

### 3. Devolved government and public sector pay setting

David Bell\*, Robert F. Elliott\*\* and \*\*\*, Tony Scott\*\*\*  
Ada Ma\*\*, and Elizabeth Roberts\*

\* Department of Economics, University of Stirling

\*\* Department of Economics, University of Aberdeen

\*\*\* Health Economics Research Unit, University of Aberdeen

---

#### Introduction

Public sector pay is of critical concern to the governments in Westminster and Edinburgh. Pay accounts for the major part of these government's current expenditures and its level and structure is a crucial determinant of the government's capacity to deliver the quality and range of the services it has promised. Yet the mechanisms for setting the pay of public sector workers are UK-wide and as a result reveal little sensitivity to specific conditions in Scotland. One likely consequence is that the rates paid to public sector employees are not set at levels appropriate to either the underlying market conditions or the needs of Scotland.

Since devolution there have been a number of important developments in public sector pay setting, moreover conditions in private sector labour markets have changed as a result of the slow down in the rate of economic growth. The balance between pay in the public sector and pay in the general labour market therefore seems likely to have changed. In this paper we seek to establish the degree of misalignment of public sector rates of pay in Scotland and England before and after devolution in order to determine how the position has changed since devolution. The analysis focuses on both the difference in mean pay and differences in the distribution of pay between the public and private sectors. We detail the degree of inequality in the public and private pay structures and forecast the changes in the public sector pay structure that might be expected to result from reform of public sector pay setting arrangements.

#### Public sector pay and public policy

Public sector pay is of critical concern to the Westminster government and the government of Scotland for the following reasons:

- Public sector pay is a major item of public expenditure, the public sector pay bill accounts for over half of all government current expenditures;
- The level at which public pay is set and rate at which this major item of public expenditure grows relative to budgets grows may constrain the ambitions of politicians;
- Governments are only able to provide the public and merit goods the electorate

require if the public sector can attract and retain well motivated staff - pay is a crucial element of the reward package;

- In some local and regional labour markets the public sector is the dominant employer and it then provides policy makers with a lever that can influence these labour markets;
- The level at which public sector pay is set will have a major influence on private sector pay levels in local markets
- The rate at which public sector pay grows will feed through to and inform the pay expectations of employees in the private sector.

#### Devolution and public sector pay: pressures for reform

Governments have been established in the territories to provide public services appropriate to the needs of the populations in these areas. As the governments better understand the specific needs of the populations they serve and the opportunities that devolution affords them to meet these needs, we should expect them to begin to fashion distinct policies. Devolution might be expected to produce a change in public sector pay setting institutions and outcomes.

Centralised, UK-wide, arrangements determine the rates of pay of large numbers of public sector employees. These result in far less regional variation in public sector rates of pay than exists in the private sector and in consequence the public sector pays above the private sector market rate in some parts of the UK and below in others. This limits the capacity of devolved governments to respond to changing local market conditions in important areas of public service. There is also be an efficiency loss, with resources devoted to public sector pay that could be better used on other items of expenditure.

Reform of public sector pay systems may not result in lower public sector pay growth in Scotland than England. Though the 'Barnet squeeze' will exert greater pressure on Scotland to use the available resources more efficiently, Scotland may still choose to pay its public sector workers above market clearing rates. This might be because it is thought to

increase the electoral appeal of the Scottish government or it may sit more easily with its' ideology. Any shortfall in service provision resulting from setting pay too high might be blamed on insufficient financing from Westminster.

### **Public sector pay setting**

The current arrangements for setting the pay of public sector employees in the UK reveal that there is very limited flexibility available to governments in the territories. Only in the case of local authority employees, school teachers and, most recently, prison officers do the institutional structures for setting pay map on to the devolved structures. Since devolution there have been some important and distinctive developments north and south of the border in some areas of public sector pay setting. The new pay structure for teachers in Scotland is quite distinct from that agreed for England and Wales, the new Local Authority framework agreement has introduced greater sensitivity to local market conditions, particularly in England, additional London and South East payments were awarded to some police officers and hospital doctors have enjoyed enhanced levels of earnings due to agreements on working time for junior hospital doctors. These might be expected to have a different effect on the public sector pay structures north and south of the border in the post devolution period.

### **The public sector pay premium and regional labour markets**

The most recent estimates of the size of the public sector pay premium in Britain, Disney and Gosling (1998) and Disney, Goodman, Gosling and Trinder (1999) reveal very distinct cycles in the size of the premium and no trend in the 'raw', the unadjusted, public sector pay premium over the period 1979 to 1994. But controlling for changes in the occupational composition of the workforce reduces the premium to less than 12 per cent for women and to 4 per cent for men. Using the GSH for 1983 and BHPS for 1991-95, to adjust the raw differential to allow for differences in the education and other productive characteristics of workers in the two sectors, Disney and Gosling (1998) found the premium fell from 5% to 1% for men, between 1983 and the early 1990s, but rose from 11 to 14 per cent for women. The increase in the public sector premium for women was caused by an increasing premium for women at the lower end of the distribution of pay.

In the only study to seek to estimate the size of the public-private wage gap in the different areas of Britain Henley and Thomas (2001) found that the public sector pay premium exhibited substantial variation both between 1991 and 1996 within a single region and between regions within a single year.

### **Data**

The data employed in this study comes from the Labour Force Survey. We use only the data provided by full-time employee respondents in the fifth wave. The three years from 1996 to 1998 are pooled to construct a pre-devolution period and data for the three years 2000 to 2002 are pooled to construct a comparator post devolution period.

We use the respondents reported gross pay and divide this by their basic hours of work plus paid overtime hours where these latter are multiplied by 1.25. Respondents to the LFS are categorised under two area description variables; the place where they work and the place where they live, we categorise them by the place where they work.

### **Method**

The pay formation process is different in the two sectors and we therefore estimate separate equations for each sector. Adopting the method proposed by Oaxaca we decompose the resulting difference in hourly pay into that part which is accounted for by differences in the measured characteristics of employees in the two sectors and that part attributable to differences in the returns to these measured characteristics in order to distinguish the 'adjusted' public sector pay premium.

We use the same framework to analyse differences in the distribution of pay between the public and private sectors in each country and to forecast how these might change post devolution if the wage setting institutions in the public sectors in Scotland and England were reformed and offered the same returns to the productive characteristics of their employees as the private sector in England.

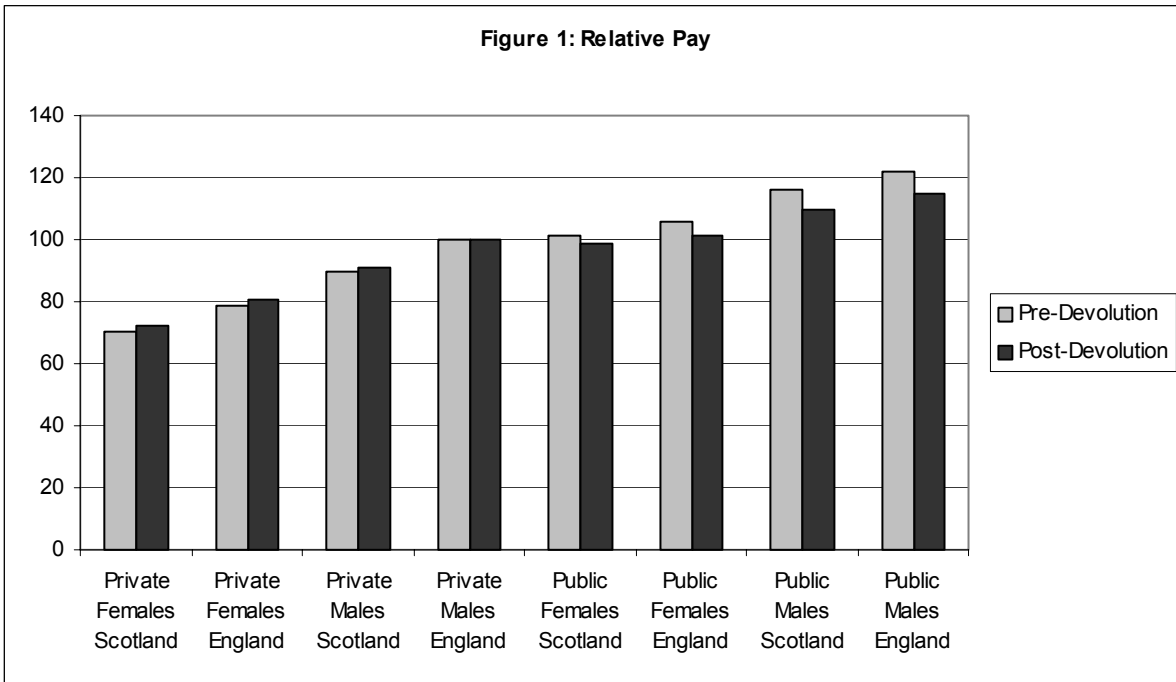
Pay in the public sector can be expressed in terms of both public sector observed returns and unobserved characteristics and the difference between these and equivalent private sector values. Following but adapting the methodology of Juhn, Murphy and Pierce we construct 'synthetic' earnings distributions for the public sector revealing what would happen if employees in the public sector received the same rewards for their measured *and* unmeasured characteristics as obtain in the private sector.

### **Results**

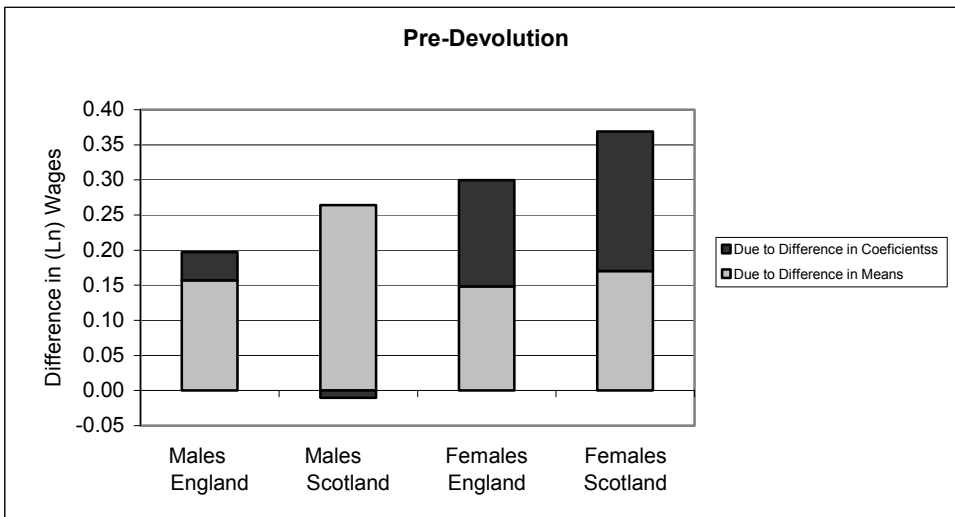
Figure 1 reports relative, unadjusted, pay levels for men and women in the public and private sectors in England and Scotland before and after devolution. The pay of each group of employees is expressed as a percentage of that of males in the private sector in England for the same period. It can be seen that:

- The average level of pay for men and women in the public sector in both England and Scotland was higher than that of private

- sector males in England before and after devolution;
- The magnitude of the relative pay advantage enjoyed by public employees in both countries has declined since devolution;
- Women in the public sector earn less than men in the same sector;
- The average level of pay of males in the public sector was higher in England than in Scotland before and after devolution;
- Women in the public sector in England were paid more than women in the Scottish public sector in both the periods before and after devolution.



**Figure 2**



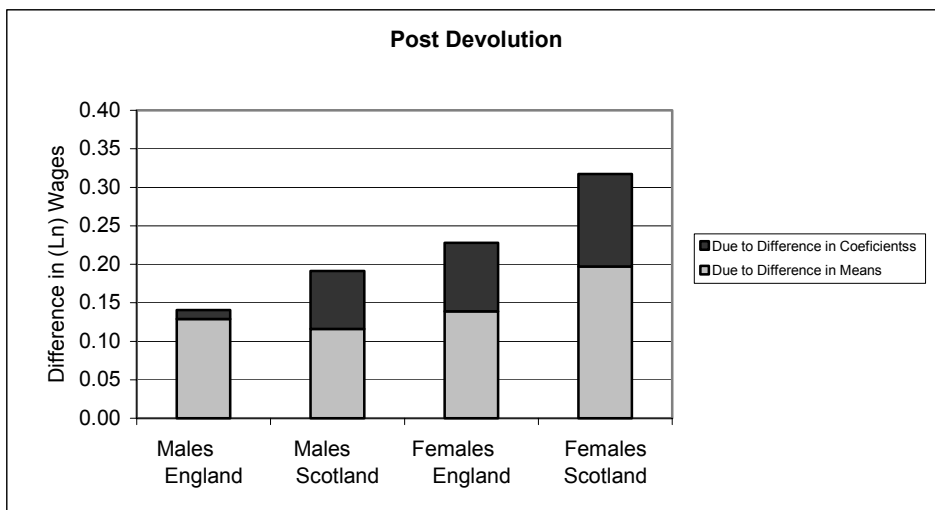
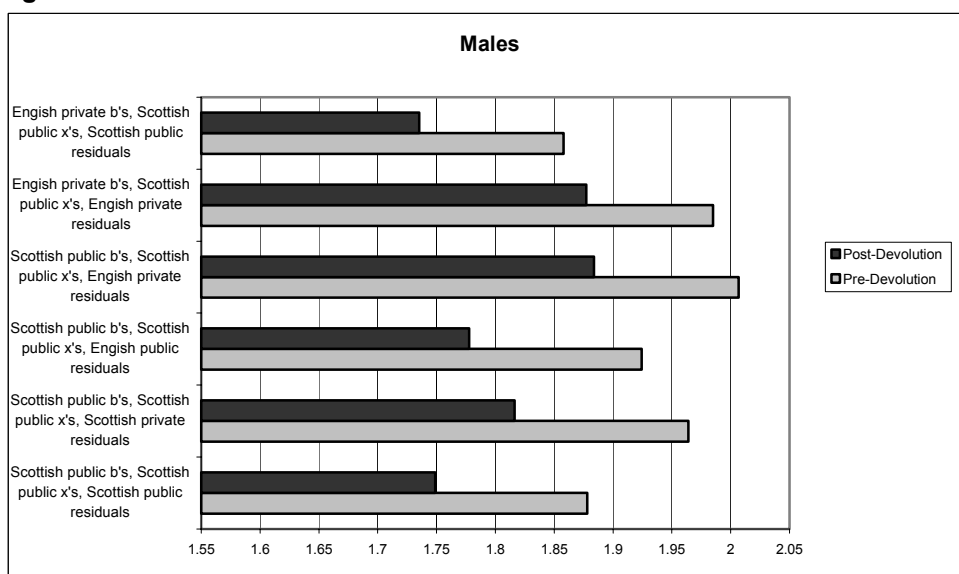


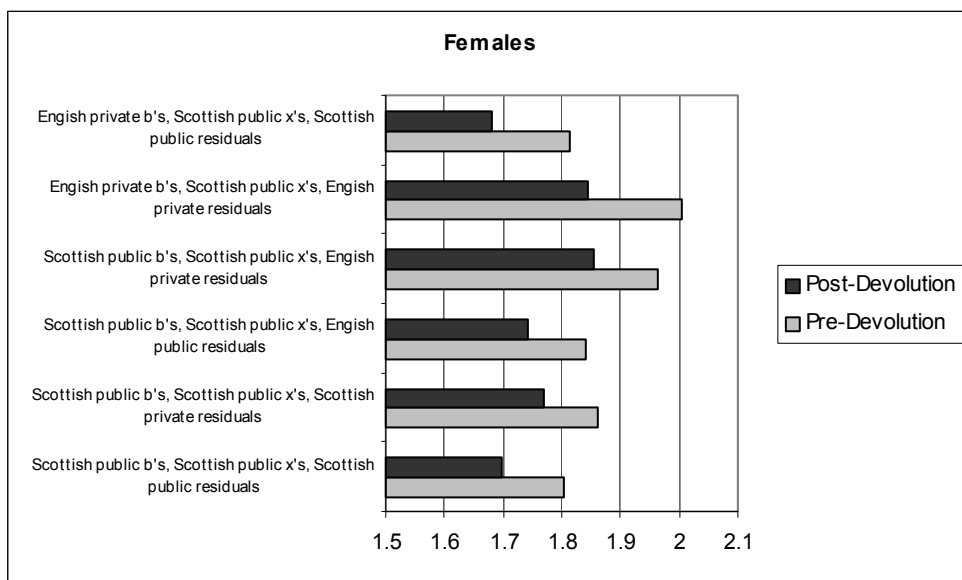
Figure 2 reveals that prior to devolution the adjusted pay difference between women in the public and private sectors in Scotland was 20 per cent while it was 15 per cent in England. After devolution the adjusted differential shrinks to 12 per cent in Scotland and 9 per cent in England. For men prior to devolution the adjusted differential was 4 per cent in England and -1 per cent in Scotland. After devolution it was 7 per cent in Scotland and -1 per cent in England. Average differentials of 12 and 7 per cent for women and men respectively in the post devolution period appear sufficient to motivate pay reform. The forecast impact of such reform on the pay distribution is the final step in the analysis.

Figure 3 reports the distribution of pay, measured by the ratio of pay at the 90<sup>th</sup> percentile to pay at the 10<sup>th</sup> percentile and shows the marked narrowing of the distribution in the post devolution period. Something unrelated to devolution was responsible

for this, the introduction of the national minimum wage in April 1999. A comparison of the forecast change in the pay distribution following reform and the current pay distribution for public sector workers in Scotland is obtained by a comparison of the bars in Figure 3. The bar labelled 'Scottish public b's, Scottish public x's, Scottish public residuals' reveals the actual pay distribution in Scotland before and after devolution. This can be compared to the hypothetical distribution 'English private b's, Scottish public x's, English private residuals' which reveals what the distribution would look like if the measured and unmeasured characteristics of Scottish public sector workers attracted the same rewards as offered in the English private sector. Figure 3 shows that if this happened pay inequality would rise in the post devolution period, the difference between the 90<sup>th</sup> and 10<sup>th</sup> percentile would rise to 1.87 rather than 1.75 for men and to 1.82 as opposed to 1.70 for women.

Figure 3





### Conclusions

In the analysis above we have calculated the adjusted pay differentials for the public sector in Scotland in the pre and post devolution period. The adjusted differentials inform us of the size of any pay premium that exists and where they are large provide an incentive for the reform of public sector pay setting. Average differentials of 12 and 7 per cent for women and men respectively in the post devolution period appear sufficient to motivate reform. If such reform were undertaken it would have a substantial impact on the distribution of public sector pay. We show that pay inequality, as measured by the difference between the 90<sup>th</sup> and 10<sup>th</sup> percentile, would rise in the post devolution period to 1.87 rather than the existing level 1.75 for men and to 1.82 as opposed to 1.7 for women.

### References

- Disney, R and Gosling A. 1998. "Does it Pay to Work in the Public Sector?" *Fiscal Studies*, 19 (November): 347-374
- Disney, R., Goodman A., Gosling, A. and Trinder C "Public Pay in Britain in the 1990s", *IFS Commentary No 72*
- Henley A. and Thomas D. (2001) " Public Service Employment and the Public-Private Differential in British Regions", *Regional Studies*, 35 (3), 229 - 240
- Juhn, C., Murphy K.M., and Pierce B (1993) "Wage Inequality and the rise in the Returns to Skill" *Journal of Political Economy*, 101 (June 1993):410-442
- Oaxaca, R. 1973, "Male-Female Wage Differentials in Urban Labour Markets", *International Economic Review*, Vol. 14, No. 3 (October), pp. 693-709.