

# **Regionalisation of Public Sector Pay**

Report to Devon County Council

22<sup>nd</sup> November 2012

**SQW**

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# 1: Introduction

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## Context

- 1.1 In the 2011 Autumn Statement, the Chancellor of the Exchequer stated that public sector pay should be made more responsive to local labour markets. His basic rationale was that

*differences between public and private sector pay can adversely affect private sector businesses which have to compete with higher public sector wages. It also leads to unfair variations in public sector service quality and limits the number of jobs that the public sector can support<sup>1</sup>*

- 1.2 In this context, in December 2011, the Chancellor of the Exchequer wrote to the Pay Review Bodies; he asked them to consider the issues and to report by July 2012. On behalf of four Pay Review Bodies, the Office of Manpower Economics (OME)<sup>2</sup> issued a call for evidence on how to make pay more market-facing in local areas for: NHS workers covered by the Agenda for Change pay system, school teachers, operational staff in public sector prisons, very senior managers in Special Health Authorities and NHS Executive Non-Departmental Public Bodies, and senior civil servants<sup>3</sup>. In August 2012, the head of civil service, Sir Bob Kerslake, invited all government departments to prepare individual proposals for local market-facing pay<sup>4</sup>.

## Purpose and scope of this study

- 1.3 Within the context set out above, Devon County Council (DCC) commissioned SQW and Cambridge Econometrics to undertake a short piece of research to investigate the surrounding issues. Specifically, our brief was to understand better the various proposals for establishing regional pay and the potential impacts that might follow in relation to Devon's economy. **The timescale available for this review was tight – roughly two weeks – and our findings must be seen in this context; they are initial insights drawn from a quick review of a complex and incomplete evidence base.**

- 1.4 Nevertheless, we have sought to:

- complete a light touch literature review of government statements and “think tank” research on regional pay to summarise key issues and perspectives
- generate estimates of the first round impacts on Devon's economy of a nominal loss of income among public sector employees, in terms of associated employment and GVA impacts (at a headline level only, excluding dynamic effects)

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<sup>1</sup> HM Treasury, 2011, *Autumn Statement 2011*, p: 37

<sup>2</sup> Office of Manpower Economics provides secretarial and research support for each of the six Pay Review Bodies and the Police Negotiating and Police Advisory (England & Wales) Boards, the Government asked four of the independent pay review bodies to consider how to make the pay of some their remit groups more market-facing in local areas: NHS Pay Review Body, Prison Service Pay Review Body, School Teachers' Review Body, Senior Salaries Review Body

<sup>3</sup> Office of Manpower Economics, 2011, *Call for evidence on how to make pay more market-facing in local areas for certain groups of public sector workers*

<sup>4</sup> [http://www.publicservice.co.uk/news\\_story.asp?id=20513](http://www.publicservice.co.uk/news_story.asp?id=20513), accessed 4/10/12

- use the analysis above to estimate the first round employment impact of regionalising pay for staff at DCC, based on workforce numbers and incomes data provided by DCC's Human Resources Department
- complete targeted consultations with business representative organisations to understand their views on the consequences – good and bad – of localised pay settlements for public sector workers in Devon.

## Structure of the report

1.5 This report is structured as follows:

- Section 2 summarises key areas of debate within the national literature
- Section 3 presents our assessment of first round impacts on Devon's economy of regionalising public sector pay
- Section 4 provides a headline analysis of data on DCC's workforce numbers and incomes, and estimates the impact of regionalising pay for staff at DCC
- Section 5 summarises the key findings from our consultations with business representative organisations
- Section 6 summarises our conclusions.

1.6 Our detailed literature review is presented in Annex A.

## 2: National evidence and debate

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- 2.1 As a follow-up to the Chancellor of the Exchequer's *Letter to the Pay Review Bodies*, a document – entitled *Government Evidence to the Pay Review Bodies: Economics of Local Pay* – was posted on the Office of Manpower Economics' website<sup>5</sup>. Its purpose is to “*set out the evidence on the scale of the pay premium in the public sector and how it varies within and between regions*”. Further, it seeks to explain these differences and consider the impacts. The Autumn Statement and the *Letter to the Pay Review Bodies* also prompted a flurry of responses from various “think tanks” and lobbying organisations.
- 2.2 The evidence from government and the various reports and analyses that followed are reviewed in detail in Annex A. Here, we summarise the main findings from this review. Three key issues are especially important and these are considered, very briefly, in the paragraphs below.

### **1: Whether there actually is a real difference between public and private pay, and the extent of this difference**

- 2.3 Government's premise is that there is a pay differential for employees working in the public sector. In its evidence paper, it quotes data from the Institute for Fiscal Studies and the Office for National Statistics which point to average public sector pay premia nationally of 8.3% and 7.8% respectively. For the South West region, the corresponding figures are even higher: 10.4% (IFS) and 9.5% (ONS).
- 2.4 Among the commentators, CBI<sup>6</sup> and Policy Exchange<sup>7</sup> quote broadly similar differentials. However NEF<sup>8</sup> argues that public and private sector wage levels are simply incomparable because occupational structures in the private and public sector are radically different and a number of other factors impact on relative pay (e.g. organisation size, job tenure, managerial responsibility). After factoring in these additional considerations, it concludes that pay differences between the public and private sector are reduced significantly.

### **2: Consequences of differences in pay**

- 2.5 In its evidence paper, government asserts that

*[p]rivate sector firms have to compete with public sector employers more in some areas. Reducing the public sector pay premium would help private businesses, particularly in some sectors, to become more competitive and expand<sup>9</sup>*

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<sup>5</sup> <http://www.ome.uk.com/Article/Detail.aspx?ArticleUid=a782b32d-b08b-423b-8061-361211188711>

<sup>6</sup> CBI, March 2012, *CBI response to Office of Manpower Economics call for evidence on market-facing pay in local areas*, p 1 (from ONS ASHE, 2011: median gross hourly pay, work based travel to work area)

<sup>7</sup> Policy Exchange, 2012, *Local Pay, Local Growth*, p 34

<sup>8</sup> New Economics Foundation, July 2012, *The economic impact of local and regional pay in the public sector. A report by NEF for the Trades Union Congress (TUC)*, p: 6

<sup>9</sup> Chancellor of the Exchequer, no date, *Government Evidence to the Pay Review Bodies: Economics of Local Pay*

2.6 In economic terms, this boils down to a “crowding out” argument. However there are other interpretations of what the economic consequences of regionalised pay might be, and NEF identifies two further possibilities:

- *crowding-in* – based on demand-driven economics – assumes that payment of wages to public sector employees creates demand for goods and services, which leads to turnover for private businesses, generating positive multiplier effects
- the *surplus recycling* mechanism implies that there are benefits from the redistribution of resources from richer to poorer areas which helps to sustain less well-off regions and, more importantly, ensures that demand from less well-off regions produces opportunities and enhances the overall potential and productivity of the macro economy.

2.7 In practice, deciding which of these arguments is “correct” is enormously complex – and in practice there may not be one “correct” answer: the picture is likely to vary over time and geography.

### **3: Recommendations for establishing regional pay**

2.8 Currently, there is no clarity over the mechanism or timing of any move to regionalised pay: some reference is made to “zonal pay” but it is unclear what this might mean. In practice, the detailed mechanics and timing of any transition would be materially important in determining the impacts that could follow.

### **Conclusion**

2.9 Both the evidence presented within the different assessments and the arguments constructed on the basis of that evidence are seriously complicated. However, on a quick review, there appears to be little consensus (and, at times, significant differences of view) regarding:

- the starting point – i.e. the scale of any public sector pay premium
- the process through which any pay premium influences economic performance locally
- the mechanism – or timing – of any transition to regional pay arrangements.

## 3: Analysis of potential economic impacts on Devon

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3.1 In this Section, we estimate the direct impact on Devon's economy of a nominal loss of income to public sector employees which could arise from the regionalisation of public sector pay, and we estimate the first round impacts in terms of employment and Gross Value Added (GVA)<sup>10</sup>, based on modelling undertaken by Cambridge Econometrics (CE). This modelling is limited in scope and the assumptions and caveats that accompany the findings are very important.

### Overview of approach

3.2 Our literature review (see Section 2 and Annex A) suggested that government's estimate of the public sector pay premium varies across regions. For the South West, this premium is placed at between 9.5% (average Q2 2009 to Q1 2011) and 10.4% (between 2009 and 2011), after controlling for a range of worker characteristics such as age, qualifications and education<sup>11</sup>.

3.3 In our analysis we therefore test **the impact of a 10% reduction in public sector pay in Devon in 2012**, and we consider the **impact that this would have on certain other parts of the economy** (namely retailing, hotels & catering, and other (mainly leisure) services) **due to a reduction in spending**. Impacts are projected forward to 2020, and sensitivity testing is undertaken to reflect uncertainty in the level of the public sector premium (at 10%  $\pm$  2.5%)<sup>12</sup>.

3.4 In order to estimate the impact of regional pay arrangements in Devon, we therefore:

- estimate the earnings of public sector workers in Devon: this is based on ASHE data for the South West, adjusted to reflect the ratio between average earnings in Devon and the South West as a whole
- estimate the number of public sector workers in Devon, focusing on the public administration, education and health sectors<sup>13</sup>
- determine the scale of reduction in average public sector earnings, and calculate loss of incomes for public sector workers
- determine the associated loss of consumer spending (reflecting reduced disposable incomes, after Tax and NI) and profile the lost spending across commodities<sup>14</sup>

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<sup>10</sup> GVA is the value generated by any unit engaged in the production of goods and services. It is measured at current basic prices, excluding taxes (less subsidies) on products. GVA plus taxes (less subsidies) on products is equivalent to Gross Domestic Product (GDP). ONS, 22 May 2012, *Regional Gross Value Added* p: 1

<sup>11</sup> Chancellor of the Exchequer, no date, *Government Evidence to the Pay Review Bodies: Economics of Local Pay*

<sup>12</sup> As noted in the introduction, there is considerable uncertainty and variation in the difference between public and private sector pay – and the extent of this difference - the literature produced to date the issue.

<sup>13</sup> It is assumed that 100% of workers in public administration are public sector, and 80% from education and 80% from the health sectors are public sector.

- calculate the loss in demand for key sectors (retailing, distribution, hotels and catering, and other services)
- estimate the loss of employment and GVA in these consumer-related services resulting from the loss in demand in Devon.

## Assumptions and caveats

3.5 **This modelling approach is very limited. It explores *first round* impacts on selected sectors of regionalising public sector pay in Devon only.** It does not take into account wider potential impacts on the private sector of regionalising public sector pay. In part, this is because – as outlined in Section 2 and explored in detail in Annex A – there is no consensus on the nature of those impacts.

3.6 Moreover, in our modelling, **two sets of simplifying assumptions** have also had to be made:

- one important assumption is that public sector employment levels do not change as a result of regionalising pay but continue to follow employment projections through to 2020 as set out in CE’s “business as usual” projections from its Local Economy Forecasting Model
- a second is that the impacts of regionalising public sector pay would be instant; in reality any scheme would take a number of years to implement<sup>15</sup>.

## Modelled impacts on employment and GVA in Devon

3.7 Based on the approach, assumptions and caveats described above, we estimate that **a 10% reduction in public sector pay would lead to a ‘loss’ of income to Devon residents working in the public sector of £129m in 2012** (and a loss of £88m in disposable income).

3.8 **The *first round* impacts of this 10% reduction in public sector incomes are estimated to be a loss of just over 700 jobs and £15.5m in GVA in 2012.** This represents 0.2% of jobs, and 0.1% of GVA across Devon as a whole, as shown in Table 3-1. The largest number of jobs lost are in hotels & catering (spending on restaurants and hotels is one of the categories of spending most affected by the lost income).

Table 3-1: Impacts on associated jobs and GVA of a 10% reduction in public sector pay in Devon (2012)

	Loss of jobs	Loss of GVA (£m, rounded to the nearest million, cvm 2005)
Retailing	241	5
Distribution	57	2
Hotels & catering	310	6
Other services	97	3

<sup>14</sup> The pattern of spend across commodities is based on South West data from the Family Spending publication. We have assumed the loss in spending is more likely to impact on discretionary spending categories.

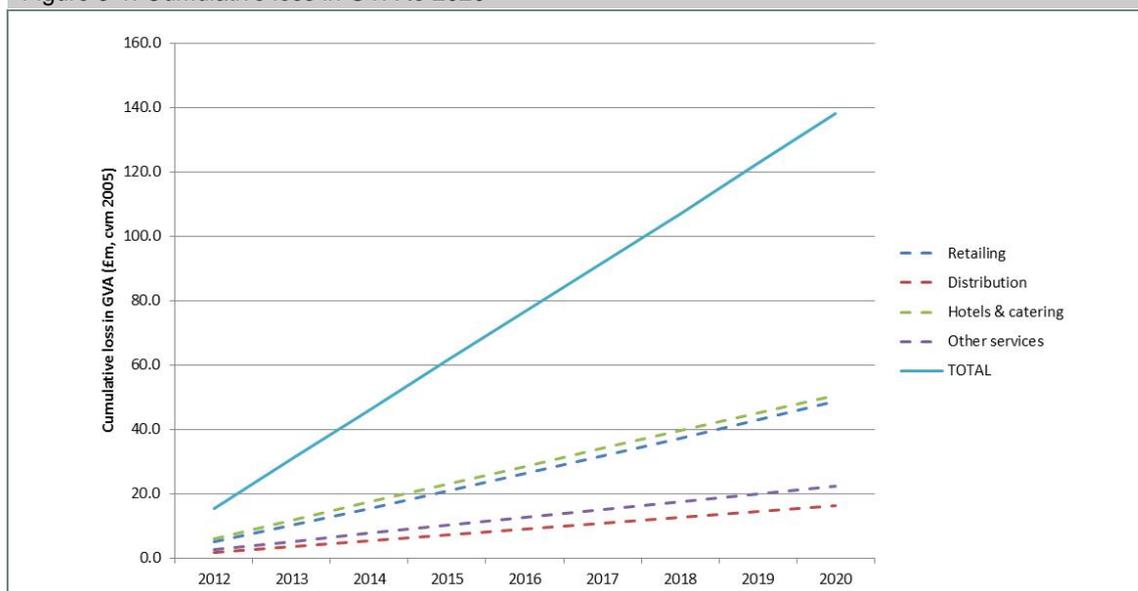
<sup>15</sup> Policy Exchange, 2012, *Local Pay, Local Growth*

	Loss of jobs	Loss of GVA (£m, rounded to the nearest million, cvm 2005)
<b>TOTAL loss</b>	<b>705</b>	<b>15</b>
<b>TOTAL loss (% of all jobs/GVA)</b>	<b>0.2%</b>	<b>0.1%</b>

Source: SQW analysis of CE data

- 3.9 The analysis above translates into a multiplier of around **five jobs lost for every £1m reduction in the (gross) income of public sector workers in Devon**. However, it is important to caveat this figure and interpret it carefully: it is calculated on the basis that all lost disposable income for public sector workers would have been spent (which perhaps would not be the case if “larger” losses of income to the economy were under consideration).
- 3.10 Figure 3-1 shows the cumulative loss in GVA, from 2012 to 2020 inclusive, as a result of a 10% reduction in public sector pay in Devon. **By 2020, it is estimated that the cumulative first round impacts of regional pay arrangements (of a 10% cut in pay within the public sector) could amount to a loss of approximately £138m in GVA in Devon**. As above, the cumulative impact on the retailing and hotels/catering sectors is expected to be particularly high, with an estimated loss of £49m in the retail sector and £51m in hotels and catering (due to the highest annual impacts, described above).

Figure 3-1: Cumulative loss in GVA to 2020



Source: SQW analysis of CE data. Notes: GVA in constant prices (cvm 2005)

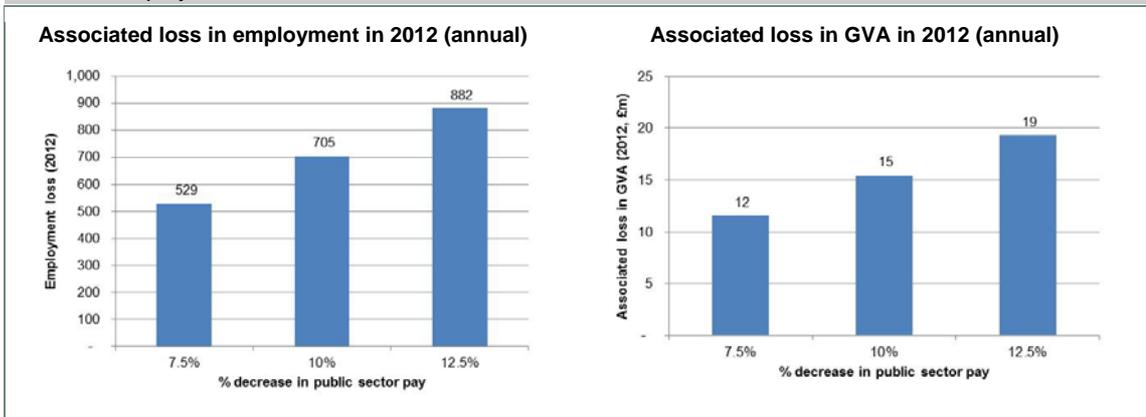
## Sensitivity testing

- 3.11 Given the uncertainty in the level of public sector premium, and therefore the implications of local pay arrangements for Devon in terms of the scale of pay reductions for the public sector, we have tested the first round impacts of a 7.5% and 12.5% cut in public sector pay on Devon’s employment and GVA. The results of this analysis are illustrated in Figure 3-2 below, and suggest that:

- impacts in 2012 could range from a loss of around 530 jobs up to 880 jobs, with associated GVA losses of between £12m and £19m (annual impact)

- cumulative loss of GVA between 2012 and 2020 is estimated at £104m-£173m.

Figure 3-2: Sensitivity testing: implications of adjusting the percentage decrease in public sector pay for Devon's employment and GVA



Source: SQW analysis of CE data

## 4: Analysis of potential economic impacts linked to the pay of Devon County Council's staff

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4.1 In this Section, we present a headline analysis of HR data provided by Devon County Council (DCC) and compare this with data collected through the Annual Survey of Hours and Earnings (ASHE) 2011<sup>16</sup>. While we have tried to generate comparable metrics from these two sources, there are differences between the data. The definitions of key terms (to which we subsequently refer) are set out below:

- **DCC annualised salary:** Salary figures for DCC employees which have been annualised so that full time equivalent salary figures can be used for part time employees. Allowances and any earnings apart from salary have been excluded.
- **DCC actual earnings:** Salary figures for DCC employees which have not been annualised. Allowances and any earnings apart from salary have been excluded.
- **ASHE gross pay:** Gross pay (including basic pay and any additional payments e.g. profit sharing, productivity performance, bonus or incentive pay, overtime and shift premium pay) before tax, National Insurance or other deductions, excludes payments in kind. These figures have not been annualised.

4.2 DCC provided annualised salary data for its staff. These data are summarised in the table below, i.e. the adjusted full-time equivalent salary. Adjusting earnings of all DCC staff (full-time and part-time) to full-time equivalent salary, the median full-time equivalent salary of all staff at DCC is **£16,830**. Adjusting the part-time earnings of DCC staff to full-time equivalent salary, the median full-time equivalent salary of part-time staff at DCC is also **£16,830**<sup>17</sup>.

Table 4-1: DCC annualised salary data

DCC indicator	
Annualised salary, all staff, median	£16,830
Annualised salary, all full-time staff, median	£27,849
Annualised salary, all part-time staff, median	£16,830
Annualised salary, all male staff, median	£20,858
Annualised salary, all female staff, median	£16,830

Sources: SQW analysis of DCC September 2012 snapshot; ASHE 2011

4.3 Statistics for all workers across Devon that are comparable to the annualised salary data provided by DCC are not available. Annual information presented in ASHE relate to gross pay before tax, National Insurance or other deductions, and excludes payments in kind.

<sup>16</sup> ASHE is a sample survey, so standard errors apply to all figures. Latest data available from ASHE are for 2011.

<sup>17</sup> The median full-time equivalent salary of male staff at DCC is £20,858. The median full-time equivalent salary of female staff at DCC is £16,830.

4.4 To enable comparison between ASHE and DCC data, the human resources team at DCC calculated approximate actual earnings for DCC employees for one year to September 2012.<sup>18</sup> However, the approximate actual earnings for DCC employees calculated by DCC exclude allowances, and are an estimate of actual earnings rather than the sum of all earnings over a year.

4.5 Nevertheless, there are some important implications arising from the comparison of ASHE gross pay and DCC actual earnings data which are explored in the paragraphs below. The table below summarises some of the key metrics from both sources.

Table 4-2: Summary of key indicators: for DCC and ASHE

DCC indicator	DCC data	ASHE indicator	ASHE data for Devon (residence-based)	Comparative Index for DCC (ASHE=1.0)
Actual earnings, all staff, median	£9,230	Annual pay – gross of all employees, median	£18,572	0.50
Employees working part time (%)	about 80%	Jobs that are part-time (%)	about 33%	n/a
Actual earnings, all full-time staff, median	£27,849	Annual pay – gross of full-time employees, median	£22,570	1.23
Actual earnings, all part-time staff, median	£7,250	Annual pay – gross of part-time employees, median	£8,638	0.84
Actual earnings, all male staff, median	£19,223	Annual pay – gross of male employees, median	£22,814	0.84
Actual earnings, all female staff, median	£8,291	Annual pay – gross of female employees, median	£13,326	0.62

Sources: SQW analysis of DCC September 2012 snapshot; ASHE 2011

## Analysis of employment and actual earnings at Devon County Council

4.6 The snapshot of September 2012 actual earnings provided by DCC generates the following headline metrics:

- the **mean actual earnings** for DCC workers is £11,731
- the **median actual earnings** for DCC staff is £9,230

[The median is lower than the mean due to a long “tail” of lower paid staff].

4.7 ASHE data show that in 2011, the median gross annual pay of all employees (full time and part time) in Devon was £18,572<sup>19</sup>, so **median actual earnings at DCC are around 50% of the (resident-based) county-wide average**<sup>20</sup>. DCC actual earnings are also low compared to the annual median gross annual pay across all employees resident in the South West.

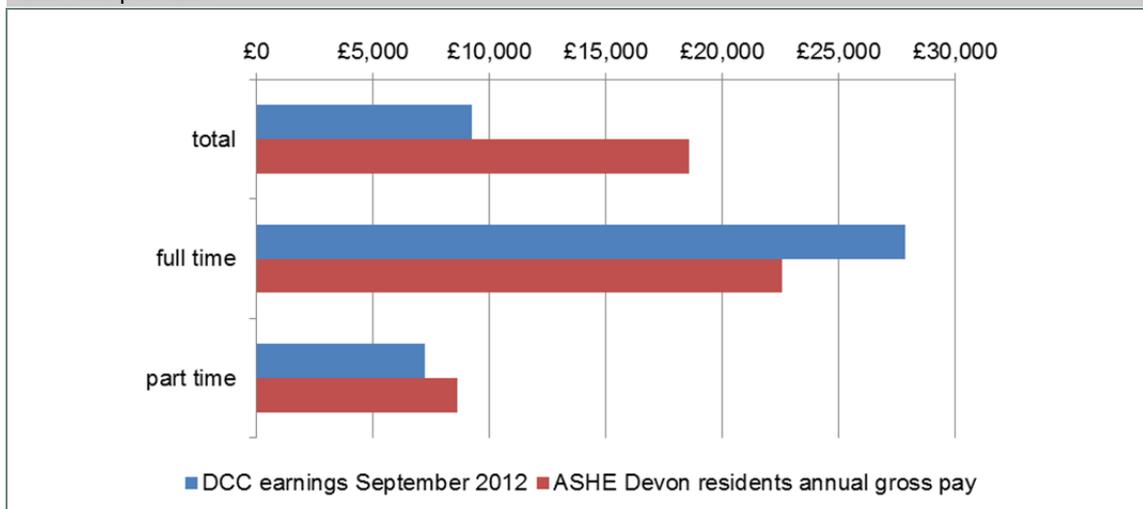
<sup>18</sup> Example illustrating the difference between DCC Actual Earnings and DCC Annualised Salary: A part time employee working 18.5 hours out of a 37 hour a week on an annual salary of £30,000 would be shown as £30,000 under DCC Annualised Salary and £15,000 under DCC Actual Earnings.

<sup>19</sup> ASHE 2011

<sup>20</sup> Please note, data on public / private earnings at County level are not available from ASHE.

- 4.8 Within DCC, a **high proportion of staff are employed part-time** (nearly 82% of DCC staff work part-time, compared to around one-third of all employees living in Devon); **this compositional factor explains why the average actual earnings across all DCC staff appear to be so low**. At around 80%, the proportion of DCC staff who work part time is also higher than the South West average for local government workers; the Local Government Earnings Survey 2011/12 showed that 61% of directly employed local government workers in the South West work part-time<sup>21</sup>.
- 4.9 In terms of a like-for-like comparison, it is instructive to note that actual earnings for DCC staff who work part time are lower than the (resident-based) average for all part time employees in Devon. Our data analysis shows that the median DCC actual earnings of part-time staff is around 84% of the median pay of part-time employed Devon residents<sup>22</sup> (see Figure 4-1). Conversely, full-time workers at DCC earn more than the Devon resident average (DCC actual earnings are 23% higher)<sup>23</sup>.

Figure 4-1: Comparison of DCC actual median earnings and Devon resident employee median pay, full-time and part-time



Source: DCC September 2012 snapshot, ASHE 2011

- 4.10 An analysis of actual earnings by gender shows that:
- male workers at DCC have median actual earnings of £19,223, which is 16% below the median gross annual pay of Devon’s resident male employees
  - female DCC workers have median actual earnings that are around 62% of the average pay for female employees resident in Devon; this reflects the higher proportion of female part-time workers at DCC (86% work part-time, compared to 56% for all female employees who live in Devon)<sup>24</sup>.

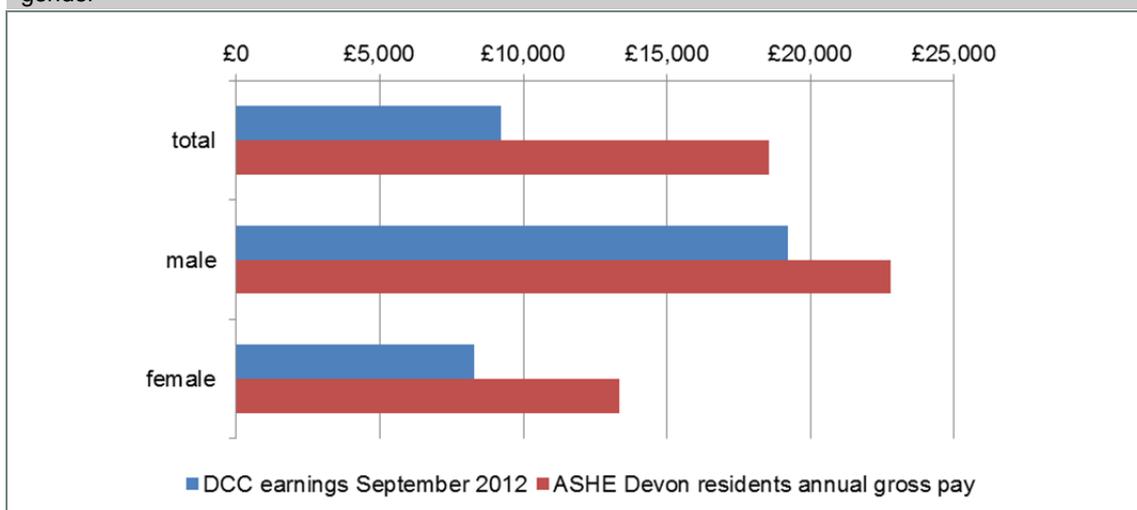
<sup>21</sup> Local Government Association, Local Government Earnings Survey 2011/12

<sup>22</sup> Approximate actual earnings for part-time DCC staff: £7,250; Devon resident annual gross pay of part-time workers: £8,638

<sup>23</sup> DCC staff median actual earnings of full-time staff was £27,849; cf £22,570 pay for full time Devon resident average

<sup>24</sup> No approximate actual earnings data are available for female part-time DCC staff. From ASHE 2011 (on a residence basis), we know that annual gross pay for part time female employees in Devon is £8,357

Figure 4-2: Comparison of DCC median actual earnings and Devon resident median employee pay by gender



Source: DCC September 2012 snapshot, ASHE 2011

## Potential impact of regionalising public sector pay at Devon County Council

- 4.11 Based on the data provided by DCC, the mean actual earnings of DCC workers are £11,731 (September 2012) and the Council employs a total of 15,194 workers. This suggests total gross annual pay of around £178m.
- 4.12 If we assume regional pay arrangements in Devon result in a 10% reduction in DCC salaries, and apply the multiplier of five jobs lost for every £1m reduction in the (gross) income of public sector (as set out in Section 3), the analysis suggests that **around 90 jobs would be lost in Devon as a result of regionalising pay at DCC in 2012.**
- 4.13 Again, it is important to caveat these figures heavily: they assume all lost disposable income for public sector workers would have been spent; they focus on the associated job losses in key sectors only (retailing, distribution, hotels and catering, travel agencies and other services); and they do not account for potential creation of jobs in the private sector as a result of regionalising public sector pay.

## 5: Consultee views

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5.1 Alongside the desk-based research and modelling, we have consulted with two business representative organisations and one senior public sector representative to gather views on the impacts of regionalising pay. Specifically, we discussed with them:

- whether, pre-recession, their members in Devon reported any difficulties attracting or retaining skilled staff because they could not compete with public sector wage levels and/or whether they were having to pay a premium to attract staff (because of competition from the public sector)
- in terms of their members, what would be the potential consequences – good and bad – of localised pay settlements for public sector workers in Devon
- from the public sector perspective, whether competition around pay has been observed and any consequences that have followed.

5.2 The key findings from the three short consultations are summarised below. Note that given the timescale for this research, consultees from business representative organisations had not been able to canvass their membership widely on the specific issue of regionalising public sector pay, so **the views below are based on day-to-day engagement with their member businesses, not on robust survey evidence.**

### Key messages

5.3 Overall, feedback from consultees suggested that regionalising public sector pay could have a (net) negative impact on Devon's economy. Various arguments and observations led to this conclusion:

- Both business representative consultees believe their members have **not experienced major difficulties** attracting or retaining skilled staff because of competition with public sector wage levels in Devon; neither were they were paying a premium to attract staff to the private sector. This was not an issue for businesses before the recession, and the situation has not changed in this respect since. From the public sector perspective, our consultee was not aware of complaints from the private sector about market distortion created by public sector pay levels in Devon.
  - Any competition between the public and private sector was likely to be very dependent upon the type of sector/occupation in question. For some sectors where skills are directly transferable (e.g. IT), consultees thought there might be some (limited) competition. But for many other sectors in Devon, skills/occupations were not perceived to be particularly transferable, so in practice workers could not shift from the private to public sector as easily as the literature might suggest.

- One example given was for Devon’s renewable energy sector, where a consultee felt that highly skilled workers are being attracted to the County to work in the industry, and competition with other businesses to recruit the best employees is driving wages up – this wage rise is not being driven by competition with the public sector.
- One business representative consultee was concerned about the consequences of regional pay deals in terms of the decline in disposable incomes and associated spend in the local economy by public sector workers. This would have **negative impacts on SMEs serving local demand** in particular. Given that Devon is a low pay economy already, one consultee argued that reducing public sector earnings (which make up a large share of the workforce) would have a significant impact on average wage levels. Furthermore, parts of North Devon that are heavily dependent upon the public sector for employment are amongst the most deprived parts of the county, so reducing public sector workers’ spend in these areas would have a far greater negative impact.
- There was some concern amongst all consultees around how regionalised pay would be calculated, and the spatial scale at which this would be done.
  - If implemented at a relatively small spatial level, this could lead to **public-to-public sector competition**, with local markets competing for workers through pay. This has already been observed in the childcare/social work labour market in the South West (and South East). Also, where house prices are high and for those living on the borders of Devon, there may be an incentive to **increase commuting levels** (with workers living in lower cost areas and commuting to areas with higher public sector pay deals). This would have negative knock-on implications for sustainability/carbon footprints.
  - The *process* of pay negotiations at a local/employer-to-employer level would also become much more expensive, creating a **significant cost to the public sector** that must be factored into any calculations. One consultee was also concerned about the likely increase in legal challenges/unrest associated with reducing pay, particularly where workers are being paid different salaries for the same job in close proximity (e.g. close to county borders).
- There is a risk that a reduction in public sector pay would result in the **loss of highly skilled public sector workers** from the county, with negative consequences for the standard of public sector services and the ability of Devon to recruit/retain the best people in public sector positions of responsibility to drive forward economic growth in the County.
- There is a concern that regionalisation of public sector pay would impact upon female workers (especially lower paid female workers) the most, which would create **significant social equality issues**.

- Both business representative **consultees could not foresee positive knock-on benefits for the private sector** as a result of regional pay deals: in their view, public sector pay has not held back private sector growth, and a reduction in public sector pay would be unlikely to result in private sector growth or improved competitiveness.

## 6: Conclusions

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6.1 This report has been prepared in a very short space of time and it has depended on a quick review of a complex literature; some economic modelling which has had to make major simplifying assumptions and in any case could only consider first round effects; and a handful of consultations with business representative organisations. Our conclusions must be seen in this context.

6.2 Overall, we have observed that:

- among national commentators there is no consensus with regard to the starting point (i.e. the extent of any public sector pay premium) or the mechanisms through which any premium might impact on economic performance
- currently there is no clarity as to the process or timing of any proposals to regionalise pay and in practice, these detailed provisions would have a material impact on the overall impact
- our modelling – which has been limited in scope and has relied on very significant simplifying assumptions – suggests that the reduced purchasing power resulting from a cut in public sector pay would have a small immediate impact on Devon’s economy (i.e. the loss of perhaps 700 jobs); but in practice, various second order mechanisms could come into play either to offset or exacerbate these effects (and it is with regard to these mechanisms that the literature is so inconclusive)
- currently Devon County Council’s full time staff are paid more than full time employees elsewhere in the county (on a residence measure); however the very high incidence of part time staff within the County Council’s workforce means that in aggregate, the average pay of its staff is lower than the all-county average
- applying the findings from our model to Devon County Council’s workforce suggests that a 10% reduction in pay could result in the loss of around 90 jobs county-wide – although again, we would stress that these are first round effects only and no account has been taken of the second order mechanisms that would in practice come into play
- from our consultations, the view – which is based on observations rather than robust survey (or other) work – is that overall, reducing public sector pay would be detrimental because of its effects in relation to local demand; from our consultations, there is little sense of private sector firms in Devon paying a premium because of inflated public sector salaries and hence (implicitly) the economic model that appears to prevail locally is one of “crowding in”.

## Annex A: Literature review

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### Review of government evidence and of the surrounding literature

- A.1 Alongside the Chancellor of the Exchequer's *Letter to the Pay Review Bodies*, a document – entitled *Government Evidence to the Pay Review Bodies: Economics of Local Pay* – was posted on the Office of Manpower Economics' website<sup>25</sup>. It “sets of the evidence on the scale of the pay premium in the public sector and how it varies within and between regions”. Further, it seeks to explain these differences and consider the impacts.
- A.2 The Autumn Statement and the *Letter to the Pay Review Bodies* prompted a flurry of responses from various “think tanks” and lobbying organisations. These include:
- Policy Exchange, 2012, *Local Pay, Local Growth*
  - New Economics Foundation, July 2012, *The economic impact of local and regional pay in the public sector. A report by NEF for the Trades Union Congress (TUC)*
  - CBI, March 2012, *CBI response to Office of Manpower Economics call for evidence on market-facing pay in local areas*
  - IoD, March 2012, *IoD response to call for evidence on market-facing pay in local areas*
- A.3 In this short literature review, we use these different sources to reflect on three main issues:
- the evidence that exists surrounding differentials in public and private sector pay
  - the economic consequences of pay differentials
  - recommendations for establishing regional pay.

#### **1: The evidence in terms of differences between public and private sector pay**

##### *Government evidence*

- A.4 The evidence on the scale of the pay premium in the public sector presented by the government is based on two sources: estimates prepared by the Institute for Fiscal Studies and by the Office for National Statistics (ONS). In April 2010, ONS estimates suggest a 7.8% pay premium for employees working in the public sector compared to the private sector in the UK. Conversely, between 2009 and 2011, IFS points to an average 8.3% pay premium. The ONS and IFS estimates account for a range of worker characteristics such as age, qualifications and education.
- A.5 The level of this premium varies across the regions. IFS estimates that between 2009 and 2011 public sector workers in the South West earned on average 10.4% more compared to the private sector. Using data from the Labour Force Survey and a similar methodology to that

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<sup>25</sup> <http://www.ome.uk.com/Article/Detail.aspx?ArticleUid=a782b32d-b08b-423b-8061-361211188711>

used by IFS, the government estimates a 9.5% public sector pay premium for the South West (average Q2 2009 to Q1 2011)<sup>26</sup>. The government argues that “[p]ublic sector pay does not adjust to local conditions as well as the private sector. This can explain the existence of higher public sector pay premia in places where labour market conditions are less favourable to workers and price levels are lower”<sup>27</sup>.

### Responses

- A.6 **CBI** refers to research it carried out together with Hays in 2011 which found that substantial changes in the relationship between employers and employees have taken place in the private sector over the last two decades which are noticeable in more flexible individual work and reward agreements and allow businesses and employees to work together to find ways to reduce costs and retain jobs and skills<sup>28</sup>. CBI argues that the public sector cannot respond to change because of national wage bargaining agreements. It asserts that in many areas of the public sector, pay structures remain inflexible, with pay not dependent on performance but factors such as grade and length of service. CBI compared public and private wages across the UK and found that average hourly wages in the public sector are 24.3% higher than in the private sector; controlling for differences in age, experience and qualifications, public sector wages are 8.3% higher.<sup>29</sup> Furthermore, average public sector workers receive pension contributions which are much higher than in the private sector. CBI also argues that pay bargaining should be local as differences in earnings are more often found within regions than between them.
- A.7 **Policy Exchange** 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”<sup>30</sup> and leads to potentially large differentials between public and private sector pay for similar individuals in similar areas. Large variations in wage differentials between the public and private sector exist within different regions and across the wage distribution. For example, wages in the South West for males employed in the public sector around the tenth percentile of the wage distribution are around 14% higher than for private sector employees, while males at the top of the wage distribution earn around 10% less than private sector equivalents.<sup>31</sup>
- A.8 In contrast, **NEF** found that public and private sector wage levels are not comparable because occupational structures in the private and public sector are radically different (e.g. average educational and skill level) and a number of other factors impact on relative pay (e.g. organisation size, job tenure, managerial responsibility). Accounting for these additional factors, pay differences between the public and private sector are reduced significantly. It asserts that evidence presented by the Treasury is not adjusted for all of these additional

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<sup>26</sup> Chancellor of the Exchequer, no date, *Government Evidence to the Pay Review Bodies: Economics of Local Pay*

<sup>27</sup> Chancellor of the Exchequer, no date, *Government Evidence to the Pay Review Bodies: Economics of Local Pay*

<sup>28</sup> CBI, March 2012, *CBI response to Office of Manpower Economics call for evidence on market-facing pay in local areas*, p 2

<sup>29</sup> CBI, March 2012, *CBI response to Office of Manpower Economics call for evidence on market-facing pay in local areas*, p 1 (from ONS ASHE, 2011: median gross hourly pay, work based travel to work area)

<sup>30</sup> Policy Exchange, 2012, *Local Pay, Local Growth*, p 25

<sup>31</sup> Policy Exchange, 2012, *Local Pay, Local Growth*, p 34

factors, the micro-economic and micro-social studies referenced by the Treasury cannot be assumed to apply to other parts of the public sector.<sup>32</sup>

## **2: Consequences of differences in pay**

### *Government evidence*

- A.9 Two impacts of the varying pay premia are highlighted by the government: first on the quality and effectiveness of public service delivery and second on the local economy. Citing evidence from studies of the education and health sector, the government concludes that

*[p]ublic sector pay premia have a clear impact on the quality and effectiveness of public services around the county. Their existence implies a sub-optimal use of public resources. In some areas, there may not be sufficient incentives to recruit, retain and motivate quality public sector staff. In other areas, the public sector pays more than is necessary to recruit the right staff<sup>33</sup>*

- A.10 Government acknowledges that overpaying staff in poorer areas is a form of redistribution, but it is not a particularly efficient one as public sector pay was not designed with this objective in mind. Some regions rely more on public related services and a higher proportion of the regional GVA is contributed by the public-related services (e.g. 22% in the South West compared to the UK average of 20% contribution of public administration, defence, education, health and social work to total regional GVA). Based on this information, the government comes to the conclusion that

*[p]rivate sector firms have to compete with public sector employers more in some areas. Reducing the public sector pay premium would help private businesses, particularly in some sectors to become more competitive and expand<sup>34</sup>*

### *Responses*

- A.11 **Policy Exchange** identifies three key problems arising from the current pattern of public and private sector pay:

- it is unfair to public sector workers, because their pay does not deliver the same living standards for the same jobs across the country
- it damages public services because the public sector can struggle to recruit and retain the right staff in high cost areas or areas with significant disadvantages
- it damages local growth because regional redistribution through national pay bargaining is not the best use of public money; Policy Exchange strongly supports the principle that the government has a role in making fiscal transfers between relatively

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<sup>32</sup> New Economics Foundation, July 2012, *The economic impact of local and regional pay in the public sector. A report by NEF for the Trades Union Congress (TUC)*, p: 6

<sup>33</sup> Chancellor of the Exchequer, no date, *Government Evidence to the Pay Review Bodies: Economics of Local Pay*

<sup>34</sup> Chancellor of the Exchequer, no date, *Government Evidence to the Pay Review Bodies: Economics of Local Pay*

rich and relatively poor areas, and believe that this money would be better spent on investment to boost local growth and jobs<sup>35</sup>.

- A.12 The case is made by **CBI** that more flexible and localised pay offers significant benefits for the public sector. Making use of market-facing pay will help the public sector to allocate public spending efficiently. CBI argues that as the public sector experiences deadweight costs from paying high salaries in low cost areas, and struggles with recruitment and retention challenges in areas where pay levels are higher. It asserts that local pay would minimise inefficiencies in pay and also improve the quality of public services through targeted and flexible pay that rewards performance, promotes competition, and enables employers to attract better workers to poorly performing services or difficult to recruit locations or fields. CBI concludes that

*[g]enuinely competitive and local labour markets best allocate resources, achieve fairness between the public and private sectors and encourage growth, job creation and prosperity<sup>36</sup>*

- A.13 It notes further that enabling regions to use their comparative advantages will help businesses to attract investment; this business investment is needed to offset declining government spending. The public sector pay premium has a negative effect on hiring in the private sector by preventing the private sector in less affluent regions from fully utilising the lower wage comparative advantage. The private sector must pay competitive salaries compared to the public sector to attract comparable quality staff; where public sector salaries are higher than the efficient market-facing pay levels the private sector is crowded out.<sup>37</sup>

- A.14 An online survey was carried out by **Institute of Directors (IoD)** in 2011 which asked IoD members<sup>38</sup> if in their experience it has been difficult for SMEs in some parts of the UK to attract skilled staff, because they cannot compete with public sector wage levels. Of the 1,051 IoD members that responded to the survey 27% have found this to be a problem at least once, the majority (57%) of respondents reported this has never been a problem (16% did not know).<sup>39</sup> Of the 91 IoD member based in the South West that took part in the survey, 35% have found this to be a problem at least once. The IoD survey suggests that crowding out of the private sector through public sector pay levels has been a problem for a significant minority of businesses.

- A.15 **NEF** investigates three assumptions of economic impacts of public sector pay: crowding-out, crowding-in and surplus recycling:

- the *crowding-out* hypothesis assumes that public and private sector employers compete for workers in a supply-driven economy; higher public sector wages would lead to additional labour costs for the private sector through competition for workers on the labour market (workers would prefer higher paid public sector positions),

<sup>35</sup> Policy Exchange, 2012, *Local Pay, Local Growth*, p 8

<sup>36</sup> CBI, March 2012, *CBI response to Office of Manpower Economics call for evidence on market-facing pay in local areas*, p 4

<sup>37</sup> CBI, March 2012, *CBI response to Office of Manpower Economics call for evidence on market-facing pay in local areas*, p 5

<sup>38</sup> About 72% of the total of about 40,000 IoD members are directors of SMEs, there are no information on the company size of survey respondents

<sup>39</sup> IoD, March 2012, *IoD response to call for evidence on market-facing pay in local areas*

reducing the private sector's ability to expand and creation of jobs and thereby reduce overall economic activity. Particularly at macro-level there is inconsistent evidence on the "crowding-out" hypothesis to which government subscribes

- *crowding-in* is based on demand-driven economics and assumes that payment of wages to public sector employees creates demand for goods and services, which leads to turnover for private businesses, generating positive multiplier effects
- the *surplus recycling* mechanism implies that there are benefits from the redistribution of resources from richer to poorer areas which helps to sustain less well-off regions and, more importantly, ensures that demand from less well-off regions produces opportunities for better-off areas and enhances the overall potential and productivity of the macro economy

A.16 The economic impact of a reduction in average public sector pay to private sector levels was then modelled by NEF, applying at one end the government's crowding out argument and to the other end of the spectrum no crowding out. The model used by NEF indicated that "*the costs of the political proposal would, under all scenarios considered, outweigh the benefits*".<sup>40</sup> For all six scenarios considered by NEF, the net GVA impact of a reduction in average public sector pay to private sector levels in the South West is negative: NEF estimates that the South West would lose between £300m and £1,185m in annual GVA<sup>41</sup>.

### **3: Recommendations for establishing regional pay**

#### *Government evidence*

A.17 Based on the evidence it reviewed, the government concludes that

*there is scope for public sector pay to become more responsive to local labour markets; individuals in some areas should be paid relatively less in real terms and relatively more in other areas*<sup>42</sup>

A.18 Over the medium-term, changes to pay systems should be introduced in a way that is appropriate for each workforce and consistent with equal pay law. The government refers to the use of pay zones, and where relevant extra payments in particular 'hotspots', in multi-site private sector organisations. It gives the example of the successful implementation of more local, market facing pay within the national bargaining structure for Court Service staff by the Ministry of Justice. Following a detailed analysis of economic data and local salary surveys the Ministry of Justice developed a zonal pay model, with a 'hotspot' rate in some urban areas: "*Pay bargaining still takes place at a national level in the Courts Service; but pay rates more closely reflect local markets*"<sup>43</sup>. Since the implementation of the new model, analysis of recruitment data showed that salaries were still competitive enough to attract sufficient number of applicants, turnover was not significantly high.

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<sup>40</sup> New Economics Foundation, July 2012, *The economic impact of local and regional pay in the public sector. A report by NEF for the Trades Union Congress (TUC)*, p: 27

<sup>41</sup> New Economics Foundation, July 2012, *The economic impact of local and regional pay in the public sector. A report by NEF for the Trades Union Congress (TUC)*, p: 24

<sup>42</sup> Chancellor of the Exchequer, no date, *Government Evidence to the Pay Review Bodies: Economics of Local Pay*

<sup>43</sup> Chancellor of the Exchequer, no date, *Government Evidence to the Pay Review Bodies: Economics of Local Pay*

## Responses

- A.19 Based on its research, **NEF** concluded that the government does not have robust evidence for introducing measures to make public sector pay more local and market facing, and through its model calculated that the costs of the proposal would outweigh the benefits. NEF stated that “[o]verall, the policy proposal put forward by the chancellor of the exchequer has little to commend it from the economic evidence”<sup>44</sup>.
- A.20 **IoD** and **CBI** both support the proposal of making public sector pay market-facing. CBI argues that public sector pay should be devolved to the lowest possible level, i.e. the employer. Neither of the two bodies makes further recommendations on how regional pay could be implemented.
- A.21 **Policy Exchange** states the nationally-negotiated zonal system favoured by the government does not resolve all the issues related to nationally set pay bands. It believes that the emphasis of government’s proposals should change and 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”*<sup>45</sup>
- A.22 To achieve this, it suggests that a fundamentally different system of pay negotiations should be implemented. Public sector employers should implement reward packages which are aligned closely to equivalent roles in the private sector and vary by performance. However pay negotiations should not by default happen at the employee-employer level but at the level chosen by employers (e.g. employee-employer, workforce, Local Authority, sector, national level). To enable this, data should be collected and published that enables easy comparison of public and private sector pay and takes into account local labour markets and living costs. Performance management and reward frameworks should be recommended by the Pay Review Bodies to increase productivity and performance.<sup>46</sup>
- A.23 Policy Exchange recognises that it would take a number of years to implement this system. In the short term, Policy Exchange suggests a more rigorous performance related pay framework which is expected to act as a catalyst for a cultural shift in thinking about linking performance to pay in the longer-term. It suggests that the following measures should be introduced:

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<sup>44</sup> New Economics Foundation, July 2012, *The economic impact of local and regional pay in the public sector. A report by NEF for the Trades Union Congress (TUC)*, p: 28

<sup>45</sup> Policy Exchange, 2012, *Local Pay, Local Growth*, p 9

<sup>46</sup> Policy Exchange, 2012, *Local Pay, Local Growth*, p 9

*[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 [a]utomatic pay progression points should be abolished [...] [a] system of performance related pay increases should be introduced across the public sector [...] 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”<sup>47</sup>*

- A.24 To increase budgets where labour costs are more expensive, budgets of public sector organisations should be adjusted through ‘Local Cost Adjustment’ factors (these would also be applied to performance-related pay budgets). Savings in low labour market cost areas should be ring-fenced for expenditure in those areas for initiatives that stimulate local growth (e.g. local infrastructure, regional growth initiatives or job creation schemes)<sup>48</sup>.
- A.25 **Policy Exchange** estimates that the reforms will create at least 288,000 jobs per year in the UK<sup>49</sup>. Policy Exchange advocates that a collaborative approach between trade unions, Pay Review Bodies and other relevant organisations is needed to bring about the wider reforms in pay negotiation institutions, which is expected to lead to more jobs, more growth and better public services.
- A.26 Separately, a recommendation on investing savings in public sector pay into infrastructure spending is also made by the IMF:

*[f]iscal space for further growth-enhancing measures could be generated by [...] restraint of public employee compensation growth, and better targeting of transfers to those in need. This fiscal space could be used to fund higher infrastructure spending, which has a high multiplier and raises potential output<sup>50</sup>*

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<sup>47</sup> Policy Exchange, 2012, *Local Pay, Local Growth*, p 11

<sup>48</sup> Policy Exchange, 2012, *Local Pay, Local Growth*, p 12

<sup>49</sup> Policy Exchange, 2012, *Local Pay, Local Growth*, p 87

<sup>50</sup> International Monetary Fund, 22 May 2012, *United Kingdom—2012 Article IV Consultation Concluding Statement of the Mission*, <http://www.imf.org/external/np/ms/2012/052212.htm> accessed 5/10/2012