continue to be negotiated under existing arrangements.

Controlling the public sector pay bill – long-run

How local pay affects public spending

The previous section outlines a system for pay negotiation across the public sector that provides pay which is both locally focussed and performance-based and allows flexibility for public sector organisations to choose the level of negotiation that suits their needs.

However, it is clear that removing the existing national pay structures has the potential to undermine central government control over the total public sector pay bill. In particular, we have already noted that in principle there is a possibility that local pay setting might put upwards pressure on pay. Evidence from Sweden also demonstrates that this can happen in practice (albeit from a base where public sector workers were paid less than their private sector counterparts). This means that 'all forms of decentralised pay setting have to take place within an economic framework that ensures central control of aggregate costs.'[143] We therefore need to look at how our proposals would relate to the existing structures of public spending.

This is clearly going to be a complex process requiring sophisticated data on the public sector pay bill: where the money is spent in particular regions and how much an equivalent workforce in the private sector would cost to employ in that area. However, data on the overall government pay bill, its departmental, regional distribution and projected growth is weak.

For example, the Office for Budget Responsibility has no robust method to estimate total pay bill growth, but simply assumes that it rises by the same percentage as general government resource spending: hardly a reasonable proxy given all the non-pay forms of spend this includes.[144] Historic figures for the overall pay bill are provided by the UK National Accounts 'Blue Book', but this is not broken down by department or region. Central government data on pay bills for arms-length bodies and public corporations is also lacking. A detailed remuneration report on the 1,500 public sector entities is not included in Government Accounts.[145] Data contained in the Treasury's COINS database and Departmental datasets are useful in indicating existing paybill spend but inadequate to determine the appropriate level of pay bill spending in particular locales. However, a previous effort to control the public sector paybill during the 1990s is instructive.

Box 6: Clarke's 1993 Budget and the public sector paybill

In 1993/4, the budget deficit reached nearly 8% of GDP. To reduce this, the then Chancellor Kenneth Clarke raised taxes and limited public spending increases. Clarke sought to reduce government spending by £3.5 billion by freezing public sector paybills at current cash (not real) levels. He also stated that:

> *'Pay increases for public sector staff will... have to be paid for by greater efficiency or by savings in the cost of running government itself.'*[146]

Despite the nominal paybill freeze, public sector wages did not, in practice, fall, but rise. Trade unions were able to negotiate pay settlement increases through a package

143 'Governance of Decentralised Pay Setting in Selected OECD Countries', OECD 2007, p. 29, http://www.oecd.org/dataoecd/1/18/38487114.pdf

144 March 2012 Economic and Fiscal Forecast, Table 2.23 (Pay bill and pay bill per head growth assumptions), Office for Budget Responsibility 2012

145 Whole of Government Accounts 2009–10, HM Treasury, p. 35, http://cdn.hm-treasury.gov.uk/whole_government_accounts200910.pdf

146 *HC Deb 30 November 1993 vol 233 c926*

of savings over and above those stipulated in the Budget, such as greater outsourcing and efficiency measures. The median basic pay award fell to 1.5% in 1993 and remained below 3% until 2001.

The rule, that 'pay increases for public sector staff... have to be paid for by greater efficiency or by other economies' was reaffirmed for the rest of the Major Government.[147] Since the freeze was in cash terms, the real paybill shrank as a consequence of inflation (though in cash terms it continued to rise due to efficiency savings). For example, the paybill rose slightly in cash terms from £90.0 billion to £90.1 billion between 1993 and 1995 but fell by 4% in real terms.

Since pay continued to rise, the burden of the paybill cut fell entirely on job reductions. The paybill cost per worker rose by 3.5% in real terms between 1993 and 1999 while the paybill fell by 3.5% from £130.5 billion to £125.9 billion. At the same time, the public sector workforce fell by 377,000, or around 7%.

It is clear that a framework is needed that could deliver both budgetary control for the Treasury and pay flexibility for local organisations. It would also need some sort of benchmarking to the local private sector such that pay differentials between public and private sectors could be tackled and so that local managers can use pay flexibility to recruit, retain and reward staff to meet their needs.

Given the current data constraints, it is beyond the scope of this paper to suggest detailed reforms as to how this could be achieved for different roles and public services. What data and how it should be used (for example ASHE or LFS, which have different advantages and disadvantages)[148] is likely to vary significantly between workforces (whether the competition for this role is local, regional or national, for example). This determination is likely to need to be made at both the Treasury, at Departmental and local level organisations. Its implementation will require detailed consultation between the Treasury, the Office of Manpower Economics, relevant Departments and the wider public. For this reason we recommend that:

- A consultation exercise should be undertaken to design a framework and method of implementation to allow pay bill envelopes for public sector organisations at an appropriate level to be set, such that they act as a constraint on upward pay pressures and reflect equivalent costs of private sector organisations.

Given the time needed to develop this system, short to medium-term reforms are needed so that we can begin to move towards the goal of more localised pay, without increasing cost pressures on government, before long-term reforms are implemented.

Short-term pay bill control and pay setting solutions

The reforms outlined above are our view of how the system of pay bargaining in the public sector should look in the future. However it is clear that, as was the case in Sweden, it will take a number of years to move to this system. As we highlighted, new budgetary frameworks are likely to be required and expertise and managerial experience will need to be developed in various parts of the public sector where it does not necessarily currently exist. This section lays out a series of shorter-term reforms aimed at moving the public sector towards the long-term system outlined above.

147 John Major, *HC Deb 09 February 1995 vol 254 cc347-8W*

148 'The Best Data to calculate the Area Cost Adjustment', Office of the Deputy Prime Minister, SWG 05/21, http://www.local.odpm.gov.uk/finance/0607/swg0503/swg-05-21.pdf

Creating room for manoeuvre

The first difficulty in the short-term is creating room for manoeuvre within the tight budgets laid out by the Chancellor as part of the ongoing fiscal consolidation programme. We have already outlined that, following the payscale freeze implemented for staff not in multi-year paydeals, the Chancellor has announced that payscale increases will be an average of 1% for 2013/14 and 2014/15 (excluding some civil service departments which entered the pay freeze early and left it in April 2012).[149]

An average 1% increase up to 2014/15[150] leaves very little room for flexibility either in terms of creating differential pay settlements in different areas in order to close public – private pay differentials or to try to introduce pay structures that adequately reward good performance. It is easier to increase differentiation when pay is rising faster.

Significant legacy difficulties will also inevitably arise in any reform of the system. In particular, the ability to cut or freeze nominal wages may be limited by contractual obligations. For example, NHS employers have calculated that pay drift arising from automatic staff progression up their incremental scales, added 2% to the cost of the NHS pay bill in 2011/12 despite the pay freeze.[151]

For these reasons we propose that divergence from the existing system occurs gradually. To facilitate this we propose that, for staff across the public sector:

- A permanent nominal freeze on generalised annual pay scale uplifts should be introduced for the period of the spending review; and
- Automatic pay progression points should be abolished.

These policies should be introduced immediately for new entrants and for existing staff where contractually feasible. Given the theoretical reliance of pay progression on satisfactory performance in many parts of the public sector, this may be possible for many staff within the context of more rigorous performance evaluation, outlined below. Where this is not immediately implementable for existing staff, it should be introduced at the earliest possible stage.

The introduction of these policies would provide the flexibility we need to change reward structures since, on their own they provide significant pay bill reductions compared to the assumed 1% uplift in pay scales. However, we do not envisage this being a cost-saving measure. Instead:

- All savings from pay scale freezes and the ending of automatic progression points should be re-invested in providing locally facing and performance-related pay structures or ringfenced for growth enhancing investment in local areas.

Together, these policies will allow greater differentiation in pay awards across different local areas and between individual employees with different levels of performance. In essence it is freeing up money to start a process of individualisation, without changing the total amount which is spent on public sector pay.

In the longer-term, the reliance on performance related pay and local flexibility in pay uplifts will create greater distinctions between different workers in the

149 This step has been vigorously opposed by trade unions: http://www.unitetheunion.org/news__events/latest_news/unite_rejects__poisonous__two-.aspx

150 We note that OBR estimates of a nominal 2.6% in paybill growth per head in 2013/14 and 2014/15 (i.e. including wagedrift).

151 NHS Employers Evidence to the NHS Pay Review Body 2012/13, September 2011, p. 7, http://www.nhsemployers.org/Aboutus/Publications/Documents/The-NHS-Employers-organisations-submission-to-the-NHS-pay-review-body.pdf

public sector and will slowly erode the 'national pay bargaining' base pay for individual staff. This will make pay levels much more reflective of individual performance and could help to close pay gaps at a local level if managers take their role in pay setting seriously and are supported in relying on local labour market indicators to set pay.

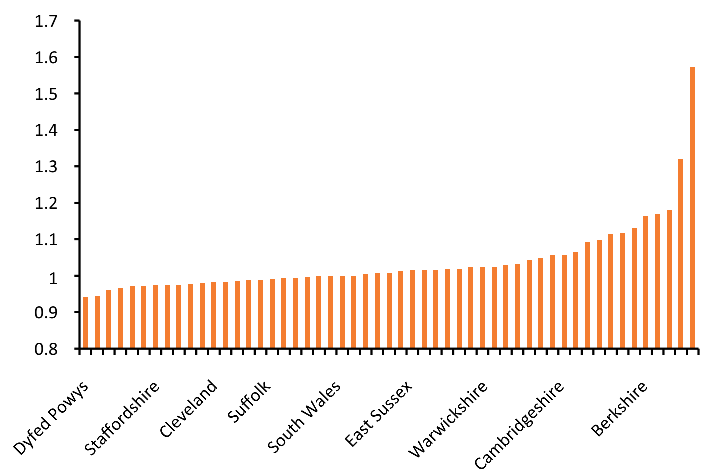
Allocation of pay awards in the short-term

There are a number of ways in which this pay bill increase could be allocated across public sector workers in the short-term. One simple solution would be to simply assess the pay bill impacts of a 1% increase in pay scales and allocate this across public sector workforces based on performance.

Such an approach would introduce an element of performance related pay, but it would be unlikely to tackle differences in living costs across local areas or the pay differentials that exist between the public and private sectors. For this reason, and before a new system of budgetary control that reflects local area costs is introduced, other solutions are needed.

Interestingly, short-term solutions may not be as difficult to find as one might imagine. Chapter 2 outlined that, in general, public sector budgetary formulas already attempt to account for differences in the regional labour costs and this has been the case for many years. For instance, the Department for Health has a Market Forces Factor and Local Government has a Labour Cost Adjustment (LCA) which creates factors for local areas. Figure 23 outlines how these vary across different parts of the country. For ease of understanding, below we refer to all of these separate indices as LCA factors.

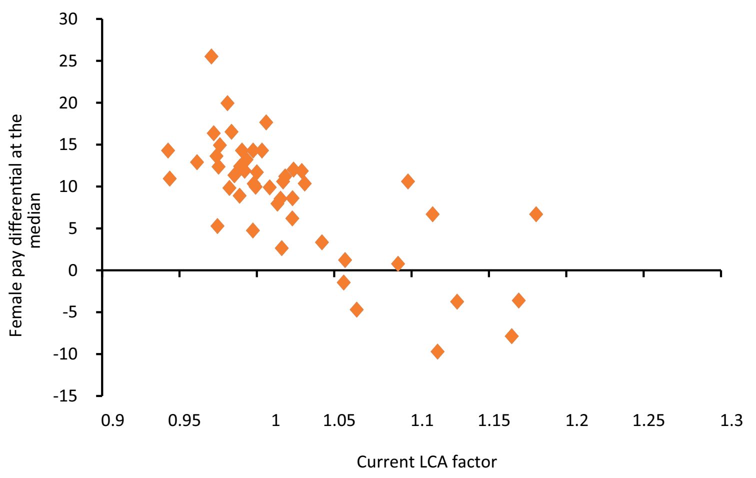
Figure 23: Labour Cost Adjustment by region (without lower limit)



In simple terms, LCA factors mean that in areas where wages are higher, a school or hospital receives a higher budget than one in a lower wage cost area. As we have already highlighted, the problem is that, although these higher costs are explicitly accounted for, they have not fed into pay settlements because of national pay bargaining.

This is even more surprising when the LCA factors are compared to the public sector pay differentials that we estimated above. In theory, given the fact that national pay bargaining leads to a lack of ability to pass through the LCA into wages, one would expect to see high pay premia where the LCA is low (i.e. a relatively cheap area or one with a looser labour market) and low pay premiums or pay penalties where the LCA is high (i.e. a relatively high cost area or one with a tight labour market). Figure 24 demonstrates that this is exactly the case.[152]

Figure 24: Correlation between LCA factors and pay differentials (average female) by area



To take two examples, the LCA factor for Durham is 0.97 – i.e. a relatively cheap labour market. But because this is not reflected in public sector pay, the male public sector pay premium is 11.4% – i.e. public sector workers are paid 11.4% more than their equivalent private sector counterparts. In contrast, the Hertfordshire and Buckinghamshire fringe have an LCA factor of 1.13 – that is, the price of labour is relatively high. But – again – since this is not reflected in public sector pay, the male public sector workers have a pay deficit of 8.7% relative to their private sector peers. The correlation between these two variables suggests that, if the area cost adjustments had actually been fed through into wages, pay differentials would be significantly less than we see today. In essence, the LCA should be reflected by differences in pay across areas: meaning that, for example, if a public sector employee in South Yorkshire were paid £10,000 the equivalent public sector employee in Warwickshire should be paid £10,290 and those in Cornwall should be paid £9,436.

Given that this is not currently the case, it suggests a ready-made way in which pay bill allocations could be adjusted in the short-term. We recommend that this happens as follows:

- Where they do not already exist, the Pay Review Bodies should be required to create LCA factors for their respective workforces. These should build on existing best practices.
- In areas where the LCA is equal to or above one, the pay bill impacts of the 1% pay scale uplift should be estimated for individual public sector organisations and ring-fenced for performance-related pay (PRP) budgets.

152 Note that the regional groupings a slightly different between the LCAs and our analysis of pay differentials, so we have only used data points where we get a close geographical match.

- Where the LCA factor is less than one, the pay bill impacts of the 1% pay scale uplift should be estimated for individual public sector organisations. Half of this should be ring-fenced for PRP budgets, with budgets adjusted to reflect this saving. This means that those areas with low labour costs would see a fall in their PRP budgets. This policy should remain in place until public sector pay in these areas is at the level considered appropriate based on LCA factors.

An immediate criticism is that this policy appears to suck money out of areas where the LCA is low. To make sure that this is not the case and that the policy does not add to regional disparities, the following should apply to the overall budgets in each area:

- In areas where the PRP budgets are reduced to reflect low LCAs, total public spending for the area should stay the same, and the amount of money by which the PRP budgets are adjusted should be ring-fenced for expenditure in the same areas in order to stimulate local growth in a more effective way than pay premia. Possibilities for expenditure are explored in chapter 8, such as spending more on local infrastructure and regional growth initiatives.

This policy would introduce performance related pay and go some way to tackling the misaligned pay that national pay bargaining has created, using an existing and recognised framework, without creating a fiscal transfer between low income and high-income regions. Over time, given the correlation between the LCA factors and the estimated pay differentials, it will also reduce the extent of pay differentials between the public and private sector.

Box 7: Example of local area

Taking the example of a local area with:

- An LCA factor of 0.97
- Total current public sector pay bill of £1 billion; and
- An equivalent of a 1% uplift in pay scales results in a 3% increase in total pay bill

This would mean that total expected increase in public sector pay in the area would be £30 million and this would be split equally between creating performance-related pay budgets and financing investment in local growth.

This policy would continue until public sector pay in this area was judged to be at around 97% of the equivalent in an area with an LCA of 1.

Another criticism is that since PRP budgets are not rising where the LCA is above 1 (and where public sector pay penalties are generally found), this will not tackle the underpayment of some public sector staff, meaning that there is less of an opportunity to improve staff quality and performance in these areas. There are a number of reasons for this approach.

Firstly, we recognise that, in the short-term, local managers should be able to pay their senior staff more highly where for example a public service's delivery is being seriously affected by the lack of talented management. This might be the case in deprived areas within high LCA areas where extra pay is needed to fill vital roles (the need to pay more to recruit or retain an exceptionally good headteacher in a struggling inner city school, for example). This sort of flexibility is already in place in some of the most senior public sector roles and within the LCA framework; budgets in high LCA areas already reflect the fact that labour costs are high since they have been adjusted upwards in line with the LCA factor. However, until now they have been unable to reflect this in the pay rates they offer because of national pay bargaining. Under our proposed system, public sector organisations (including those in high LCA areas) would be able to offer higher pay if they chose to if this came within existing budgets. We recognise that this will result in a trade-off between numbers of employees and pay rates. However, these are the productivity/performance related trade-offs that would have ordinarily been made without the system of national pay bargaining.

Secondly, those public sector workers who we find to be underpaid compared to their private sector counterparts tend to be above the median of the wage distribution (and often towards the top). We believe that in the short-term increasing the rates of pay of these employees should not be a priority. Box 8 explores why.

Finally, we believe that the key driver in performance and productivity will come from performance related pay, rather than general pay increases. This system will introduce performance related pay.

Box 8: Should we attempt to increase pay for top earners in the public sector?

The analysis in Chapter 2 has shown that public sector workers at the top of the wage distribution are significantly underpaid compared to their private sector counterparts. For example, Chief Executives of local councils run large organisations and are comparatively underpaid relative to the size of their staff and budgets: 'CEOs of companies with a turnover of between £101 and £300 million earn more than twice their public sector counterparts, and the gap rises as turnover rises.' This contributes to an overwhelming concentration of top earnings in the private sector: 'while public sector employees represent around 7% of the highest 1% of earners, those 7% only receive 1% of top earnings.'[153]

This can lead to poor outcomes. For instance, the Civil Service has suffered from very high turnover rates of up to 30% and even higher for senior staff, particular at Permanent Secretary and Director General level, more than double the public sector average of 12.6%.[154] HM Treasury has seen staff turnover been described as 'higher than McDonald's',[155] at around 25% for several years (28% in 2011), with many staff leaving after three years for better pay and promotion prospects.[156] This lack of experience and failure to preserve institutional knowledge has been identified as a key problem in its ability to react both before and after the financial crisis.[157] A recent CIPD survey showed 38% of public organisations surveyed struggled to fill managerial and specialist positions.[158]

It is for these reasons that, in principle, we believe that there is nothing wrong with highly paid public sector employees. The idea that the Prime Minister's salary should constitute some sort of 'cap'[159] for senior public servants was rightly rejected by the Hutton Review on fair pay in the public sector.

153 Hutton Review of Fair Pay in the Public Sector, pp. 17–18, http://www.hm-treasury.gov.uk/d/hutton_fairpay_review.pdf

154 Labour turnover rates: XpertHR survey 2011, http://www.xperthr.co.uk/article/109819/.aspx

155 http://www.ft.com/cms/s/0/a0c737e0-4c23-11e1-b1b5-00144feabdc0.html#axzz1zYLKhJaq

156 'Review of HM Treasury's management response to the financial crisis', HM Treasury 2012, http://www.hm-treasury.gov.uk/d/review_fincrisis_response_290312.pdf

157 'Review of HM Treasury's management response to the financial crisis', HM Treasury 2012, http://www.hm-treasury.gov.uk/d/review_fincrisis_response_290312.pdf

158 http://www.cipd.co.uk/hr-resources/survey-reports/resourcing-talent-planning-2012.aspx

159 The Coalition Agreement, Cabinet Office 2010, p. 21. http://www.cabinetoffice.gov.uk/sites/default/files/resources/coalition_programme_for_government.pdf The Prime Minister earns £142,500 (reduced from £194,000 to £150,000 by Gordon Brown in 2010 and subsequently cut by a further 5% following an electoral pledge); it is not based on any particular market comparator. It includes an MP's salary of £65,738 as well as additional benefits. The salary is fairly low compared to other leaders (the Chancellor of Germany's £194,000, the Canadian Prime Minister's £189,000, the French President's £193,000 or the American President's £256,000). The Prime Minister of Singapore's £1.4 million is an outlier.

It is our belief that, over time, pay for some senior employees in the public sector should increase to better reflect remuneration in the private sector where their total remuneration is not competitive. This will allow the public sector to attract more of the best managers, leaders and innovators and help to drive improvements in public services. More detailed analysis of the wider elements of reward packages should be conducted to help inform local decision makers about the appropriate level and mix of reward packages.

However, before that has happened, we believe that rises in pay for senior public servants would be problematic for a number of reasons. First, as we have outlined, pay is not the totality of remuneration and there is also a well-established argument that senior public sector employees are motivated by 'knightly motives' – that it is interesting and rewarding work, and they may view public service as a vocation, or be attracted by greater job security.[160] This suggests that significant pay increases may not actually be needed and might not be an effective use of public money.

Second, within a fixed pay bill envelope, this would draw money away from low paid workers. It would also be likely to introduce large differences in pay for senior officials across different areas (areas where pay bills are falling would be unable to match pay increases in those areas where pay bills are rising). In the short term, this would be undesirable for both equity and public-service delivery reasons.

Large redistributions from low-paid public sector employees in low LCA areas towards high-paid public sector employees in high LCA areas would also be likely to increase the gender pay gap significantly. Again, this is obviously unattractive. For these reasons, we believe it is prudent not to target increases in pay for all senior public servants in the short term.

How to distribute Performance Related Pay budgets

Developing managerial capacity and expertise to undertake performance related pay assessment across the public sector will take time. As we have seen, performance management in the public sector, while theoretically present, has proven weak. In particular, managers have been reluctant or unable to use the discretion given to them. The case of Academy Schools, where pay flexibility is already present, is informative. The Department for Education's evidence to the Pay Review Body outlines that 65% of Academies had no plans to use pay flexibilities. There were two key reasons for this lack of desire to use flexibility: 60% said that national pay bargaining made it difficult and 20% said that trade union opposition made it difficult.

For these reasons, we believe it is necessary to compel managers into a rigorous performance related pay framework which can be put in place easily in the short term. This will catalyse a cultural shift towards thinking about performance in relation to pay in the longer term. Our suggested method for bringing in a system such as this in the short-term is that:

- From 2013/14, a temporary bell curve appraisal system (or forced ranking system) is mandated across the public sector where this is contractually possible and alternative individual or local negotiation or performance-related pay systems are not already functioning effectively.

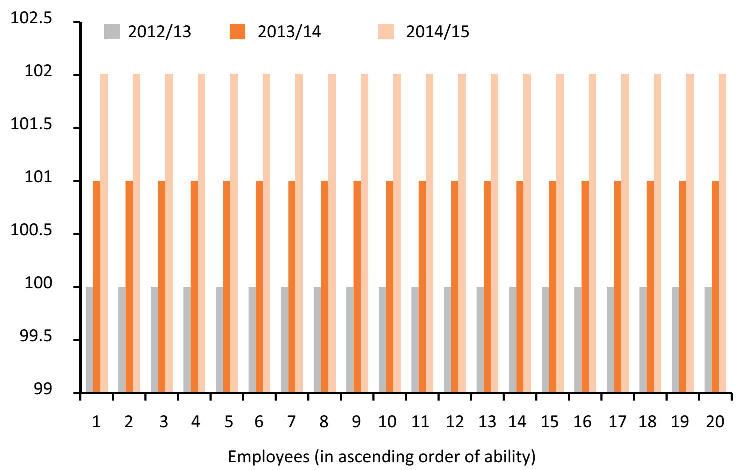
160 Gregory R, Borland J, 'Recent Developments in Public Sector Labour Markets', in Ashenfelter O, Card D (eds.), Handbook of Labor Economics, 3C, 1999

This may vary in composition for different roles in consultation with the Pay Review Bodies. In order to ensure performance is genuinely accounted for, this will involve placing tight constraints as to what proportion of staff can be awarded the highest performance rankings, to avoid managers simply awarding all their staff top scores (a problem which has plagued the introduction of a similar scheme in the Irish Civil Service).[161] Box 9 demonstrates an example of how this might look.

Box 9: Stylised example of how a bell curve appraisal system might work in 2013 and 2014

A public organisation has 20 employees, each of which are paid £100 a year (for the sake of simplicity, we will ignore wage and staff level variation, wage drift, etc.) The manager has been awarded a 1% per year pay bill increase for 2013/14 and 2014/15 (i.e. in proportion to the figures specified in the Chancellor's mandate). Under a national pay bargaining system, the result may well look like the situation in Figure 25.

Figure 25: Stylised pay increases under national pay bargaining system

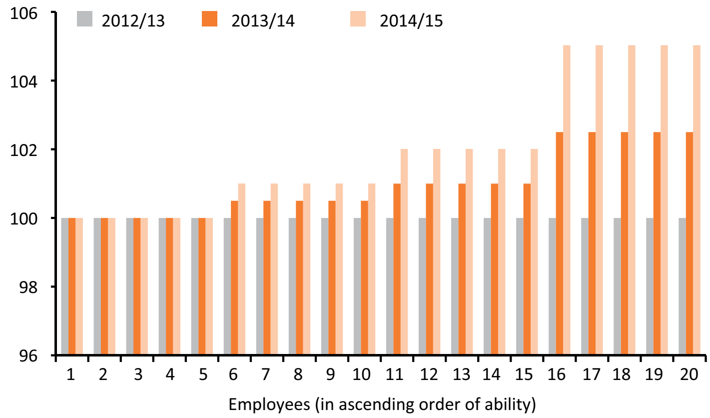


The 1% increase is shared equally across all employees regardless of performance. Under a bell curve appraisal system, however, the managers rank employees in order of performance, allocating them pre-determined proportions (in this example, quarters). Within the same pay award, the manager makes a very different pay award:

Employees ranked	Performance band	Pay award
1 to 5	Bottom 25%	0%
6 to 10	25 to 50%	0.5%
11 to 15	50 to 75%	1%
16 to 20	Top 25%	2.5%

161 'Civil Servants to face sanction', Irish Times, April 11th 2012, http://www.irishtimes.com/newspaper/breaking/2012/0411/breaking3.html#.T4Uuwplgl7E.twitter

Figure 26: Stylised pay increases under bell curve appraisal system



In the case highlighted in Box 9, the top 25% of staff have accumulated just over a 5% increase instead of 1%, while the bottom 25% have received no increase at all. This allows the best performers to be better rewarded than under the previous system, strongly increases incentives within the workforce and gives a clear picture of the best performers (for example, to be considered or fast-tracked for promotion). It also allows a clear evaluation outcome and incentive structure even when targeted behaviours may be complex, multifaceted, hard to quantify or vulnerable to gaming, a frequent issue in public sector roles.[162] This system is frequently used by the private sector, and is already used, for example, in the Department for Work and Pensions, Treasury and Senior Civil Service.

How this performance evaluation is used to determine pay increases will also need to vary significantly from workforce to workforce (for example, how opportunities for career progression are accounted for). A key issue will be adapting this model for existing legacy contracts and liabilities. For example, an effective adaption of private sector best practice (outlined in the Appendix) could be to convert existing payscales into flexible salary ranges, with employees given clear information on what the salary opportunities are for their job. Instead of automatic pay progression, pay increases could be determined both by relative performance and position in that pay range (with a benchmarking process between managers to ensure consistency) – a 'pay progression matrix':

Example of a pay progression matrix

Job evaluation						
Outstanding	5					
Above average	4					
Average	3			●		
Below average	2					
Well below average	1					
Salary % of pay range mid-point		80–89	90–99	100–109	110–119	120–129

● = mid-point

162 Propper C, Wilson D, 'The Use and Usefulness of Performance measures in the Public Sector', Oxford Review of Economic Policy, Volume 19(2), 2003

For example – an employee with a salary of only 80% of the mid-point of her salary opportunity and an 'outstanding' performance evaluation would receive the highest increase, whereas someone with a 'below average' rating above the mid-salary point might receive no increase at all. In the short-term, these salary opportunities could simply be based on existing payscales, and within planned paybill budgets. Over time, the mid-point could be determined by local labour market data and overall affordability within the available paybill budget.

In the longer-term, we recognise that the bell curve appraisal model may not be the most effective means of performance management in the public sector. However, we believe it could prove a useful 'stepping stone' to strongly improve incentives in the short-term. Most importantly, its strong emphasis on relative performance should help catalyse a culture shift and improvement in innovation and management practices across the public sector.[163] While it is by no means perfect, mandating that employers must grade relative performance in this way would be a strong move towards the type of pay system that is needed.

Once that process has begun in earnest, managers and staff will become more used to the concept of performance related pay, and capacity will be built to ensure the process continues even after more flexible measures are put in place after 2015.

163 For example, a corollary of this policy might be greater use of bonuses for the highest performers and a system of Performance Improvement Plans for low performers.

8
What To Do with the Savings Locally?

Keeping money in local areas

The question of local pay has become muddled and conflated with the prevailing view that any reform would involve taking public spending away from deprived regions.[164] Indeed, on its own there is likely to be some truth to this: any reform (including zonal pay) which sought to equalise wages without any further changes would be likely to result in low-wage labour markets losing public funds relative to higher ones.

This type of reform would be highly controversial, unpopular in low-income regions and unlikely to be sustainable in the long-term. For these reasons it is clear that taking money away from areas reliant on public sector employment and potentially suffering from relatively low growth would not be attractive. As the Deputy Prime Minister recently pointed out: '...we are not going to do anything which simply willy-nilly exacerbates a north-south divide.'[165]

We also support the principle that an important role for government is to redistribute resources from relatively rich to relatively poor areas. Fiscal transfers between regions – in other words, the balance of money flowing into a region through public spending and that flowing out in taxation – is, we believe, necessary to ensure fairness in public service provision. They are also necessary to boost growth, deliver better life chances and improve living standards and lives in the areas which are in receipt of them.

However, we do not believe that transferring resources crudely through a system of national pay bargaining is the most effective way of delivering these objectives and, in particular, growth.

For these reasons, while our proposals would mean that pay might change for public sector workers in different parts of the country, we do not believe that overall public spending in these areas should fall. We recommend that:

- Any public spending lost through pay reform should be recycled back into the same local areas.

This means that instead of exacerbating regional inequalities, our proposals represent a major opportunity to boost growth and improve living standards in areas currently dominated by public sector employment. We explore how this could be achieved below.

164 For example, see 'The economic impact of local and regional pay in the public sector: a report by the New Economics Foundation for the Trade Union Congress', NEF, (2012),. http://www.tuc.org.uk/tucfiles/345/EconImpactPublicSector.pdf

165 Deputy Prime Minister Nick Clegg, 14th May 2012 – http://www.bbc.co.uk/news/uk-18065853

Local growth

> *'Once you start thinking about growth it's hard to think about anything else.'*
>
> Robert Lucas

The key priority for the UK economy is growth and in particular, growth and employment in low-income regions.[166] This means that an obvious place to re-invest any savings from pay reforms is into growth enhancing spending. One proposal along these lines would be to reinvest savings into capital spending like public infrastructure. The idea is that public infrastructure investment stimulates demand growth, and generates multipliers of growth in other sectors. By doing so it generates employment and improves the productivity of the wider economy. As such, it is likely to be a better way to boost growth than transfers through current spending in the context of limited public funds.[167]

In its recent report on Britain's economic outlook, the International Monetary Fund advocated a similar strategy. It stated that:

> *'There is scope within the current overall fiscal stance to improve the quality of fiscal adjustment to support growth… through cuts in spending on items with low multipliers (such as public employee wages) to fund higher spending on items with high multipliers (such as infrastructure)… Fiscal space for further growth-enhancing measures could be generated by… restraint of public employee compensation growth, and… used to fund higher infrastructure spending, which has a high multiplier and raises potential output.'*[168]

In short, recycling savings from pay and into public infrastructure development is likely to lead to increased growth and more jobs.

But this money should be spent carefully

We should also sound a note of caution, however. Capital spending is not a panacea if it is done badly. If businesses are choosing not to invest or employ labour (even at relatively low costs), it is probably due to poor projections for return-on-investment. The 'crowding in' effect of private investment through public capital projects is generally positive, but not universally so.[169]

Being less responsive to demand and supply changes signalled by prices, government is unlikely to be any better than the private sector at making decisions as to where to invest. Capital investment projects thus have the potential to be 'vanity projects' which only notionally add to GDP, while real economy grows no faster and simply becomes more indebted – a fate arguably attributable to Japan in its large public works programmes since the 1990s (derelict airports or 'roads to nowhere', for example). Economic activity might look good on the books in any form, but if it does not add to real output (and in fact takes resources away from potentially productive uses), it will actually hinder growth. Public works have to be selected carefully to ensure lasting economic impact.

For this reason, we believe it important not to be too prescriptive in the policy and to give local decision makers flexibility as to where these funds are allocated. As we have seen, the degree of public spending made available in this way will vary greatly between regions, and is likely to be low at first as adjustment takes place. Local actors are more likely to be able to determine the most effective form

166 We have set out a number of strategies as to how to achieve this. 'Looking to the Future of Growth', Policy Exchange 2011, http://www.policyexchange.org.uk/publications/category/item/looking-to-the-future-of-growth

167 Munnell M, 'Policy Watch Infrastructure Investment and Economic Growth', Journal of Economic Perspectives- Volume 6, Number 4, Fall 1992, pp. 189–198

168 'United Kingdom—2012 Article IV Consultation Concluding Statement of the Mission', IMF May 22nd 2012, http://www.imf.org/external/np/ms/2012/052212.htm

169 Afonso A, St. Aubyn M, 'Macroeconomic rates of return of public and private investment crowding-in and crowding-out effect', ECB Working Paper Series No 864, February 2008. http://www.ecb.int/pub/pdf/scpwps/ecbwp864.pdf

this spending might take. Fortunately, we already have a mechanism and model well placed to achieve this.

A localised approach – the Growing Places Fund

The Growing Places Fund is a local infrastructure fund designed to unlock short-term growth by addressing 'immediate infrastructure and site constraints and promote the delivery of jobs and housing' for particular local areas. The Fund, which provides unringfenced financing for infrastructure projects which can be applied for on the sole condition 'that capital allocations are spent on capital projects'[170] is already operational in many parts of the UK, conducted through a bidding process from local enterprise partnerships and channelled through a lead local authority.

It is designed to 'enable the development of local funds to address infrastructure constraints, promoting economic growth.'[171] It is small, however: only £500 million in its first round. As we have seen, the potential of a localised pay policy could release billions in additional funding (our lowest estimate, as we have seen, being £6.31 billion a year in the longer-term) – dramatically multiplying its potential impact on regional growth. Hypothecating funds saved from equalising public and private sector wages and pensions in this way and spending it on local infrastructure is likely to create greater growth in that area than would have occurred otherwise, more than offsetting the loss of public sector consumption. Administratively, this would involve reallocation of savings, delivered through LCA factor adjustments to the pay bill, to the Growing Places Fund through ringfenced allocation to its joint leads – the Department for Transport and Communities and Local Government.

What might the impacts be?

It is worth considering what impact this might have on job creation and how similar schemes have fared. For example, a recent report by the National Audit Office found that the Regional Growth Fund – announced in the June 2010 Budget and aimed at increasing 'business employment and growth in those places currently most reliant on the public sector'[172] cost £33,000 per job created, and was criticised for its low impact.[173] We note similar programmes – Regional Selective Assistance in the 1990s or the Regional Development Agencies, were found to cost around £27–28,000 a job.[174] It seems likely this record can be significantly improved on, particularly with a more localised approach.

In the shorter-term, the extent of investment in growth and, by implication, potential for job creation is limited by only targeting a rebalancing of public sector pay to reflect the existing LCA factors, rather than explicitly underlying public sector pay premiums. Even in this context, using the example area set out in Box 7 above and the higher estimated cost of £33,000, annual job creation would run at 450 new jobs in that relatively small area alone. If considered over the spending review period, across the country, we expect this to have the potential to lead to the creation of tens of thousands of jobs.

Over the longer-term, by looking to match remuneration in the public and private sectors, significantly higher levels of investment could be facilitated. By ensuring that redistribution between different parts of the UK is focused on growth enhancing investment and even using our cautious estimate of a £6.3 billion saving from pay and pension equalization, we calculate that at least

170 'Growing Places Fund prospectus', Department for Transport, http://www.communities.gov.uk/documents/regeneration/pdf/2024617.pdf

171 http://www.communities.gov.uk/publications/regeneration/growingplacesfund

172 'National Infrastructure Plan 2010', HM Treasury 2010, p. 14, http://www.hm-treasury.gov.uk/d/nationalinfrastructureplan251010.pdf

173 'The Regional Growth Fund', National Audit Office 2012, http://www.nao.org.uk/publications/1213/regional_growth_fund.aspx

174 'The Regional Growth Fund', National Audit Office 2012, p. 24, http://www.nao.org.uk/publications/1213/regional_growth_fund.aspx

175 London and the South East are excluded from the job creation totals in this table as the pay premium for these regions is negative. However, this does not imply that the same principle may apply at the sub-regional level in these areas where there is a positive premium, thus creating jobs in these regions not included here.

288,000 jobs could be created. Table 12 outlines estimates of how these jobs might be distributed around the country:[175]

Table 12: Public sector overpayment/total redistribution and potential jobs created by region

Region	Yearly overpayment/total redistribution (£ '000s)	Equivalent jobs created (at Regional Growth Fund costs)	Equivalent nurses (salary only)	Equivalent teachers (salary only)
Tyne and Wear	251,612	7,500	9,000	7,000
Rest of North East	433,439	13,000	15,000	12,000
Greater Manchester	681,464	21,000	24,000	18,000
Merseyside	374,687	11,000	13,000	10,000
Rest of North West	531,713	16,000	19,000	14,000
South Yorkshire	486,444	15,000	17,000	13,000
West Yorkshire	419,533	13,000	15,000	11,000
Rest of Yorkshire and Humberside	561,106	17,000	20,000	15,000
East Midlands	771,564	23,000	27,000	20,000
West Midlands Metropolitan County	458,973	14,000	16,000	12,000
Rest of West Midlands	679,518	21,000	24,000	18,000
East of England	206,765	6,000	7,000	5,000
South West	769,043	23,000	27,000	20,000
Wales	1,254,449	38,000	44,000	33,000
Strathclyde	587,398	18,000	21,000	16,000
Rest of Scotland	612,781	19,000	21,000	16,000
Northern Ireland	420,806	13,000	15,000	11,000
Inner London	-1,341,798	N/A	N/A	N/A
Outer London	-446,890	N/A	N/A	N/A
South East	-1,404,128	N/A	N/A	N/A
Total	**6,308,480**	**288,000**	**332,000**	**252,000**

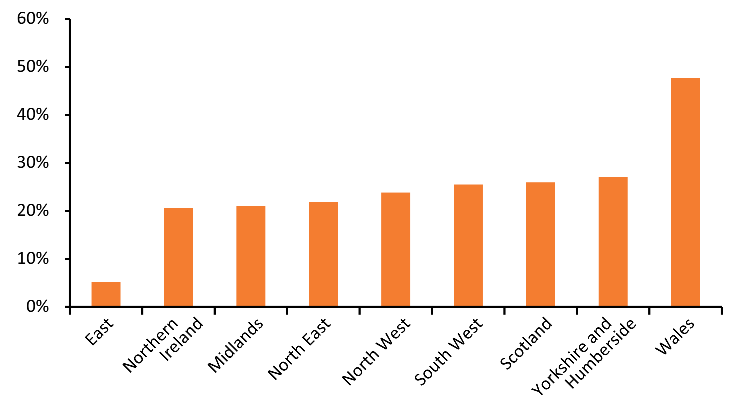
Source: authors' own calculations; Labour Force Survey, Department for Education, NHS Information Centre. Nurses defined as median full-time equivalent total earnings (Band 5 Agenda for Change); teachers as median full-time equivalent qualified teachers in England and Wales. Jobs created rounded to nearest 500; yearly payment to nearest £1,000; totals may not sum due to rounding.

When we consider that this is a very low estimate (incorporating the lowest estimate for public sector pensions we identified earlier, excluding sub-regional savings in London and the South East, as well as the expensive job creation record of the Regional Growth Fund), these figures must be taken as the bare minimum of what might be achieved. Unlike the National Audit Office's Regional Growth Fund analysis, which is a calculation of one-off cost which does not predict with certainty their sustainability over the longer term, the figures used above are annualised savings, meaning their potential impact could be cumulative and thus create far more jobs over the longer term.[176] However, even despite their likely significant underestimation of the real impact, 288,000 additional jobs would

176 'The Regional Growth Fund', National Audit Office 2012, p. 27, http://www.nao.org.uk/publications/1213/regional_growth_fund.aspx

be a tremendous boost to the UK economy. To put this in perspective, this is the equivalent of just under a fifth of the number of people claiming unemployment benefit in the UK, and much more for some regions:

Figure 27: Jobs created projections versus seasonally adjusted claimant count



Source: authors' own calculations (as above), equivalent jobs created at Regional Growth Fund costs. Seasonally adjusted claimant count, July 2012 (Office for National Statistics).

Even given this low estimation of their likely impact, these figures show just how transformative to the employment of many regions local pay could be.

We do not suggest a prescriptive means by which these funds could be spent here. As we have outlined, much of these savings will take many years to realise,[177] and it would be prudent to open the means by which this could be facilitated to public consultation in the interim period. But by establishing a clear policy that no region will lose out as a consequence of local pay in terms of public spending, but, on the contrary, will gain in terms of additional jobs and growth, a public case for local pay can be built and sustained over the long term.

Other options for local spending

The Growing Places Fund may not be the only approach, however. Where local enterprise partnerships are not operating, do not need additional finance, or feel it could be better used in other ways, alternative uses which enable job creation could be found, such as:

- Increasing spend on non-pay public services spending (though this has the potential to recycle into pay 'by the back door');
- Direct funds into local training programmes (sector-based work academies for example[178]) or through additional public sector employment (for example, a corollary of localised pay could be a regional relocation of appropriate public sector staff to save public money as non-customer facing roles are relocated to relatively less expensive labour markets, following the direction set out in the Lyons Review[179]);
- Providing finance, credit or guarantees to third sector and social enterprises;
- An increase in the budget of the Regional Growth Fund (though note the caveats outlined above);
- Targeted tax breaks and incentives.

177 We do not preclude the possibility of 'frontloading' some of these anticipated savings through a 'DEL/AME' type model, however.

178 http://www.direct.gov.uk/en/Employment/Jobseekers/programmesandservices/DG_198948

179 Lyons Review, 2004, http://www.hm-treasury.gov.uk/consult_lyons_index.htm

9
Impacts On Areas and Individuals

As well as outlining the potential overall impacts on jobs in the chapter above, this chapter outlines illustrative case studies for what our reforms might mean for specific areas and individuals.

Impact on areas – case studies

It is worth spelling out how all these reforms might fit together. We believe that a practical, fair form of locally-facing public sector pay would be better for all areas of the country, both in growing local economies and improving public service outcomes. The following stylised case studies explore examples of how these reforms might affect particular areas.

Small town on the outskirts of a large city

Circumstances under old system: The area has a public sector overpayment relative to the private sector, but this is unclear from existing data. Unemployment is high.

Circumstances under new system: The new data gathering exercise identifies the disparities in wages between the local labour market and locally-competitive employment. Over several years, local pay increases in the town run slower than the private sector. This enables existing businesses to compete more effectively, as well as attracting new ones. These businesses hire additional workers, reducing unemployment.

Cost savings from lower pay increases are also reinvested in local infrastructure, creating better links to a nearby city. This eases commuting and reduces unemployment. It also creates new demand for local businesses as visitors from the nearby city take advantage of the new transport links.

Why the new system is better: By effectively paying the public sector a locally competitive rate, a fairer level of pay is set and businesses are better able to compete for the best workers, reducing 'crowding out' effects. This boosts employment in the area.

Large city outside the South East of England

Circumstances under old system: The city has an overall slight underpayment for public sector staff, but this is diverse. In the low-income end of the city, demands on public service workers are higher – for example, the schools are more demanding and social services have to cope with more demanding caseloads. This is not reflected in national pay scales, causing higher turnover and vacancy rates.

Circumstances under new system: Wage bills rise slightly faster than the private sector over time allowing the public sector to recruit and retain high quality staff. Local managers, able to flex salaries according to service needs, pay more in the more demanding roles (for example, higher paybill budgets are provided to allow salaries to be higher for teachers in the more challenging schools), reducing vacancies and increasing retention. The quality of public services improve.

Why the new system is better: The new flexibilities allow intra-regional variation of wage rates according to public service needs at a very local level. Resources can be more fairly and effectively targeted at the most demanding roles, improving service outcomes where they are needed most.

Remote rural area

Circumstances under old system: Public and private sector remuneration is broadly equal: some underpayments and some overpayments exist. But national pay scales do not reward the best performers or the demands of the job. Low-performing, long-serving public sector staff exist in many services.

Circumstances under new system: Long-serving workers no longer have pay increased due to length of service. Underperforming workers lose all annual uplift and performance increases; many improve their performance or leave. Where pay levels are too low or too high, managers are able to adjust wages to compensate. Performance related pay which reflects service innovation spurs new ways of working, creating a more productive and risk-taking culture.

Why the new system is better: Pay more fairly reflects the contribution of public sector workers and this has a positive effect on the quality of public sector staff. Workers are rewarded for carrying through reforms, incentivising innovation and improving productivity.

Impact on individuals – case studies

A nurse in a high-cost area outside the South East

Circumstances under old system: House prices, public transport options and costs of staple goods and services are high relative to the rest of the UK. However, because this is not reflected in the nurses' nationally-set pay, he struggles to get by. The cost of his mortgage and raising his family mean he has relatively little to spend on holidays or entertainment and makes saving very difficult.

Circumstances under new system: Locally facing pay means that the additional cost of living and working in the nurses' area is reflected in paybill budgets. This means that the nurses' pay rises faster relative to the rest of the UK.

Why the new system is better: The nurses' pay is increased faster than it would have done under national salary scales. This is fairer because it allows him and his family to enjoy a standard of living equivalent to that enjoyed by his peers in other parts of the country.

Newly qualified, highly motivated teacher

Circumstances under old system: despite being recognised as an excellent teacher able to inspire children more effectively than his colleagues, his new status in the profession means he is only paid the newly qualified rate. This means he is paid less than other teachers in the school who have been there a long time and are not as motivated or put in fewer hours. The headteacher would like to pay him more but is unable to do so because there is almost automatic pay progression awarded across the board. Over time, the teacher becomes demotivated that his contribution is not recognised and begins to 'coast'.

Circumstances under new system: though his initial rate of pay is little different to other newly qualified staff, his exceptional talent for teaching is quickly recognised by the departmental head. A performance review at the end of the academic year places him towards the top of the schools' performers and, because he is also one of the least well-paid, he is awarded one of the biggest increases; in a few years, he is among the best paid. The teacher appreciates that his efforts are noticed and continues to perform to a high level, while his relatively underperforming peers are motivated to up their game. The schools' academic results improve.

Why the new system is better: The system is fairer because pay is related to contribution to the job rather than length of service. The high performance of the teacher is sustained by being properly recognised, while underperforming staff are spurred to improve their game. Educational outcomes improve.

Long-serving public servant with low morale

Circumstances under old system: After a long career, she is cynical about her work. She feels innovation is rare, productivity low and waste is rarely dealt with. She feels there is a cultural barrier against reform which is impossible to challenge. Though she is serious and dedicated to her work and continues to perform as best she can, she no longer tries to make suggestions for improvements or question established practices because she feels they will not be acted on or even resented. Close to retirement age, her pay is higher than her equivalent role in the private sector.

Circumstances under new system: though her paysetting arrangements are quite different, she receives little difference in terms of pay than she would otherwise: small annual increments. However, over several years, the wider effect of local pay in the public sector has radically changed the environment in which she works. Grades are no longer so hierarchical, the best staff are able to rise quickly and underperformers become more motivated or leave service; absence rates fall. Suggestions, feedback and innovations are encouraged and rewarded. Though it has affected her little financially, she is much more enthusiastic about her role.

Why the new system is better: Linking performance to contribution rather than length of service has the effect of greatly improving the atmosphere in which she works. Morale improves, staff feel able to become more dynamic and innovative. The workforce feel more fairly rewarded for their efforts and are able to become more productive.

10
Other Reforms Needed

The role of trade unions

> *'The trade unions too must be brought to face up to their responsibilities in these matters… They can and do connive at inefficiency springing from wage systems no longer relevant to present day conditions, from reluctance to link pay settlements to changes in working methods, and from leap-frogging inflationary pay settlements.'*
>
> *'The principles which apply in private industry… must also be shown to be applied in the public services. The need to see that pay and performance are linked together is just as critical in the public services as outside them.'*
>
> Barbara Castle, Memorandum on White Paper In Place of Strife, 23rd September 1969, pp. 2, 4

In 1969, Labour's Secretary of State for Employment and Productivity, Barbara Castle, attempted to fundamentally restructure the nature of industrial relations in the UK with her White Paper 'In Place of Strife'. This legislation would have placed Britain's industrial relations much more on the path of continental Europe: improved recognition rights for unions, compulsory registration, 'cooling off' periods before strikes could take place, and inter-union disputes regulated, with the possibility of unions being fined. The government was forced to back down under trade union pressure. Subsequent to its failure (and many of the similar provisions of the following Conservative Government's Industrial Relations Act), attempts to implement such a social contract between unions and employers have been largely lacking in Britain. Britain is atypical by the standards of continental Europe in having no form of social contract involving trade unions in management and pay decisions. Trade unions rarely play a leading role in improving a firm's working habits or efficiency, and active consultation is uncommon.

Thus, rather than acting as stakeholder engagement bodies and being genuine partners, some trade unions are regarded as little more than militant campaigning organisations in the public sector. This is in stark contrast to trade unions in many parts of continental Europe and, indeed, in the UK's private sector. It means there is little opportunity to work with management and workers in a mutual effort to improve workplace practices and efficiency.

For a locally based performance related pay system to work, effective communication and buy-in to the reforms by public sector workers will be needed. Within this context, it is clear that trade union opposition to any reform is likely to be a significant difficulty. Indeed, the World Bank has identified that this trend is prevalent globally:

> *'it is rational to adopt a goal for pay reform that is the attainment of a pay structure that enables recruitment and retention of needed skilled personnel for the public service to perform efficiently and effectively. Implicit in this policy principle is the decision that pay levels would generally reflect the "market" price of the jobs in the service. However, experience shows that the behaviour of labour unions or vested groups in the public service makes it difficult for policy-makers to sustain a "market-based" pay policy.'*[180]

Box 10 explores some of the reasons for the strength and success of trade union opposition to market-facing pay structures.

Box 10: The problem – unions working against pay flexibility

While as we have noted unions can play a positive and constructive role in effective negotiations and improving workplace productivity, there are a number of elements in play which contribute to the ability of less cooperative unions to enforce sectoral collective bargaining practices and oppose reforms. A key driver of this is the ability to coordinate industrial action across the public sector. A trade union normally has a choice whether to ballot by workplace or more widely. However, while it has been a principle of industrial relations law since the 1980s (responding to 'secondary picketing'[181]) that a 'trade dispute' should happen with an individual employer (including separate ballots), it has become common practice in the public sector for balloting to take place across legal employers – largely because employment contracts in large parts of the public sector are imposed nationally, regardless of who the actual employer is.

The level of legal employment, in fact, varies considerably across the public sector. For example, Academy staff are usually employed by their school, whilst other schoolteachers are employed by Local Authorities. University lecturers are employed by their university, local authority staff by their Local Authority, hospital doctors by their NHS Trust, GPs by their Primary Care Trust, Civil Servants by the Crown and so on.[182] Yet central pay, terms and conditions setting through collective bargaining processes which predominate across the public sector (either directly or as an anchor point), mean that these distinctions are largely theoretical – and this is replicated through the negotiation and industrial action processes. Since in the private sector, there is generally no common interest among employees and the level of unionisation is lower, this happens less frequently (it is more likely if there is a shared collective bargaining process which there rarely is). In contrast, in the public sector, there is a perception of common interest because there is much more likely to be a series of collective bargaining arrangements for different employers and a centralised employment contract.

In summary: existing law does allow for a ballot to be conducted for several different employers around the country, but the exercise of this right overwhelmingly occurs in the public sector due to the collective and contractual connection between different employers and the perceived commonality of interest. This makes changes to pay structures in the public sector in the UK particularly difficult to implement. Even reforms aimed at improving productivity and public service delivery are opposed and widespread industrial action can be used to enforce political pressure on the government.

180 'Public Service Pay Reform: Tactics Sequencing and Politics in Developing Countries: Lessons from Sub-Saharan Africa', World Bank 2003, p. 4. http://www1.worldbank.org/publicsector/civilservice/Mayseminar/PayReformStudy.pdf, our underlining

181 Duport Steels Ltd v Sirs (1980): the Court of Appeal's injunction effectively denied the right to secondary picketing.

182 We note however that the status of legal employer is not always straightforward. For example, section 244 of the Trade Union and Labour Relations (Consolidation) Act 1992 deems the Minister to be the employer of those in his or her department, in given circumstances, in the context of industrial action ballots. Section 279 of TULR(C) A deems the Primary Care Trust to be the employer of primary care dental, medical and pharmaceutical employees, ingiven circumstances.

Despite this historical opposition, any reform that moved the public sector towards localised public sector pay would provide an opportunity for trade unions in the UK to modernise and become a productive and effective partner in the UK labour market. As we have seen in the case of Sweden, it is far from the case that high levels of unionisation necessarily mean that local pay bargaining is impossible. Indeed, it could help unions become more relevant and play a constructive role in the paysetting process. We have laid out evidence of the problems with current national pay bargaining structures. These include: higher than needed unemployment, a reduction in public service quality due to higher turnover, lower morale and retention rates, and severe underpay in some of the parts of the public sector where we vitally need highly skilled public sector workers.

A more collaborative approach from the unions could see reforms target these areas while ensuring that all public sector workers are rewarded in a fair way that reflects their contribution to vital public services. A more collaborative and modern approach to union activity would also present the trade unions with an opportunity to bolster their dwindling role in the operation of the UK labour market.

This is particularly relevant since the UK trade union movement faces significant challenges. Membership has almost halved over the past thirty years, with many of the remainder close to retirement age. Less than 30% of workers still pay their dues and this falls to just 16% in the private sector (often concentrated in formerly nationalised industries). The Trade Union Congress (always weak in the UK by international standards) is struggling to assert leadership over the large, multi-sectoral unions which have emerged following a series of consolidations: in the public sector, with the creation of the PCS and Unison unions in the 1990s and with the creation of Unite from Amicus and the TGWU in 2007.[183] A new approach would provide the opportunity for this tide to be turned and the unions to act as a constructive part of delivering productivity improvements and growth.

However, it is clear that introducing a more productive and collaborative engagement between unions and the government would require significant changes to how the unions operate in the public sector. In particular, under our proposed system, the power to negotiate pay would devolve from central to local union officials (while central union officials continue to play the key role in negotiating terms and conditions). Unions would maintain their key role and perform the useful work they often do in the private sector: helping members with training and advice, resolving workplace grievances, being an effective conduit of information between employers and employees and negotiating wages where individual negotiation would be inconvenient or expensive. Achieving this new relationship would be a major step forward in public sector reform.

However, moulding the relationship of unions and public sector employers into an effective one will be tricky. Credibly establishing the relationship between improving pay and productivity where it has not functioned well previously, and creating the circumstances in which unions and government employers work together towards this end, will require a fundamental shift in attitude as well as new negotiation frameworks.

One example of where this has worked effectively has been in the union involvement in the setting of the National Minimum Wage. With a presence of

183 See http://www.unionhistory.info/timeline/1960_2000_5.php

senior union officials on the Low Pay Commission, union support of the policy has been secured. Using this as a precedent, we believe that the unions should play a stronger role in pay policy from an earlier stage in proceedings in order to build a collaborative relationship. To facilitate this we recommend that:

- Each Pay Review Body should have a permanent trade union representative as a member.

The section below covers the future functioning of the Pay Review Bodies. Alongside reform of the role and membership of the Pay Review Bodies, reforms are also needed in order to effectively tackle instances where there are disagreements.

This is because the problems outlined in Box 10 are likely to exist even where managers are given more flexibility to disaggregate from centralised negotiations and the Pay Review Bodies sit above a more devolved system. The problem is that although the Trade Union and Labour Relations (Consolidation) Act 1992, section 228 states that there must be separate workplace ballots if all those who are entitled to vote do not work in the same workplace, this is qualified by section 228A. This allows ballots to be aggregated for various circumstances. These are wide ranging enough to allow single ballots for all members who have 'an occupation of a particular kind or… any of a number of particular kinds of occupation' and 'are employed by a particular employer, or by any number of particular employers with whom the union is in dispute.'

In effect, this allows trade unions to conduct a single ballot of union members for any number of employers as long as the union was in dispute with all of them – even if the dispute were separate. It provides that the ballot 'may' be conducted across all employers – in other words, allowing the union to decide – making legal the national balloting which is standard practice across the public sector. In the context of local pay bargaining, continuing to permit this would allow unions to override the new system and continue to negotiate nationally (as already occurs in terms of limiting or blocking the theoretical flexibility to disaggregate from national pay scales and have robust performance related pay as outlined above).

We therefore recommend that:

- An essential part of the implementation of a more localised system of pay negotiation must include mandating that industrial action ballots should be held for each legal public sector employer by amending TULR(C)A section 228A.[184]

This would simply be implementing the intention of the 1982 Employment Act, which stipulated that strikes should be about a dispute between 'workers and their employer.' Since the legal employer of most public workers is at a much lower level than strike ballots are currently held – a particular hospital or university, for example – and these ballots would be counted separately, this would have the effect of making strikes local rather than national, and relate to specific grievances regarding local pay negotiations rather than national pay bargaining disputes.

A further issue exists around the lack of diversity among trade unions. In 1909 there were 1,268 trade unions in the UK. Despite a workforce nearly two-thirds

184 This idea was suggested by Tim Leunig of the London School of Economics; (Financial Times, October 27th 2009)

larger, by 2009 there were just 185: around a seventh of the total. The two largest unions, Unison and Unite, each have more than a million members out of a total UK union membership of 6.7 million.[185] In addition, trade unions are in effect a monopoly in most workplaces: both through the Employment Relations Act 1999 (EReIA 1999) giving a single trade union statutory rights to formal recognition by an employer and a general union rule against recruitment where another union has significant membership (as per the 'Bridlington principles'). This prevents workers having much choice over the union they want to join and the kind of representation they are given. We believe that introducing more choice into trade union representation, potentially through competition law would be appropriate. These issues are explored further in our Report Modernising Industrial Relations.[186]

We also hope this would have the effect of framing industrial disputes in the public sector in terms of local negotiation of pay rather than a generalised (often political) struggle between national unions and the government of the day. This shift would be a step towards the more cooperative relationship which connected pay rises to productivity, and help foster a more innovative culture across the public sector along the lines laid out by In Place of Strife some four decades ago.

The role of the pay review bodies

If national pay structures cease to exist, much of the purpose of the Pay Review Bodies will change (for example, the abolition of the School Support Staffing Negotiating Body in October 2010 followed moves to allow more local flexibility for pay and conditions for those staff.)[187] However, as we outlined in a previous report, the Pay Review bodies should continue to play a key role in any new parameters for pay setting.[188] In particular, they should continue to play a key role in setting terms such as pensions or grievance procedures nationally where the transaction costs of localised negotiation might outweigh efficiency gains. For reasons of simplicity, localisation should concentrate on pay rather than full contractual change and the Pay Review Bodies can play a leading role in defining the parameters under which this can take place effectively.

Our proposals have also outlined a key role for the Pay Review Bodies to play in a new, more devolved system. We believe that their remit should now require them to make broad recommendations for how pay should vary by outlining zonal pay differentials across the country in order to reflect differences in living costs and labour market conditions as a benchmarking measure. They should also have responsibility for developing off-the-shelf frameworks for performance management/reward and providing local labour market analysis to help inform managers and organisations across the country. Each of these aspects will provide support as organisations transition to the new system and necessary information on an ongoing basis to help inform decisions over pay in the longer-term. This will provide vital efficiencies of scale to ensure that each local organisation does not have to conduct the same analysis of the labour market.

As with the Swedish National Mediation Office, which plays a role in determining efficient wage formation as well as a dispute resolution role, we believe a similar function could also be played by the Pay Review Bodies in the UK: to recommend more effective forms of negotiation for their

185 Butler D, Butler G, 'British Political Facts', Palgrave 2011

186 Holmes E, Lilico A, 'Modernising Industrial Relations', Policy Exchange 2010, http://www.policyexchange.org.uk/images/publications/modernising%20industrial%20relations%20-%20sep%2010.pdf

187 http://www.bbc.co.uk/news/education-11642376

188 Holmes E, Lilico A, 'Controlling Public Spending: Pay, Staffing and Conditions in the Public Sector', Policy Exchange 2010. http://www.policyexchange.org.uk/images/publications/pdfs/Controlling_public_spending.pdf

(greatly differing) workforces, with a focus on bringing a more local and performance-related pay focus, strengthening the mandate set out in the 2004 Budget Statement.

- Part of the mandate of the Pay Review Bodies should be to help formulate an efficient remuneration formation process, following the precedent set by the 2004 Budget Statement.

This description of the operation of the Pay Review Bodies in the future makes it clear that their role will have to change significantly. This is also true of the Office of Manpower Economics, which acts as an independent secretariat to the Pay Review Bodies.

In order to take on these new and stretching responsibilities, we have already recommended that a union representative is appointed as a permanent member of each Pay Review Body. Alongside this we believe that the structure, size and membership of both the Pay Review Bodies and the OME should be consulted upon. In particular, we believe that the tripartite set up of the Low Pay Commission should be considered for the Pay Review Bodies. This would mean that trade unions, employers, experts and academics would all have a joint role in making recommendations.

Summary of Recommendations

To ensure efficiency and to target growth across all parts of the UK, we believe that reward packages across the public sector should become more closely aligned to those which are present in equivalent roles in the private sector. However, existing data does not allow easy comparison of public and private sector. This means that:

- The government should consult on how to best measure the total reward packages of public sector employees and publish data that allows comparisons between the public sector and private sector. As a priority, the value that public sector pensions add to individual reward packages in the public sector should be analysed and published.

In the long-term, in order to deliver a system of pay setting that reflects local labour markets and boosts public sector productivity by rewarding performance:

- The government must make it clear that local managers must take into account both local labour market conditions and individual performance when setting pay. In essence, this would require that pay setting would be localist by default.

In practice this would lead to a system where negotiations over reward packages took place at several different levels, as is the case in Sweden. Some things would continue to be negotiated nationally. In particular:

- Negotiations over pensions and broader terms and conditions, excluding pay, should continue to be negotiated under existing arrangements.

To facilitate this change and to give local organisations the support needed to make decisions over the appropriate level of pay negotiation and tools to implement a performance management/reward framework, the Pay Review Bodies should be given a new remit.

- The remit of the Pay Review Bodies under a local paysetting system should be amended to include recommending paysetting systems and guidelines over best practice in their use. As a benchmarking measure, this may include outlining zonal pay differentials.
- This remit should also require the Pay Review Bodies to make recommendations for a structure for benchmarking performance within organisations. This might take the form of several off-the-shelf performance management/reward frameworks, which organisations could choose to use in order to meet their workforce needs.

Before this system can be implemented, consideration needs to be given to how to maintain central government control over aggregate pay bills. To do this:

- A consultation exercise should be undertaken to design a framework and method of implementation to allow pay bill envelopes for public sector organisations to be set, such that they act as a constraint on upward pay pressures and reflect equivalent costs of private sector organisations.

In the short-term, movements must be made towards a system that is more locally based and that rewards performance. To facilitate this, for staff across the public sector:

- A permanent nominal freeze on generalised annual pay scale uplifts should be introduced for the period of Spending Review (up to 2015/6); and
- Automatic pay progression points should be abolished.

However, we do not envisage this being a cost-saving measure. Instead:

- All savings from pay scale freezes and the ending of automatic progression points should be re-invested in providing locally facing and performance-related pay structures or in local initiatives aimed to spur growth and employment.

By ending automatic pay progression and uplift, we will free up a budget for performance related pay increments in individual pay, as well as enabling greater growth in regions where it is needed. There is a ready-made way in which this could be distributed in the short term in order to address the current public-private pay differentials. We recommend that this happens as follows:

- Where they do not already exist, the Pay Review Bodies should be required to create Local Cost Adjustment factors for their respective workforces. These should build on existing best practices.
- In areas where the LCA is equal to or above one, the pay bill impacts of the 1% pay scale uplift should be estimated for individual public sector organisations and ring-fenced for performance-related pay (PRP) budgets.
- Where the LCA factor is less than one, the pay bill impacts of the 1% pay scale uplift should be estimated for individual public sector organisations. Half of this should be ring-fenced for PRP budgets. This means that those areas with low labour costs would see a fall in their PRP budget. This policy should remain in place until public sector pay in these areas is at the level considered appropriate based on LCA factors.
- In areas where the PRP budgets are reduced to reflect low LCAs, total public spending for the area should stay the same, and the amount of money by which the PRP budgets are adjusted should be ring-fenced for expenditure in the same areas in order to stimulate local growth. Possibilities for expenditure are explored in chapter 8.

In terms of how performance related pay should be implemented at an individual level, we understand that expertise will need to be developed, so in the short-term we recommend that:

- From 2013/14, a bell curve appraisal system (or forced ranking system) is mandated across the public sector where this is contractually possible and alternative individual negotiation or performance-related pay systems are not already functioning.

Alongside these reforms to the system of pay setting in the public sector, wider reforms will be needed to the institutions involved in the current processes. In particular:

- Each Pay Review Body should have a permanent trade union representative as a member.
- The structure, size and membership of both the Pay Review Bodies and the OME should be consulted upon. In particular, we believe that the tripartite set up of the Low Pay Commission, where trade unions, employers and experts all have a key role, should be considered for the Pay Review Bodies.
- An essential part of the implementation of a more localised system of pay negotiation must include mandating that industrial action ballots should be held for each legal public sector employer by amending TULR(C)A section 228A.[189]

189 This idea was suggested by Tim Leunig of the London School of Economics; (Financial Times, October 27th 2009)

Conclusion: Local Pay, Local Growth

The current system of national pay bargaining across large swathes of the public sector is bad for the economy and bad for living standards. It is not a system that encourages productivity and it creates differentials in pay between private and public sector workers that lead to shortages of vital public sector workers in some areas. Both of these factors mean that the quality of public services is lower than it should be. In addition, the hard work and dedication of public sector workers is not rewarded nor recognised adequately. The case for reform is clear.

This system of pay negotiation is also bad for the economies of those parts of the country that rely on it most. While we recognise that a valid function of government is to redistribute resources between relatively rich and relatively poor areas, crude national pay scales are not an effective way of doing this. It has led to a situation where, when less favourable economic times come around, the areas most reliant on public sector employment and support are the areas that are hit the hardest as budgets are unavoidably cut. Redistributing resources in this manner is an inefficient use of taxpayer money.

There is also a widespread recognition that not everyone should be paid the same benefit level across the country[190] or the same amount for the same job if they live in different places with different costs of living. In short, there is 'a strong case for having regional variation in the pay awards.'[191] Not doing so means that public sector workers in high-cost areas have lower living standards those in lower-cost areas. This is fundamentally unfair.

This report has laid out policies that would benefit us all in the long-run. If implemented they would:

1. **Improve the quality of vital public sector services by:**
   - more closely aligning pay with performance;
   - ensuring that pay can be flexed where skills shortages or high turnover affect quality; and
   - improving incentives for outstanding professionals to reform the public sector by more closely aligning performance with reward.
2. **Achieve greater regional growth and job creation** by redirecting redistributed resources towards growth enhancing regional projects with higher fiscal multipliers, we can create jobs in areas that need them most.
3. **Improve mobility between the public and private sectors** through greater parity in remuneration, terms and conditions.
4. **Provide fairness** for workers across the public sector and for taxpayers by ensuring that pay in the public sector reflects market conditions and contribution to public services.

190 In fact, they are not currently since Housing Benefit varies across the country.

191 Institute for Fiscal Studies, Green Budget 2011, Chapter 5, p. 98, http://www.ifs.org.uk/budgets/gb2012/12chap5.pdf

5. **Strengthen the functioning of the labour market** by introducing a more collaborative and constructive role for trade unions in the UK.

We recognise that these reforms will face significant opposition. But grasping the nettle now will deliver growth, jobs, fairness and ultimately better public services for us all.

Appendix 1: Regression Output for Pay Differentials by Sub-region

	Q10		Q25		Q50		Q75		Q90	
	Coef.	**P>|t|**	**Coef.**	**P>|t|**	**Coef.**	**P>|t|**	**Coef.**	**P>|t|**	**Coef.**	**P>|t|**
Public sector	0.11	0.00	0.10	0.00	0.10	0.00	0.06	0.00	0.01	0.81
Male in public sector	0.00	0.74	-0.02	0.00	-0.05	0.00	-0.05	0.00	-0.03	0.00
Public interacted with:										
Tyne and Wear	Base	Base	Base	Base	Base	Base	Base	Base	Base	Base
Rest of North East	0.03	0.32	0.01	0.67	0.02	0.40	0.01	0.71	0.01	0.68
Greater Manchester	0.04	0.09	0.01	0.40	0.00	0.99	0.00	0.84	0.02	0.46
Merseyside	0.04	0.112	0.03	0.15	0.00	0.84	0.02	0.30	0.01	0.88
Rest of North West	0.03	0.24	0.02	0.33	0.00	0.85	-0.02	0.42	-0.04	0.19
South Yorkshire	0.06	0.02	0.04	0.07	0.01	0.56	0.04	0.09	0.06	0.11
West Yorkshire	0.04	0.16	0.01	0.79	0.01	0.62	0.02	0.28	-0.04	0.22
Rest of Yorkshire and Humberside	0.11	0.00	0.03	0.11	0.04	0.11	0.04	0.08	0.03	0.47
East Midlands	0.04	0.13	0.02	0.21	0.00	0.85	-0.02	0.26	-0.02	0.58
West Midlands Metropolitan County	0.02	0.54	0.01	0.74	0.01	0.69	0.01	0.68	-0.01	0.85
Rest of West Midlands	-0.01	0.81	0.00	0.99	0.02	0.39	-0.01	0.76	0.06	0.09
East of England	0.01	0.64	-0.01	0.71	-0.05	0.00	-0.07	0.00	-0.11	0.00
Inner London	0.08	0.01	-0.01	0.72	-0.09	0.00	-0.20	0.00	-0.28	0.00
Outer London	0.11	0.00	0.08	0.00	-0.04	0.04	-0.07	0.00	-0.12	0.00
South East	0.02	0.34	-0.04	0.02	-0.11	0.00	-0.14	0.00	-0.20	0.00
South West	0.03	0.17	0.01	0.78	-0.01	0.55	-0.04	0.04	-0.08	0.01
Wales	0.06	0.01	0.05	0.00	0.04	0.04	0.06	0.00	0.07	0.02
Strathclyde	0.08	0.00	0.07	0.00	0.04	0.06	0.02	0.31	0.00	0.94
Rest of Scotland	0.07	0.00	0.04	0.01	0.00	0.93	-0.01	0.52	-0.04	0.18
Northern Ireland	0.06	0.02	0.05	0.06	0.02	0.42	0.05	0.08	0.12	0.01

Appendix 2: Case Studies in Public/ Private Sector Wage Formation

Remuneration methods

As part of the process of writing this report, Policy Exchange interviewed a wide variety of Human Resources professionals in the private sector to assess how their pay negotiations operated. We also interviewed a number of Human Resources professionals in public sector organisations which have significantly diverged from national pay setting. This section summarises the main issues raised in these interviews.

Example characteristics of best practice in wage formation

- Performance or contribution to the organisation, with no reflection on length of service;
- Market-informed pay setting, combined with affordability;
- Extensive data gathering – including economic indicators, retention rates, local pay trends, benchmarking and surveys;
- Tight control of the overall paybill cost;
- Terms and conditions set in largely the same way across the business.
- Remuneration is considered from a 'total reward' perspective – factoring in the value of non-pay values of the job, including pensions, holidays, bonuses, etc.;
- Firms have moved away from single pay scales combined with regional/ London weighting in recent years because their experience shows this is not as effective in reflecting local labour markets;
- Job performance review is related to pay settlements;
- Bonuses are a key aspect of remuneration but awarded only for exceptional performance;
- More skilled and managerial roles have salaries more closely tied to specific outcomes and are often negotiated on a very local or individual basis, with labour market competition to attract them often national or international.

Private sector

Major financial services company which has moved away from London weighting

Principles

- The company bases its remuneration policy on four main principles:
- Performance or contribution to the organisation, with no reflection on length of service;
- Market-informed pay setting, combined with affordability;
- Pay settlements should be tied to individuals and business units rather than across the organisation;

- One employee benefit programme, where each employee is given an overall figure from which they can take a choice of benefits. Terms and conditions are largely the same across the business except for legacy (for example acquired businesses).

Local pay?

The most professional roles have pay set by a market anchor. For these workers, the pay setting process is discretionary – they sometimes have to pay a premium to get the right people.

For less skilled roles, such as clerical staff in their retail branches, until 2006 a single salary range was used, with employees being made aware of the 'salary opportunity' within that range, with additional pay weighting for London and smaller additions for the South East. They moved away from this because the recruitment and retention figures showed it did not work. Their analysis showed that their labour market is a lot more varied and dependent on several complex factors (such as whether the location is close to a trainline or a major city centre). In general, this caused them to struggle to recruit in city centres, but not in isolated regions.

The new pay structure introduced for more junior staff introduced five geographical bands, with band 1 being the cheapest, 5 the most expensive. These are arranged according to labour market demand, particularly turnover rates and time taken to fill vacancies. London based offices tend to be bands for 4 and 5, but not exclusively. On top of this, an annual process of review is undertaken to determine uplift for the different bands on a national basis.

Performance pay?

Distribution within the ranges set for each job is done on the basis of a job evaluation methodology: the best performing people are given the highest pay increases with a benchmarking process between managers to ensure consistency. The pay ranges themselves are based around a labour market mid-point as well as business affordability, with the bottom of the range being around 80% of this, the maximum around 120%. Local managers are given an envelope as to what they can spend overall. All employees are given data on their salary range as well as that for grades above and below them. Pay increases are calculated on a pay progression matrix:

Job evaluation						
Outstanding	5					
Above average	4					
Average	3			●		
Below average	2					
Well below average	1					
Salary % of pay range mid-point		80–89	90–99	100–109	110–119	120–129

● = mid-point

The percentage increase is calculated on a basis both of distance from the mid-point and performance. For example: those rated 5 who were in the 80–89% range would be uprated the most. However, if the employee's salary is above the mid-point for her grade, the increase will be reduced, even with a 5 rating. A 4 rating would be a bigger percentage increase than average, a 3 the average. For affordability purposes, those rated 1 or 2 get no increase at all. This matrix is then weighted by the localised pay bands described above. All of this data is available to employees.

Bonuses are discretionary and are only given for performance excellence, assessed on documentary evidence. This is done on a 1–5 scale: 1–2 being unsatisfactory (usually no bonus given), 3 satisfactory (bonuses rarely given) and 4 or 5 being exceptional (bonuses usually given). Some other employees get variable pay, where payment is made for exceeding specific targets or measures, such as a sales target, though this is never combined with a bonus.

Major discount fashion retailer with personal review for more senior staff

The vast majority of its staff are shop-based customer service staff (around 93%). These are remunerated at an hourly rate, which is set according to general industry data. HR staff at the local level report back with industry and market data. They are part of a retail industry group in which wage rates with competitors can be compared. This tends to create a small premium in London, but otherwise it is standard across the board, with a standard percentage increase each year. No account is taken of length of service.

Store manager pay is determined by individual review, allowing for market conditions, the size of store and turnover. Bonuses for managers are based on profit/loss and turnover. For corporate staff, bonuses are based on overall company performance (though this may change shortly). There is also a legacy cash bonus plan which differs according to long-run company performance and a merit-based bonus system for individual performance for corporate staff.

A major outsourcing firm with multiple remuneration systems

The company employs a very diverse range of workers, from nuclear scientists to street cleaners.

To set pay, they examine a variety of economic indicators, pay trends and other benchmarking indicators for different parts of their business. There are also ad hoc special surveys and individual line managers are working to produce better frameworks and tools. If managers go over budget, this is dealt with on a case by case basis. However, a lot of pay/contracts are determined by public sector contracts which effectively 'benchmark' those in equivalent occupations.

The overall pay bill is set by an executive remuneration committee on a discretionary basis. Around one eighth of staff have a standard performance rating and structure, with a local manager being given a particular pay bill and discretion according to performance and market demand to increase salaries for particular employees. There is no distinguishing between junior and senior staff. A much larger chunk are discrete contracts which vary widely in pay arrangements. Generally, a pay bill budget will be set in the contract with a contract manager deciding on individual pay on the basis of alignment, affordability and any related previous payscales. TUPE transfer means the latter happens a lot – local authority contracts have the local pay freeze applying for example. There is also union negotiation in these circumstances. Regional pay is used, but only applies as it relates to public sector contracts. For other employees, the company is starting to develop a banding structure, grouping jobs into 14 or 15 'families' with a generic job title assigned to each.

Bonuses are awarded for top employees globally. There is also a recognition scheme through which managers can distribute cash and non-cash rewards and a performance share plan and 'share save' plan.

Mid-size financial services firm with loose pay structures, individual negotiation

The firm has no pay scales, regional weighting, formal progression or formal benchmarking process. People are paid an individual market rate through negotiation when they first join. Salaries are generally higher in regions like London but this is not uniform. There is no collective pay bargaining process. Uprating is conducted on an individual basis through annual review. The board will decide on a target percentage increase to the pay bill on a discretionary basis based on total earnings. This is then devolved for managers to decide how this is distributed among the employees. If they feel an individual needs a bigger increase than this, higher management consider an exception on a case-by-case basis.

The total bonus pot is set by the performance of the company with an individual receiving a share according to their personal performance (in recent years, this has been just 5–6%).

There is also a share buying scheme, but since the company is limited this is only theoretical at present. All employees are given a number of shares shortly after joining. Research into pay levels is purely informal: they have a small salary survey subscription and look at things like retention rates on an ad hoc basis, as well as conducting a leavers' interview system that covers things like pay.

Major national retailer with band-based paying and conditional bonus programmes

The retailer employs just under half the employees in its stores, the rest for companies on concession stands. The basic structure is five bands: inner London, outer London, other outer London (generally smaller stores), major towns and the rest of the UK. Management grades have only three bands: London, large stores and smaller stores. Store managers' pay is directly linked to turnover.

Progression up the bands is informally done on the basis of a Performance Development Review Process: assessing competencies, delivery of results, experience, level of responsibility etc. (though pay is now frozen they intend to make this a more formal process in the future). Rates are set through a mix of a benchmarking process and available budget (based on cashable profits).

Bonuses are only available if the firm makes a minimum profit. Then, there is personal performance (between 1 and 5% of salary) for stores for which store level targets have to be met. Head office has a separate bonus scheme based on minimum profits. There have been no bonuses for the last two years. Pay was frozen last year and is likely to be frozen for this fiscal year as well. Unions play no role in pay setting but provide an information service to employees. There is a commission scheme for personal shoppers who can significantly add to their earnings by meeting sales targets.

A global energy company with a job families based remuneration system

Pay setting is done on a country-by-country basis and works largely the same for high and low-ranking jobs (except for share option schemes). The basic model is the same salary ranges for similar types of job. If they are high demand jobs (technical for example), the range would be higher. This is surveyed primarily on the attrition rate within a particular 'job family' in a particular unit – there is no regional pay as such, except a flat allowance for London-based employees. Additionally, there is external salary benchmarking on a UK-wide basis, and metrics for labour market movements, but this is used sparingly as it is difficult to make direct comparisons. Progression up the salary range is based on a performance management system, primarily a rating through an individual performance factor system. This is based on a job family performance ranking of each employee relative to each other, done by a ranking panel of colleagues within that unit (other companies often use line managers).

Additionally, there are significant bonuses which have become an ever greater share of the remuneration package. Part of this is based on the individual performance factor as above, and part on the global financial performance of the company. Both of these can vary widely and may be zero. The whole remuneration package (including the size of bonuses) is weighted by an approximate pay bill envelope set at a national level.

Public sector organisations diverging significantly from national pay systems

County council that opted out of national pay scales twenty years ago

The council abandoned the national pay bargaining system and set up local pay determination around 1990. They set up a performance management structure, with speed of progression up payscales determined by personal performance ratings. Incremental pay progression was removed completely (this was the biggest legal hurdle) but it was restored in 2004/5. However, progression is no longer semi-automatic. Despite this, the number who get no raise at all (and go through capability proceedings) is very small. However, it is felt this has a big effect on incentives for the rest.

Negotiation of terms, conditions and pay takes place locally; pay has moved further away from the national scales over time. For example, they eliminated overlapping paypoints, which created the anomaly whereby someone on a higher payscale could be paid less than someone on a lower grade. If someone is already at the top of their grade, they will get the incremental increase (if they are performing), but this is unconsolidated into their total pay (i.e. a lump sum not in pension or ongoing base pay). Once appraisal and grading of staff has taken place, pay awards can be apportioned according to the budget which would previously have been available to pay for the incremental pay progression. This appraisal involves a discussion with the line manager of an employee's deliverables, competency framework and personal development, to give a Total Contribution Rating. There are also locally based bonuses which are cash awarded. They are not expected and discretionary for local managers if an employee has done an exceptional job. If there is a particular staff shortage (some areas of the authority have very different labour markets to others) they have a market premium policy to be used to get people they need for a particular job or area (via a lump sum or ongoing market premium payment).

Terms and conditions variation from the national green book is relatively minimal (pension arrangements are exactly the same for example). They take a Total Reward Approach but there is little flexibility for employees as to how they take remuneration. They also have benefit schemes for employees, providing discounts and cashback for certain services such as childcare. There is a benchmarking process allowing a macro comparison to various paypoints, comparison of specific jobs and what is an appropriate payment in the local labour market. They feel this enables them to examine the labour market for themselves: for some jobs, the competition is national, for others purely local.

Council developing its own alternative performance related pay system

This council opted out of local government service salary payscales as part of the single status agreement process in 1999, in order to address skills shortages by increasing salaries higher than national pay deals. This system had five incremental pay points for each job, with twelve pay ranges and six for the senior team. Pay was flexible at recruitment then increased incrementally up the pay range based on length of service (in theory this could be withheld on the basis of a performance review but it happened to very few in practice – as is the case nationally). In addition, there was a locally set pay settlement negotiated with trade unions. This involved the unions submitting a pay claim (often including, for example, the request that low-paid workers get a minimum flat increase) and the council coming up with a range of scenarios which it then negotiates on. While the payscales have been frozen for the last three years, these increases have meant around 60 percent of staff have received a six percent nominal rise.

This year a new system will be implemented, removing the incremental pay points entirely and replace them with three point pay points for each job – one on entry, the second on competence, the third on exceeding competence. It will involve putting a pay envelope on how much the council can spend on the pay bill. They will then collect performance data and work up costs for different scenarios of uprating (e.g. 2% increases for satisfactory performing staff, those in competence category etc.) Progression will be measured on the basis of an online performance management system. To progress to the next point on the scale, staff must be judged as competent. Performance appraisal comes in two parts – a mid-year rating – including spread and distributional analysis and an end of financial year review. There is then a moderation process: scoring between managers on their ratings to get consistency. There is then a final pay award announcement done by June at the latest.

The paybands will be uplifted on the basis of tracking the regional labour market. This comparison involves benchmarking payline and looking at turnover and retention, recruitment data, average pay increases and other data, but ultimately it is based on discretion rather than a hard formula. The council may need to terminate contracts and reengage people on the new ones. This does not involve redundancy payments but they are concerned about the reputational effect and there are unfair dismissal risks.

The council feel they do not compete for staff in a national labour market, except for senior staff; the rest is local. Terms and conditions are negotiated with the trade unions. They oppose the new pay arrangements, particularly the automatic annual uplift and have been instructed by their national organisations to resist any changes to terms and conditions. Balloting for strike action only takes place on national issues which affect the local workforce (for example, on pensions). Pensions are based on the local government salary scheme except in one respect – those who reach the top of their jobs' payband and are still rated exceptional will get a bonus on top of their usual pay, but this pay is not consolidated into the pension scheme.

A regional ambulance service in the North of England looking at its unused powers

The ambulance service has pay set by Agenda for Change (NHS) figures for 99% of staff. Most progression is done automatically – one point on the pay scale each year. For some roles, to move to the penultimate point of a band (roles tend to have one band allocated to them, defined by nationally benchmarked standards), there is a reliance on a 'gateway mechanism' theoretically, assessing knowledge and skills through a framework, but in practice this is not applied – except in exceptional circumstances (for example, being on the penultimate point of a payband). There is also a performance development review which defines personal objectives over the financial year, but this is not reflected in salaries.

Bonus payments are technically possible but rarely used. Formal bonuses can be set above the pay bands (i.e. for senior management) by non-executive directors on the basis of a trust's delivery on meeting budget, quality indicators etc. Foundation Trusts can theoretically disaggregate from these pay arrangements but none do (Southend tried it but gave up due to trade union pressure). However, under cost pressure, some trusts are now looking at making economies in terms and conditions because they have this greater control. The service generally does not struggle to recruit, except for top clinical roles and senior management.

Appendix 3: Sweden – a Profile

Sweden is a very export-orientated economy (consisting of over half its GDP). It also has very high levels of unionisation (unusually including a high number of white-collar workers); some 70 per cent of employed people are trade members – higher in public sector, lower in the service sector (down from 80 per cent a decade ago), while most employers (some 80 per cent) are members of employers organisations.

There are very high degrees of social protection – individuals can take any disputes to a Labour Court or through the civil court system if they are not covered by a collective bargaining agreement. Almost all employers participate in these, with trade unions organising boycotts of companies which try to opt out.

Swedish labour laws are also highly restrictive, even giving the employer some responsibility for finding suitable replacement employment for any worker they wish to dismiss.[192] There is a statutory maximum working week of 40 hours with a cap of 200 hours annual overtime (with not more than 50 hours in any one month – though collective bargaining agreements can override this). Perhaps surprisingly given its strong social welfare model, there is no national minimum wage: these are defined by sector through negotiation between employers' organisations and unions without government involvement and is generally subject to factors such as working experience and age. There is also an unemployment insurance fund run via state and individual contribution with a theoretical maximum income replacement level of 80 per cent. However, with a fairly low cap (some 16,000 kroner or about £1,550 a month), the average replacement level is much lower and has declined over time. Such support is limited to 300 days, beyond which a subsistence payment is available (and also to those who have failed to build up adequate insurance contributions).

28.3 percent of the workforce is employed in general government, much higher than the UK's 14.6 percent.[193] However, this is combined with much lower levels of central government public employment – 14.7 per cent of the total against the UK's 50.7 per cent. 68 per cent of workers are union members against just 28 per cent for the UK; 91 per cent of employees are covered by collective bargaining agreements against the UK's 34.6 per cent.[194] Despite this, Sweden has an extremely low number of days lost to strike action – just 1.88 per 1,000 employees per year between 2004 and 2007, for example; the UK figure is 26.5 – a 14-fold difference.

Its population is highly concentrated in three geographical areas: Stockholm, Gothenburg, and Malmo. The northern half contains less than one million people. Swedish government is heavily localised, with regional authorities both supplying the great majority of public services and having independent rights to levy taxes (only high income people pay income taxes to the central government). Richer local authorities have a portion of their income redistributed to poorer ones by the central

192 Lag Om Anställningsskydd, 'The Employment Protection Act', LAS, 1982, p. 80

193 OECD, http://www.oecd.org/document/33/0,3343,en_2649_33735_43714657_1_1_1_1,00.html

194 http://www.eurofound.europa.eu/eiro/country/sweden_1.htm

government by a so-called 'Robin Hood' tax (though some have criticised this as having the unintended effect of disincentivising municipalities to create jobs).

History

Unlike the UK, public and private sector bargaining arrangements have generally moved in tandem in Sweden. In the 1970s, the Swedish system was characterised by heavily centralised bargaining, with central government imposition of wage increases across a zonal system. However, the system led to large wage increases which had contributed to vicious inflationary wage competition. A particularly interesting factor for the UK government's current deliberations is that wages were, in part, driven up by zonal pay systems, in which the number of higher paid zones proliferated as regions competed against each other, resulting in a wage spiral. Overall, people we spoke to agree that the system was a failure:

> *'There is a general consensus that, from the early 1970s, the system failed to deliver wage moderation, and low rates of unemployment and inflation.'*[195]

Attempts to dismantle the system began in 1983 and accelerated rapidly as a response to an economic crisis which saw Sweden's economy contract for three years running (1991–3), falling in real terms by 4.3%.[196] The reforms implemented throughout the 1980s and 1990s have led to the system described above, where pay negotiation is a mixture of local and collective bargaining and where employers, unions, employees and government work in a collaborative fashion.

195 Sveriges Riksbank Economic Review 2004:1 , p. 62

196 IMF, http://www.imf.org/external/datamapper/index.php