

# **THE DAVID HUME INSTITUTE**



## **Public Sector Remuneration In Scotland**

**May 2012**

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## FOREWORD

A few months back we were approached by Professor Bob Elliott of Aberdeen University and Professor David Bell of Stirling University, suggesting that they should put together, for publication by the David Hume Institute, a selection of essays on Public Sector Remuneration in Scotland. We readily agreed, as we shared their view that this is an important topic, and one that has implications for the debate regarding possible independence or enhanced devolution, as well as being relatively neglected to this date. We also knew that both Bob and David were expert in their field and would provide objective and informed material fitting in with the requirements of the Institute.

We agreed with them a framework for the publication and also the authors who we would ideally wish to participate. I am pleased to report that nearly all of those preferred authors agreed to contribute – and their papers follow.

We wished to cover the facts of public sector employment in Scotland and then the current and prospective position for decision making on remuneration across components of the sector. Bob and David had all the knowledge and expertise to cover the first topic and Alistair Hatchett of Income Data Services was ideal to cover the second. In addition David Bell has also covered the complex but crucial world of public sector pensions – a topic which has attracted political and media attention while these papers were in preparation. Then Bob Elliott has co-operated with Alex Bryson of the National Institute of Economic and Social Research and London School of Economics in an examination of possible reforms of bargaining structures.

We also wished to obtain views from those with an active interest in the sector. Hence our (successful) requests to Stephen Boyd of the Scottish Trade Unions Congress, David Watt of the Institute of Directors and David Lonsdale of CBI Scotland. Their views, and those of their organisations, will be critical as the debate unfolds on how public sector remuneration might develop with moves towards enhanced devolution or independence.

Finally we wished to reflect the interests of those within the public sector. Here we called upon Eddie Frizzell and Bill Howat, who between them have a wealth of experience across various components of the Scottish public sector. Their section adds considerable depth to the content and ensures that all ‘real world’ issues are more than adequately covered.

I must thank a number of people for their assistance. Obviously we owe a great debt of thanks to all our authors and particularly to Professors Elliott and Bell for their suggestion and their endeavours. Thanks once more go to our Research Manager, Lesley Sutton, for her work in keeping this show on the road and to Joan Orr in the DHI office for taking the papers from raw material to this finished product. Thanks also go to the Scottish Institute for Research in Economics (SIRE) for their generosity in funding the costs of publication; and finally to Professor Charlie Jeffrey of Edinburgh University, one of our excellent trustees, for his comments and assistance in particular with the final chapter considering implications and the way forward.

We all very much hope that this set of papers will stimulate debate and that that debate will help inform consideration of options for constitutional change. We at the DHI consider work to inform this debate as being of extremely high priority over the two years ahead, and will be working closely with others to this end.

We have developed a close working relationship with Scotland's Futures Forum (SFF), a cross-party organisation at Holyrood, and will make use of this link to ensure that the papers are made available to MSPs and other key interested parties on the policy front. We welcome all comments and suggestions as to how the key issues raised in these papers might be best addressed.

Finally, and at the risk of being tedious, I must stress once more that the David Hume Institute, as a charitable organisation, has no views of its own on the topics discussed. The views expressed are those of the authors. But we always welcome objective, informed and sceptical analysis and seek to achieve transparency for work – like these essays – which matches these criteria. I commend them to you.

**Jeremy A Peat**

**Director  
David Hume Institute**

**May 2012**

## The Authors

**David Bell** is currently Professor of Economics at Stirling University. He is a Budget Advisor to the Finance Committee of the Scottish Parliament and is a fellow of the Institute for the Study of Labor (IZA, Bonn) and of the World Demographic and Aging Forum (WDA, St Gallen). He was previously a member of the ESRC Training and Development Board.

**Stephen Boyd** is STUC Assistant Secretary with responsibility for economic and industrial policy, the environment, utilities, transport and arts and culture. He is currently a member of a number of Scottish Government Advisory Groups including the Scottish Energy Advisory Board and is a regular media contributor. Prior to joining the STUC in 2003, Stephen was a policy officer with the Scottish Government.

**Alex Bryson** is a Senior Research Fellow at the National Institute of Economic and Social Research as a Senior Research Fellow. He is also a Visiting Research Fellow at the Centre for Economic Performance, LSE, a Rutgers Research Fellow and a member of the Workplace Employment Relations 2011 Steering Committee and Research Team. His research focuses on industrial relations, labour economics and programme evaluation. He is on the editorial board of the *NIESR Economic Review* and was previously an editor of the *British Journal of Industrial Relations*.

**Bob Elliott** is Director of the Health Economics Research Unit and Professor in the Department of Economics at the University of Aberdeen. He is a Fellow of the Royal Society of Edinburgh and in 2007 was appointed as a Commissioner to the Low Pay Commission which sets the UK minimum wage. He has held visiting positions at several universities in the USA, Europe and Australia and has acted as consultant and adviser to the Police Federation, HM Treasury, the European Commission and the OECD. He chaired a Review of the Area Cost Adjustment in 1996 and was a member of the Committee of Inquiry into Professional Conditions for Teachers in Scotland (McCrone Committee) in 2000. He is a member of the Technical Advisory Group on Resource Allocation established by the Scottish Government Health Directorates. He is a member of Sub-panel 2: Public Health, Health Services and Primary Care in the 2014 Research Excellence Framework (REF). He has directed a large number of research projects and published widely in the field of labour economics. His most recent research has focused on health service labour markets and resource allocation within the health services of Scotland, England and Wales.

**Eddie Frizzell** has been Visiting Professor in Public Service Management at Queen Margaret University, Edinburgh since his retirement from the Civil Service in 2006 where he was Head of the then Scottish Executive's Enterprise Transport and Lifelong Learning Department. Between 1991 and 1999 he was Chief Executive of the Scottish Prison Service. In both roles he was responsible for the leadership and management of public service organisational and cultural change.

**Alastair Hatchett** is Head of Pay and HR Services at IDS, having been the editor of the IDS Pay Report for 20 years until 2005. He leads several teams of researchers whose work on pay and HR is highly respected and widely quoted in management, union and government circles. He has been involved in a range of research projects over the past decade for the Low Pay Commission, the Pay Review Bodies, the CIPD, HM Treasury, Government Departments, Aces and a range of unions.

He is a regular conference speaker on reward issues, the labour market and employment trends. He is a fellow of the Royal Society of Arts and the Royal Statistical Society.

**Bill Howat** had a varied career over 40 years in the public service covering academic, civil service, Chief Executive of an all purpose council, consultancy and voluntary work. This has given Bill a unique perspective. Since retiring Bill has been involved in a range of public sector projects and reviews, most notably leading the independent review of SE Budgets from Nov 2005 – Mar 2007. Bill served as the Honorary Secretary of the Society of Local Authorities Scotland Branch 2009-11. As the current President (former chair) of Volunteer Development Scotland Bill also has experience and insight of third sector issues.

**David Lonsdale** is Assistant Director of CBI Scotland, having joined the leading business lobby group at the start of 2006. Prior to this he worked at the Scottish Chambers of Commerce, rising from Policy Officer to become Head of Policy & Public Affairs. He previously worked for a leading UK firm of commercial insurance brokers and risk consultants, and as a researcher at the Scottish Parliament. David's responsibilities at CBI Scotland involve representing and promoting the interests of member companies to government, policy makers and opinion formers on a wide range of public policies affecting commerce and industry. He is a member of the Church of Scotland's Commission on the Purposes of Economic Activity, and of the Industrial Mission Trust, and chaired the Homes for Scotland 2011 Quality Awards.

**Jeremy Peat** has been Director of the David Hume Institute since 2005. Previously he was Senior Economic Adviser at the Scottish Office from 1985 to 1993 and Group Chief Economist at the Royal Bank of Scotland from 1993 to 2005. He is also a member of the Competition Commission and former BBC National Trustee for Scotland. He is an Honorary Professor at Heriot Watt University.

**David Watt** is Executive Director for the Institute of Directors in Scotland. He has run his own business for over ten years – a consultancy focussed on individual and organisational development, particularly in the sport and leisure industry. Prior to this he had worked in both the private and public sectors. David, who is GlobalScot, also serves as a non-executive director on the Scottish North American Business Council, Business Club Scotland, Fife Sport and Leisure Trust, the Intellectual Assets Centre, and Scottish Gymnastics, as well as acting as an advisor to individuals and groups in the public, private and voluntary sectors.



# **Public Sector Pay in Scotland: An Overview**

**David Bell and Robert Elliott**

## **1. Context.**

Scotland is a small open economy. It is currently part of a common currency area that covers all of the UK. Even if Scotland becomes independent, it is likely to remain part of a common currency area: either the Sterling or the Euro area. In a monetary union, Scotland will have no control over monetary policy which will remain at the command of either the Bank of England or the European Central Bank, respectively. Given the recent financial crises in Europe and the UK, it is realistic to assume that monetary union would also entail co-ordination, if not integration, of fiscal policy. Therefore, an independent Scotland would have no command over one major instrument of macroeconomic policy, monetary policy, and limited control over another, fiscal policy.

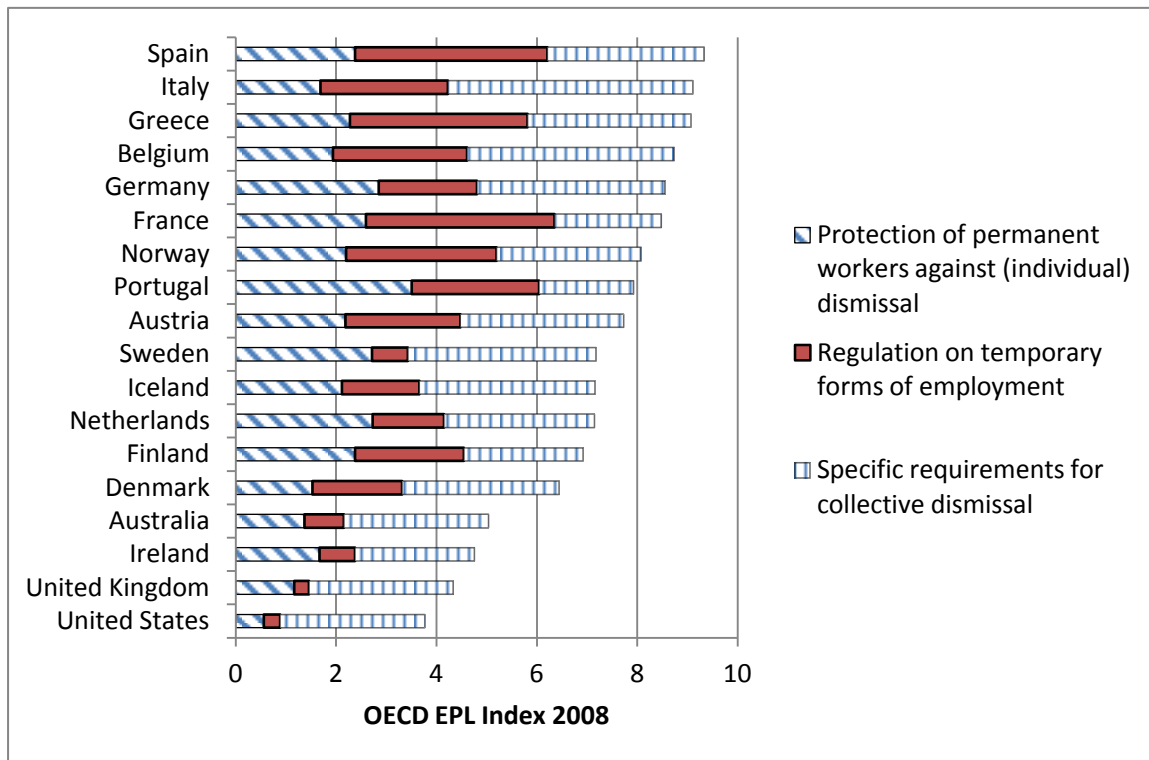
In the event of an exogenous shock to the Scottish economy, the burden of any adjustment that was required to restore competitiveness in the traded goods sector would fall on nominal wages. Absent the options of either devaluation or inflation, through which to recalibrate real wages to restore competitiveness, the required adjustment of real wages would have to be achieved by adjusting nominal wages through labour market policy. Under either 'devolution max' or full independence, labour market policy would become *more* important than it is today. While Scotland has until now been largely content to allow labour market policy to be directed from Westminster, it will not be able to do so if it achieves greater independence than it has today.

## **2. The Role of the Public Sector in Labour Market Policy.**

Labour market policy is ultimately directed toward influencing or regulating firms hiring and firing decisions and their freedom to set wages. Labour market flexibility is judged by the control firms have over these decisions. Governments regulate labour markets in pursuit of social goals, to establish minimum hiring standards and minimum wages to avoid exploitation and abuse of market power. Governments seek to influence or regulate the hiring and firing and wage decisions of private sector firms with greater or lesser reluctance according to their political philosophy and the associated confidence they have that markets left unregulated will produce socially desirable outcomes. Thus the degree of regulation in the private sector is a matter of political choice.

At present, the OECD rates the UK as having a relatively flexible labour market. Figure 1 shows the OECD assessment of the strength of employment protection legislation across OECD countries. Apart from the US, the UK has the least heavily regulated labour market in the OECD. Two points are worth noting: first, OECD countries are likely to have more heavily regulated labour markets than Asian economies, which are now providing much of the competition to UK industries; second, regulation does not explain the differing performances of OECD countries during the most recent "Great Recession". Thus, for example, Germany, with a relatively high level of regulation, has nevertheless experienced a much smaller increase in unemployment than has the relatively lightly regulated United States. In contrast, countries like Spain, Italy and Greece with high levels of regulation, are now seeking to liberalise their labour markets as part of a strategy to restore competitiveness

**Figure 1: OECD Employment Protection Legislation Index 2008**



Source: OECD

Governments can heavily influence the terms and conditions of employment for their own employees. They have to take a very active and often quite direct role in setting the rules for both the hiring and firing, and also for setting the pay of their own employees. An important part of labour market policy is therefore the policy of government toward its own employees.

Around a quarter of all employees in Scotland are employed either directly or indirectly by the Scottish Government: directly because they are civil servants employed by Scottish Government, or indirectly because they are employed by local authorities, health boards etc. which are funded by the Scottish Government. Public sector pay policy is an important element of government labour market policy and can under certain conditions have direct and immediate effects on conditions in the labour market.

What should the policy of a more highly devolved or newly independent Scottish government be toward the pay of its own employees? Can it and should it use its powers over public sector pay to influence, indirectly, the policy of private sector employers? These are the questions we address in the pages that follow.

### 3. How do we define the public sector in Scotland?

The public sector in Scotland comprises a heterogeneous group of organisations. It includes central and local government, the National Health Service, police, the fire service and public corporations. The latter includes the employees of organisations as diverse as Scottish Water and Lothian Buses.

There are international rules about how the public sector is defined. The UK abides by these rules and these regulations required the UK government, from the beginning of 2008, to define the employees of both RBS and Lloyds TSB as part of the public sector. This was when the UK government took a majority shareholding in these banks, one of which is headquartered in Scotland. These employees will remain in the public sector until the government sells its majority shareholding.

#### **4. The size of the public sector in Scotland**

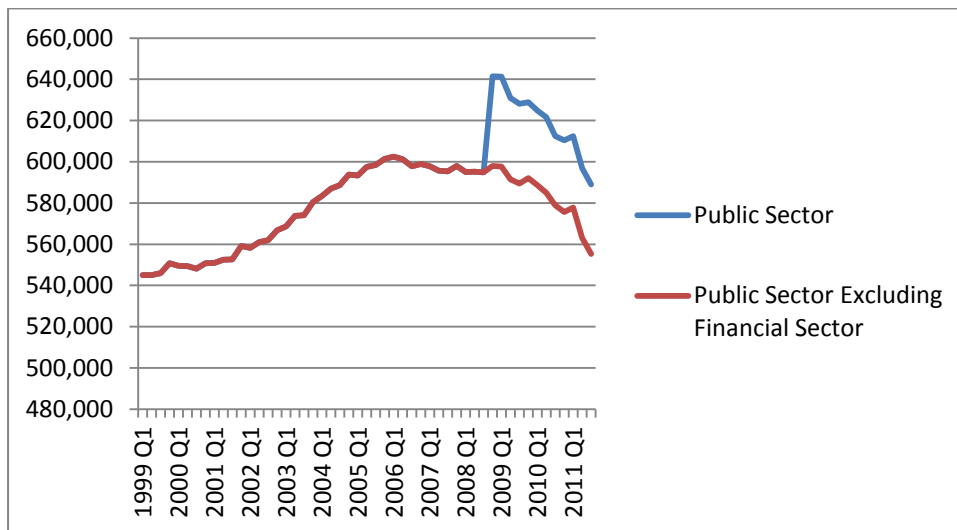
Figure 2 shows estimates of the number of public sector employees in Scotland from 1999 to 2011. The inclusion of RBS and Lloyds at the beginning of 2008 dramatically increased the numbers employed in the Scottish public sector: over 40,000 employees were added to the total. Figure 2 also reveals that since 2008, employment in the Scottish public sector has fallen quite sharply. Some of this decline results from job losses in the public sector banks. However, for the purposes of this paper, and since we assume (and hope) that their employment in the public sector will be temporary, we do not focus on these financial sector employees.

Leaving aside those employed in the financial sector, public sector employment in Scotland peaked in 2006 and has fallen sharply since 2009. In 2011 Q1, public sector employment (on the headcount method) was nearly 8% lower than its previous peak. As a share of total public sector employment, the decline in Scotland has been greater than that in the rest of the UK, where public sector employment fell by just over 6% from the end of 2009. Public sector employment is predicted to fall further throughout the UK. The Office for Budget Responsibility is forecasting a further fall of 12% between the start of 2011 and 2017<sup>1</sup> and a sharp fall of similar magnitude seems likely to result from the public expenditure squeeze in Scotland. There are no separate Scottish forecasts, but a reduction similar to that forecast for the UK as a whole would imply a further decline in public sector employment in Scotland of 66,000 by 2017.

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<sup>1</sup> OBR November 2011 employment forecasts  
<http://budgetresponsibility.independent.gov.uk/pubs/Autumn-2011>

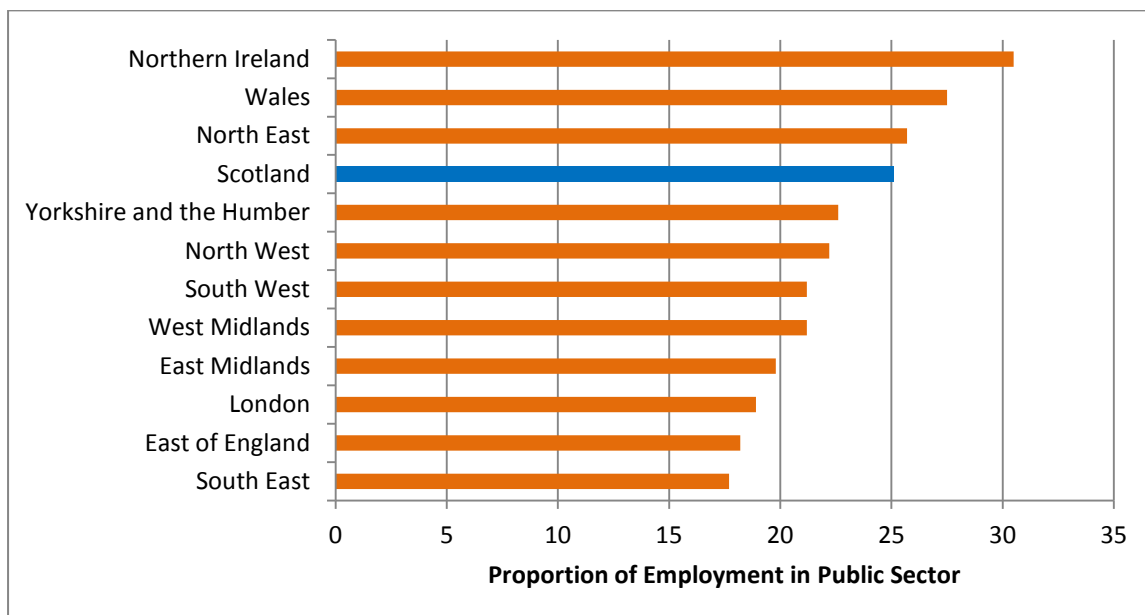
**Figure 2: Number of Employees (Headcount) in the Scottish Public Sector, 1999-2011**



Source: Scottish Government

Despite this recent fall, the share of the public sector in total employment is still much higher in Scotland than in most other areas of the UK. Figure 3 shows that 25% of employees in Scotland work in the public sector. This is nearly 8% above the share in the South East, which has the lowest proportion of public sector employees. On the other hand, more than a quarter of all employees in Northern Ireland, Wales and the North east of England work for the public sector.

**Figure 3: Share of Employment in Public Sector by UK Region 2011**



Source: Office of National Statistics

One way of interpreting these data is that they reflect the relative strength of the private sector in different parts of the UK economy. Where the private sector is strong, levels of income are relatively high.

Where the private sector is weak, incomes are lower and central government provides fiscal transfers to equalise service provision. The public sector consequently expands.

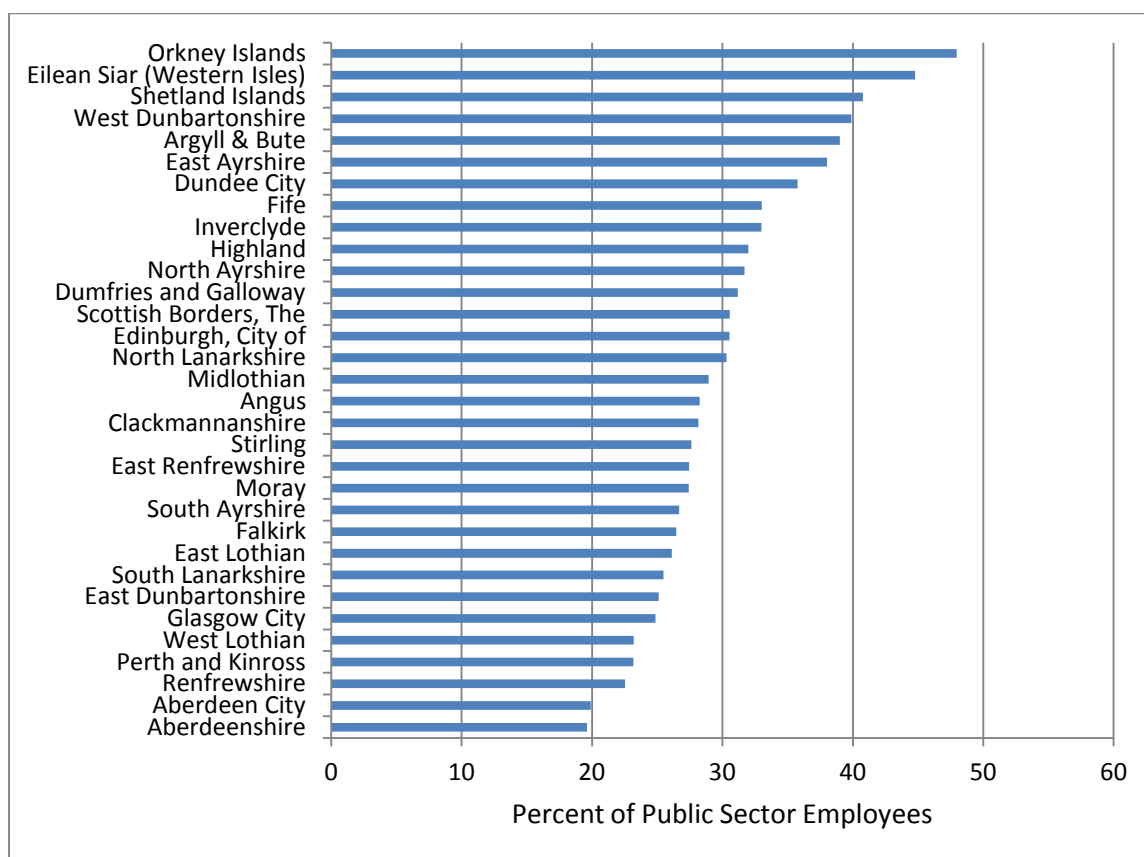
There is a danger of a negative spiral of decline with increased dependency on fiscal transfers. This may cause higher productivity workers to migrate to the public sector, further weakening the private sector and reinforcing the spiral. Breaking such a cycle is a problem confronting not only the UK government, but also for many other countries in Europe where there have been long-standing differences in regional economic performance. Regional mobility of labour has failed to reduce these differentials.

Another possible mechanism to enhance the supply of human capital to the private sector is through the adjustment of wage differentials between the private and public sectors. Clearly, this is a mechanism over which government and its agencies have a large degree of control.

Within Scotland, there is even greater variation in the share of public sector employment than there is between different parts of the UK. The Office of National Statistics has recently estimated the share of public sector employees by local authority within the United Kingdom. The shares of public sector employment in Scottish local authorities in 2010 are shown in Figure 4. These range from 19% in Aberdeenshire to 47% in Orkney, a range of 28 percentage points. In the UK as a whole, the range lies between 18% in the South East of England and 31% in Northern Ireland – a gap of just 13%. The island authorities (Eilean Siar, Orkney and Shetland) all have public sector employment shares in excess of 40%, while in contrast public sector employment in Aberdeenshire and Aberdeen City accounts for less than 20% of total employment. Again, this seems likely to be a consequence of the relative strength of the private sector across different parts of Scotland.

These differences in employment shares are also reflected in differences in the relative size of transfers from the Scottish government to local authorities and health boards across Scotland. Areas with large public sectors are dependent on large fiscal transfers from the Scottish government. Such fiscal transfers are intended to reflect differences in “need” and differences in the costs of provision of public services. But they also have the perhaps unintended consequence of rendering some parts of Scotland highly dependent on the public sector. This is true to the extent that public sector wages form an important component of demand in these areas. Significant reductions in wages or employment in these areas could have a negative effect on demand and consequently further weaken the local economy, at least in the short run.

**Figure 4: Share of Employment in Public Sector by Scottish Local Authority 2010**



Source: ONS [http://www.ons.gov.uk/ons/dcp171766\\_241911.pdf](http://www.ons.gov.uk/ons/dcp171766_241911.pdf)

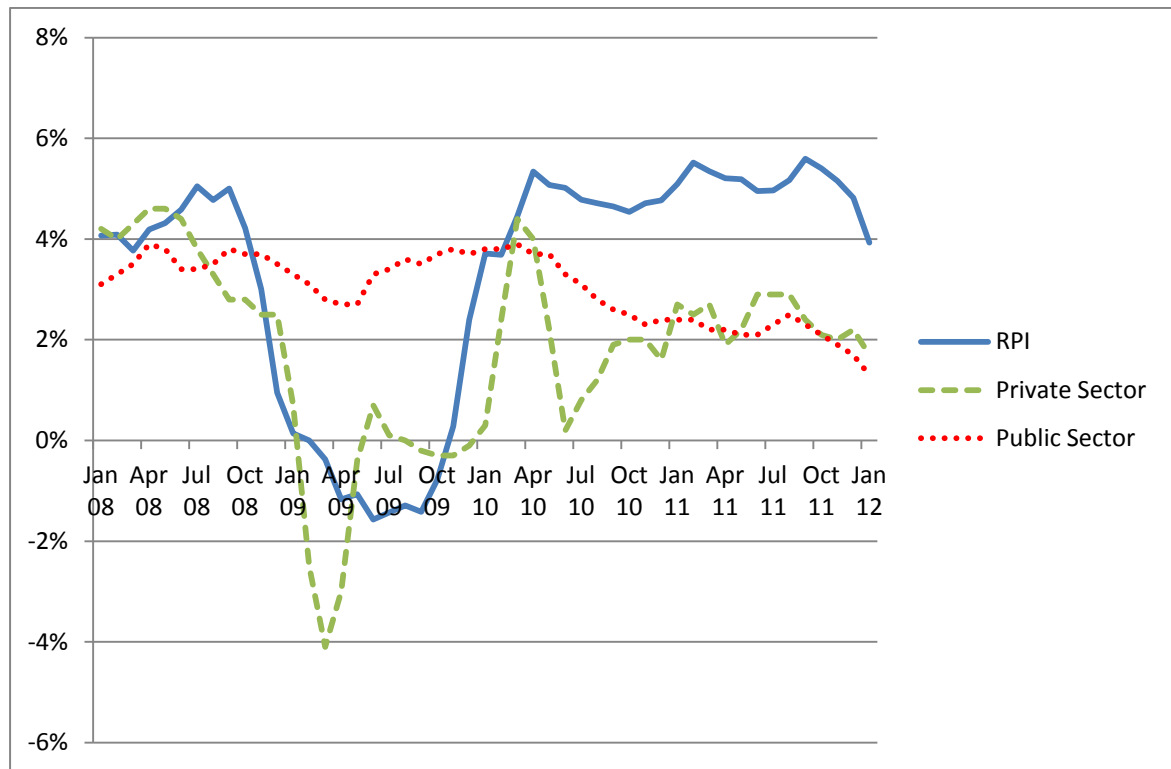
## 5. Scottish Government control over public sector pay

Pay cuts or less rapid growth in pay in areas with the highest dependency on public sector employment might be one way for the Scottish Government to mitigate the employment effects of cuts in public expenditure. This approach has already been taken in Ireland and Greece. Substantial cuts in pay and increases in pension contributions have been imposed on public sector workers in both these countries. Although its deficit problem is comparable in magnitude, the UK's control of the money supply has led to a more subtle form of macroeconomic adjustment whose effects have been felt across the economy and not simply restricted to the public sector. Depreciation and monetary expansion have caused price rises to exceed wage rises particularly since 2010. This has resulted in falling real wages and therefore weakening consumer demand. Compared to wage reductions, price inflation has to date proved to be a much less contested way of reducing real wages, even if the final outcomes, measured in lower real wages, are the same.

Figure 5 shows that in 2008, wages in both the UK private and public sectors were growing at the same rate as prices, implying that real wages were broadly constant. At the onset of recession, the growth in private sector wages fell dramatically: workers accepted lower wage growth to keep their jobs. In the public sector, wage growth did not immediately react to the recession.

Instead, it decelerated more gradually, but the effects of fiscal austerity mean that since 2011, average wages have been growing more slowly in the public sector than in the private sector. Note that although there is a “pay freeze” in the public sector, this does not apply to lower paid workers and there will always be some “wage drift” as employees move up pay scales and are promoted or find new, better-paid jobs within the public sector. Nevertheless, this overall climate of pay restraint brought about by fiscal austerity is making the industrial relations climate in the public sector more difficult.

**Figure 5: Wage Inflation and Price Inflation in the UK, Jan 2008-Jan 2012**



Source: Office of National Statistics

The 2010 UK Spending Review set out the Scottish Government's spending allocation until 2015-16. The Scottish government allocates this budget between its various functions such as health, local government, transport, economic development, etc. In many public services, wages are the main component of spending and thus a fixed budget means that the wage bill cannot exceed a given cash sum. Where there is such a constraint on the wage bill, there is a trade-off between pay levels and employment levels. What policy tools does the Scottish Government have to influence this trade-off? What part does it or could it play in setting the pay of public sector employees in Scotland? Moreover how might it exercise this control; is the pay of public sector employees in Scotland higher, or lower, than required for the efficient production of public services? These are the issues to which we now turn.

In theory, the Scottish Government can influence, either directly or indirectly, the pay of the vast majority of employees in the public sector in Scotland. Where it does not have direct control over the wage bill as in non-departmental public bodies (NDPBs) and public corporations, it has control of their overall budgets and thus influences their freedom to set pay.

Indeed, through its control of their budgets, the Scottish Government exerts significant control over the pay bill of the all bodies encompassed by the non-financial public sector in Scotland.

However successive Scottish Governments have chosen not to exercise much of the control they have. Save for teachers and local authority staff, who together account for 46% of the public sector pay bill, they have left determination of pay rates to UK-wide bodies. Many organisations within the Scottish public sector remain covered by UK-wide pay negotiating or Pay Review Bodies that effectively determine wage rates for the UK as a whole. These include large organisations such as the NHS, police and the fire service. As Table 1 shows, this means that successive Scottish governments have been content to follow the lead of these bodies whose remit extends across the UK as a whole. They have not tended to fine tune the agreements to the particular circumstances of the Scottish labour market. Instead, it is the priorities and perspectives of England which dominate the deliberations of the Review Bodies and therefore the pay rates that they set.

The Review Bodies have now been charged with addressing the issue of local pay and may recommend new pay setting institutions which result in the pay of all these public sector employees more directly reflecting the conditions in localities and territories; this will be discussed more fully in the Elliott/Bryson chapter. Recent statements by the Treasury and in the 2012 Budget suggest that the UK government also wishes to move in this direction. But whatever the conclusions of the Review Bodies and the current Police and Fire negotiations a move to greater independence would require Scotland to take back control over the pay structures of these groups of staff. As we can see from the Frizzell/Howat paper, some tentative moves have been made to take a greater control over NHS bargaining, but given that the value of the NHS pay bill is more than twice the current Scottish revenue from Corporation Tax, it is somewhat surprising that the former has received almost no attention in the independence debate, while the latter has been centre stage.



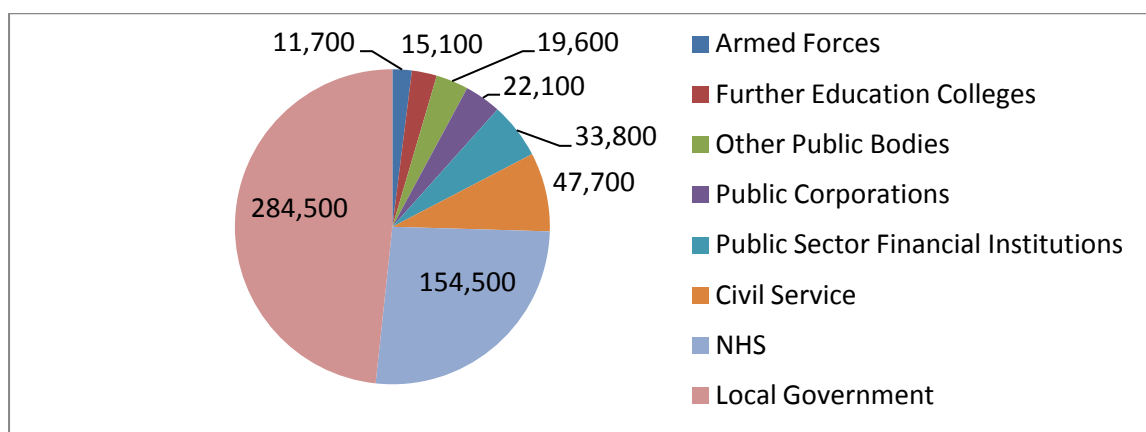
**Table 1: Breakdown of the Scottish Pay Bill by Pay Determining Bodies, 2010-11**

Pay Determining Bodies for Key Staff Groups	Staff Groups	£ million	% of total pay bill
Scottish Government directly controls ( i.e. all public bodies subject to Scottish Public Sector Pay Policy)	NDPBs, Public Corporations, Departments and Agencies, Main Scottish Government (excl. SCS) and NHS senior managers	1,178	8%
Scottish Negotiating Committee for Teachers (SNCT). Scottish Government determines alongside COSLA and Trade Unions	Teachers and associated professionals	2,409	16%
Scottish Joint Council, Scottish Joint Council for Craft Operatives, Scottish Joint National Council for Chief Officers	Local authority staff (excluding teachers, police and fire)	4,395	30%
Scottish Government determines but to date has followed UK review body recommendations of which: UK Doctors and Dentists Review Body ( DDBR)  UKNHS Pay  UK Police Negotiating Board National Joint Council for Local Authority Fire and Rescue Services	Employed Hospital Doctors, General Medical Practitioners ( GMP) and General Dental Practitioners ( GDP)  Agenda for Change - nurses, allied health professionals, clerical and administrative staff Police Fire	6,235	40%
Reserved to UK Government	Senior Civil Service ( SCS)	24	0%
Other	Independent GMP / GDP contractors	925	6%
Total		15,166	100%

Source: Scottish Government - <http://www.scotland.gov.uk/Publications/2010/07/29082838/6>

The size of the pay bills listed in Table 1 is determined by the number of employees and their average level of pay. Figure 6 below shows that local government is by far the largest public sector employer in Scotland, with almost 300,000 employees. The next largest is the NHS with over 150,000 employees. The civil service has almost 48,000 employees in Scotland. The remainder of the total is made up by contributions from the Armed Forces, further education colleges, NDPBs and public corporations such as Scottish Water.

**Figure 6: Distribution of Employment in the Public Sector in Scotland 2011**



Source: Scottish Government

## 6. The relative pay of public sector employees in Scotland.

How much should a more highly devolved or newly independent Scotland pay its public employees? The underlying principle is that, within the constraints on public spending, the public sector should pay what is needed to attract, retain and motivate sufficient staff to maintain the public services desired by the people of Scotland. To quote the Institute for Fiscal Studies (2012) *“What matters is the extent to which the overall remuneration package offered by public sector employers is well designed to attract, motivate and retain sufficient numbers of workers of the desired quality in a way that provides good value to the taxpayer. In general, this is likely to mean that public sector workers should have an overall package – in terms of financial and non-financial benefits – that is similar to that available for similar roles in the private sector”*<sup>2</sup>.

Remuneration packages comprise much more than the weekly or monthly wage. They may include a variety of non-wage benefits such as cars, subsidised housing etc. In recent years, due to a drive by HMRC to ensure that all forms of income are taxed equivalently, the attractiveness of such non-wage benefits has declined. However, another important non-wage benefit – employer pension contributions - still attracts generous tax treatment (Bell’s chapter).

Determining what constitutes similar overall remuneration is further complicated because, unlike the private sector, the labour market gives little direct guide as to what the overall remuneration package for public sector employees should be. There are two reasons for this. First the jobs which employees in the public sector do are often unique to the public sector; there are no ‘similar roles’ in the private sector which allow direct comparisons. Second public sector employees for the most part produce services that are free at the point of delivery. Because there are no charges for most health services, schooling, police and fire services, refuse collection, roads and many environmental services there is no market demand curve mapping the prices consumers would be willing to pay for different quantities of these services and thus no associated labour demand curve mapping what remuneration should be at each level of service.

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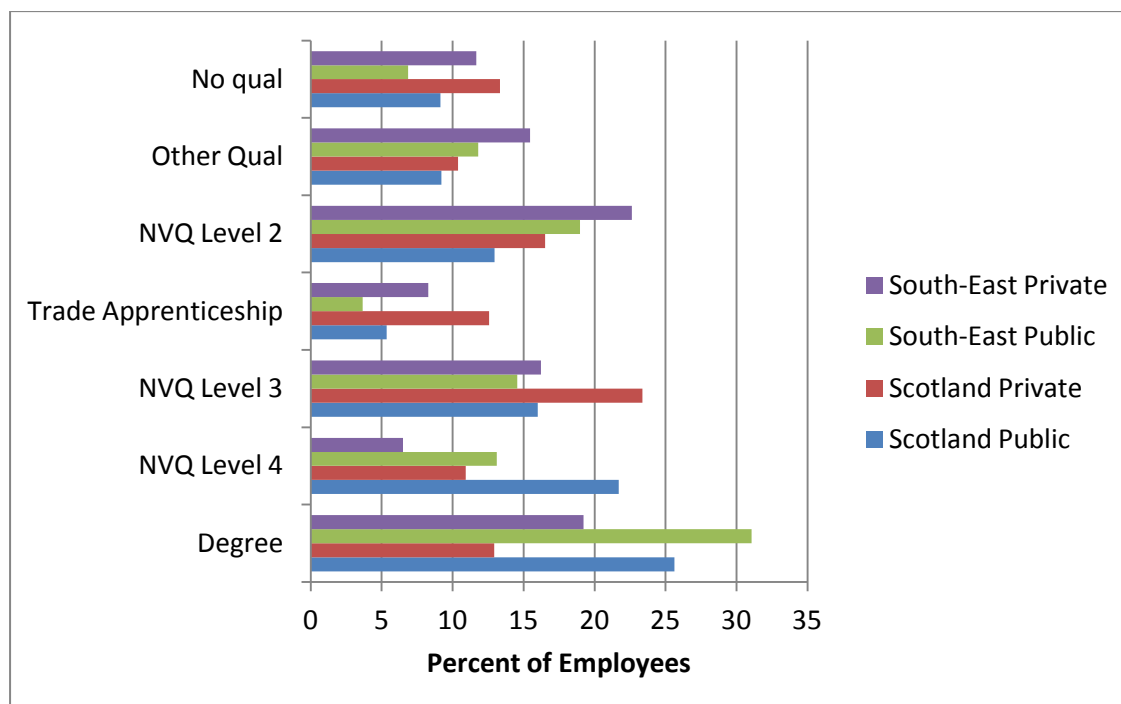
<sup>2</sup> Institute for Fiscal Studies Green Budget February 2012, Chapter 5, page 99

In the absence of a market derived labour demand curve to determine public sector employees remuneration, the answer to the question must be found by using statistical modelling methods and secondary data sets to identify ‘statistically’ identical private sector workers and distinguish their remuneration.

Comparisons thus usually focus on differences in pay. Weekly pay in the public sector is generally higher than that in the private sector. The Annual Survey of Hours and Earnings (ASHE) reveals that in April 2011, weekly rates of pay for all public sector employees in Scotland were 10.8% higher than in the private sector at the mean and 21.3% higher at the median of the distribution. The corresponding differences for hourly pay were 21.8% (average) and 42.2% (median) respectively. We should expect this: the public sector employs a much higher proportion of graduates than does the private sector, and its employees are older and more experienced. Women are better paid in the public sector; the gender pay gap is smaller in the public sector. Women account for around 62% of public sector employees in Scotland. In contrast, in the private sector, 59% of employees are men.

Figure 7 reveals that the public sector has a more highly skilled workforce. A larger proportion of public sector workers have degrees. This is true for public sector workers in both Scotland and the South-East of England. But in the South-East, the proportion of graduates in the workforce is higher than in Scotland. This is true for both the private and public sectors. More graduates will in general imply higher productivity, which in turn is reflected in higher average pay levels in the South-east. The Scottish public sector employs relatively larger numbers of those educated to NVQ level 4 than the private sector in Scotland or in either sector in the South-east economy.

**Figure 7: Employment by Qualification, Scotland and the South-East of England 2010**

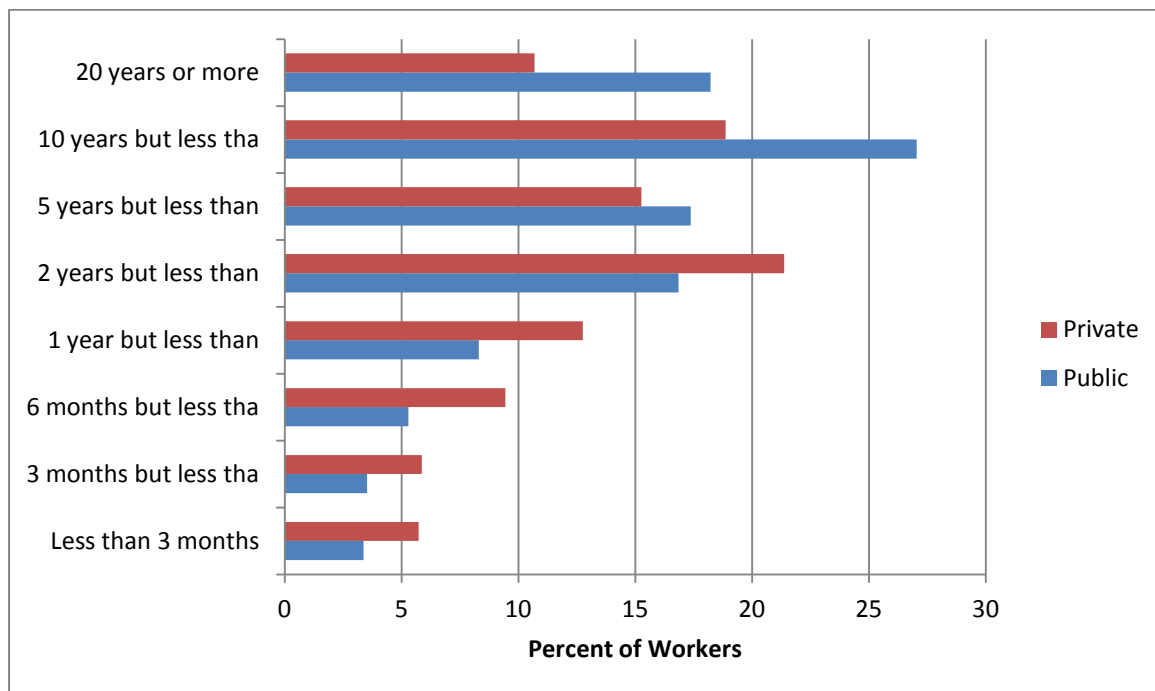


Source: Labour Force Survey. Authors' calculations

Public sector workers are also on average 3.1 years older than those in the private sector.

In 2010, the average private sector worker was aged 41, while the average public sector employee was 44.1 years old. This gap, between the ages of public and private sector workers, has changed little since 2001 though, reflecting the ageing of the population, the average worker in both sectors had aged by two years over this period. One deduction from this gap in workforce age is that public sector workers tend to have much more experience than their private sector counterparts, which might imply that they have had more time to develop their skills and so improve their productivity.

**Figure 8: Job Durations in the Private and Public Sectors, Scotland 2010**



Source: Labour Force Survey

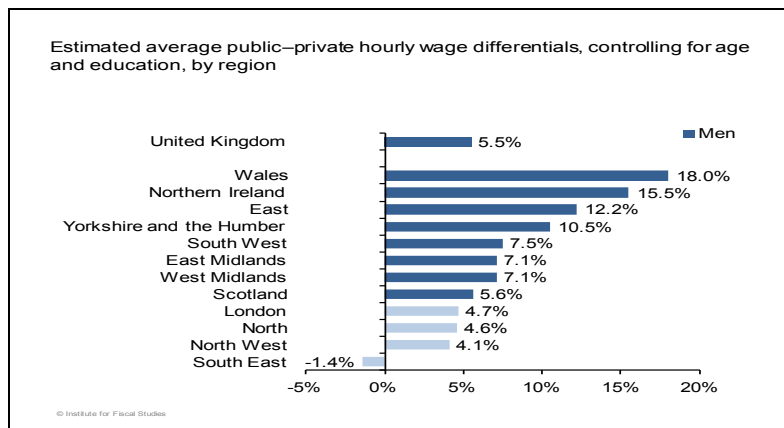
Employees experience is directly measured in Figure 8. It shows the proportion of workers with differing job durations in the private and public sectors. In Scotland in 2010, more than 40% of public sector workers had been in the same job for more than 10 years. In contrast, only 30% of private sector workers had been in the same job for 10 years or more. There is evidence that for some parts of the public sector, e.g. teaching, beyond a certain level additional experience is not necessarily associated with increased effectiveness<sup>3</sup>. Traditionally most public sector wage contracts have involved lengthy experience-related incremental pay scales, and there is now pressure to shorten these and link pay to measured contribution.

<sup>3</sup> See: Kane, Thomas J., Jonah E. Rockoff, and Douglas O. Staiger. 2008. "What Does Certification Tell Us about Teacher Effectiveness? Evidence from New York City." *Economics of Education Review*, 27(6): 615–31.

When researchers use statistical modelling methods and secondary data sets to identify ‘statistically’ identical public and private sector employees they usually control for the above differences between the workforces in the two sectors.

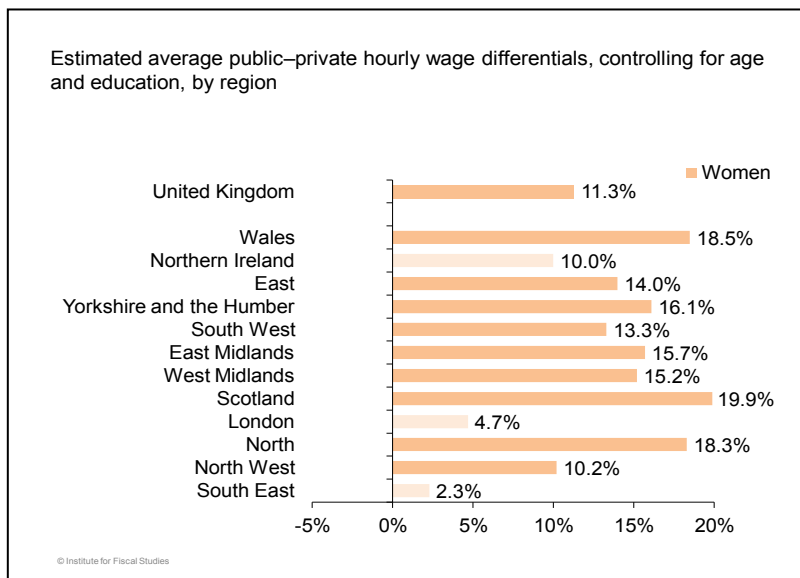
The Institute for Fiscal Studies (IFS) have recently used statistical method to estimate the difference between men in the public and private sectors of the regions and territories of the UK (see Figure 9). Controlling for just age and education they reveal that the premium in hourly pay is just 5.6% for men in Scotland in 2011 when the raw, unadjusted, difference in average hourly pay for men in Scotland in April 2011 recorded in ASHE was 21.3%. It is noteworthy that the adjusted premium is much lower than that in most regions of England and much lower than in Wales. There is no strong evidence that men in the Scottish public sector are substantially overpaid compared to men employed in the private sector.

**Figure 9: Estimated public sector pay premium for men**



Source: *The IFS Green Budget: February 2012*

**Figure 10: Estimated public sector pay premium for women**



Source: *The IFS Green Budget: February 2012.*

However the same cannot be said for women. Here the premium is nearly 20% in Scotland. It is the largest premium across the different parts of the UK (see Figure 10). There is no obvious explanation for this difference in the premium by gender, though it may reflect particular difficulties faced by women in the private sector in Scotland.

These estimates illustrate the importance of comparing like with like. Adjusting for differences in age and education really only matters if these factors affect employees' productivity; pay reflects productivity and any differential reward reflects differences in productivity. It is questionable whether beyond a certain age or job duration extra years make employees more productive and so accounting for all differences between the two sectors in age and job duration may not be appropriate. However true like-for-like comparisons would also account for differences in the nature of jobs, in the risk, stress and uncertainty of employment, in the two sectors. This again highlights the challenge of making 'true' like-for-like comparisons of employees in the two sectors.

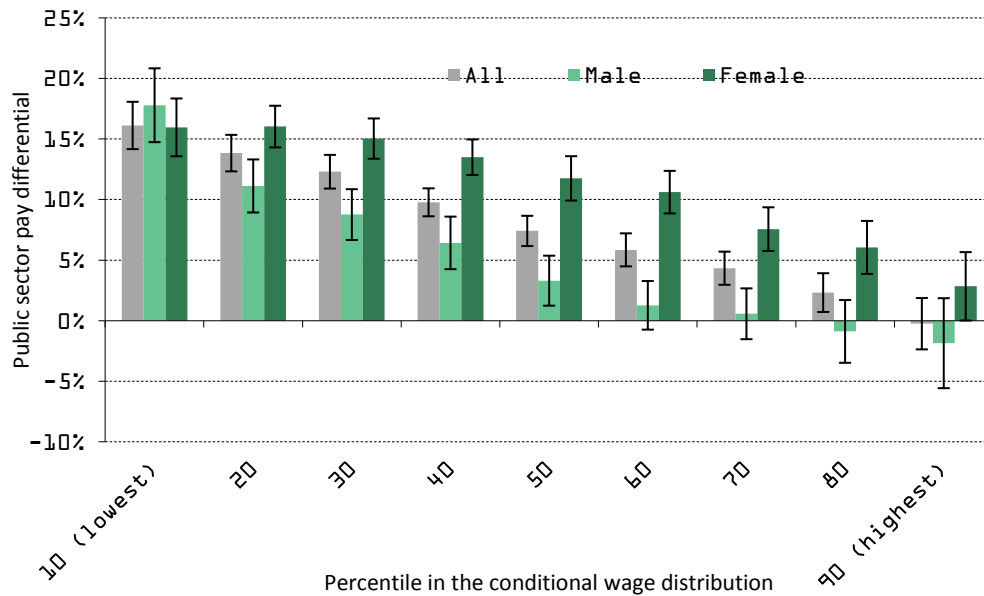
## **7. Pay Compression**

How much any public sector employee is paid relative to their private sector counterparts depends upon their position in the overall distribution of pay. The same study by the IFS also introduced a range of controls (for differences in education, age, region and qualifications), in order to identify otherwise identical employees, and compared pay at different points along the range from best paid to the poorest paid workers - the pay distribution. It revealed that the public sector tends to pay better at the bottom of the public sector wage distribution and pay less than the private sector rate at the top. In Figure 11, the height of each bar shows the gap between the (conditional) public sector wage and the private sector wage at different percentiles<sup>4</sup> of the wage distribution. These differences are expressed as percentages of the private sector wage. The error (black) bars show the confidence intervals. Figure 11 shows that the gap is over 15% for both men and women at the lowest decile and that at the 90<sup>th</sup> percentile, it becomes negative for men and falls to around 3% for women.

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<sup>4</sup> For example, if a worker is at the 75<sup>th</sup> percentile of the earnings distribution, he/she earns more than 75 per cent of workers and less than only 25 per cent of workers.

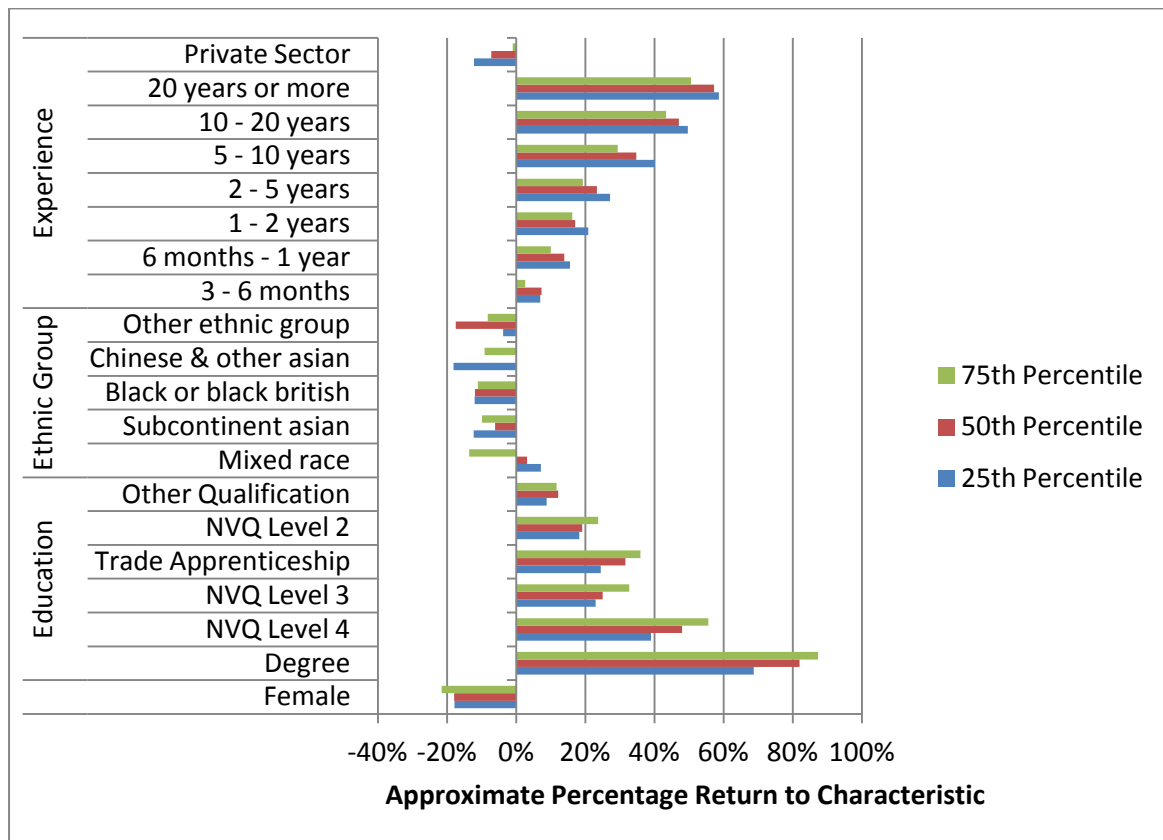
**Figure 11: Estimated UK public–private wage differential by percentile in the wage distribution**



Source: IFS Green Budget 2012, Figure 5.5, page 116 Calculations use weighted data from the Labour Force Survey, 2009Q2 to 2011Q1.

What is true for public-private wage differentials in the UK as a whole is also true in Scotland. We have used the Labour Force Survey, the same dataset as used by the IFS, to estimate the (hourly) wage returns to different individual characteristics in the Scottish labour market. These are shown in Figure 12. They are evaluated for well-paid workers (those at the 75<sup>th</sup> percentile of the earnings distribution), median workers (those at the 50<sup>th</sup> percentile) and relatively poorly paid workers (those at the 25<sup>th</sup> percentile). The results show that an employee with 10 to 20 years of service located at the 75<sup>th</sup> percentile of the earnings distribution receives a higher return to these years of service than someone at the 25<sup>th</sup> percentile. The results show that at the 75<sup>th</sup> percentile a degree enhances earnings by over 80% relative to having no qualifications.

**Figure 12: Hourly Wage Returns to Employee and Job Characteristics, Scotland 2010**

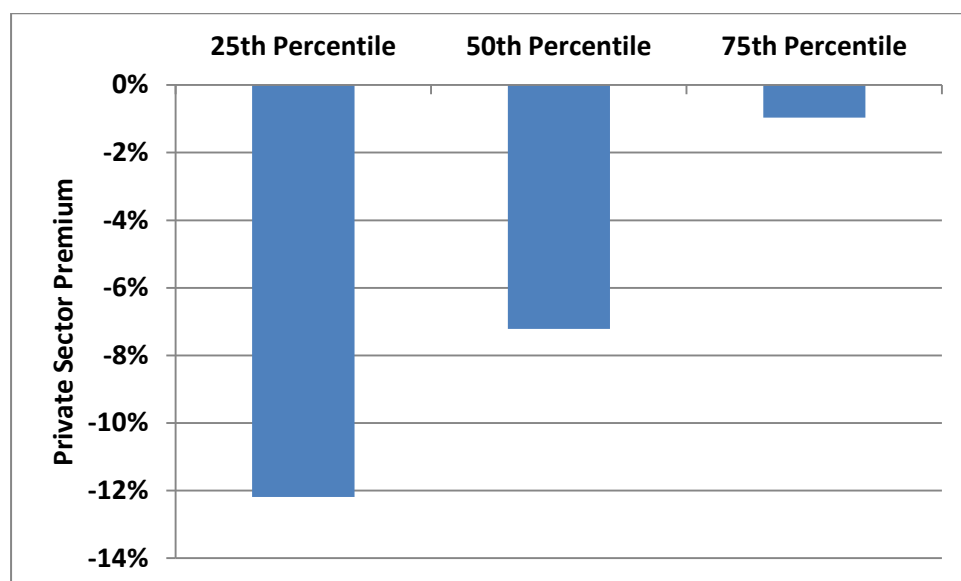


Source: Labour Force Survey Own Calculations

Of greatest interest in Figure 12 is the public sector wage premium which measures the difference in the hourly pay of public and private sector employees after controlling for all of the measurable differences between employees in the public and private sectors in Scotland. This is shown more clearly in Figure 13, which reproduces the private-public differentials shown at the top of Figure 12. Figure 13 confirms that the differential between the private and public sectors in Scotland is greatest among those with lower earnings. Public sector workers at the 25th percentile on average earn 12% more per hour than do those in the private sector with otherwise similar characteristics. At median earnings, the gap falls to 7%, while for high earners at the 75th percentile, there is no significant difference between the private and public sector hourly wages. This confirms that our results correspond with the IFS estimates for the UK as a whole as reported in Figure 11. The median in Figure 11 is the same as the median in Figure 9 and though the IFS do not report quartiles, interpolation of the values in the two surrounding percentiles suggests that again the values for Scotland and the rest of the UK are consistent. Indeed much of the analysis of that the IFS have conducted for the UK as a whole is consistent with our observations on the structure of pay in the Scottish labour market.



**Figure 13: Returns to Private Sector at Different Earnings Levels, Scotland 2010**



Source: Labour Force Survey Own Calculations

## 8. The evolution of the Public Sector Pay Premium

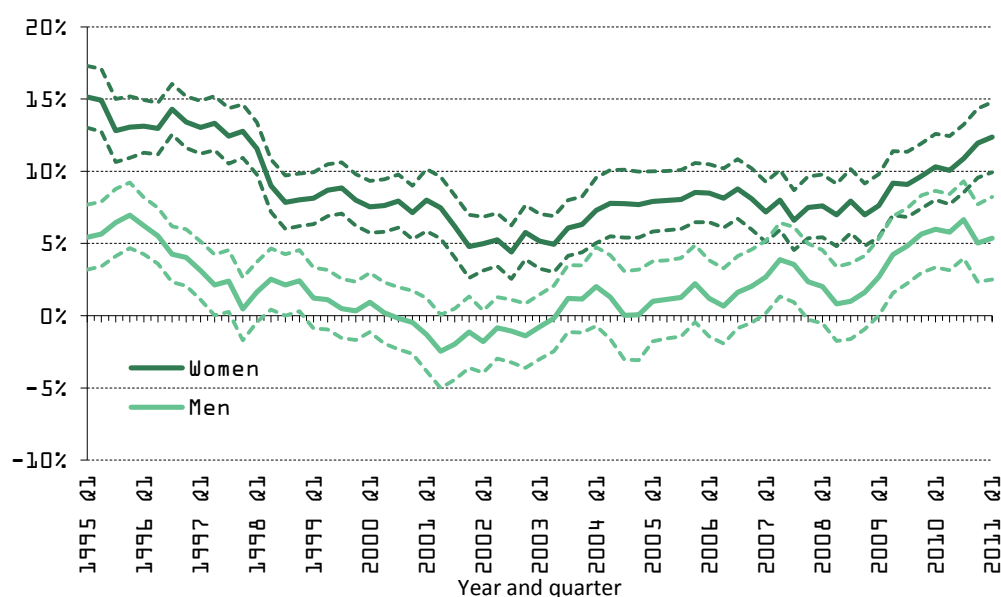
One of the reasons why the public sector pay premium stands at its current levels is the recent recession, which depressed private sector pay while the trajectory for public sector pay growth remained largely unchanged. This anti-cyclical behaviour of the public sector pay premium has been observed in earlier recessions<sup>5</sup>. Figure 14 reports IFS estimates of the public–private hourly pay differentials (after controlling for differences in individual characteristics) for men and women separately in Great Britain since 1995. The estimated public sector premium is always higher for women than for men and in the 10 years prior to the start of the recession in 2008, there was no significant public sector pay premium for men. However, since 2008, a public sector premium for men has started to emerge. It had reached almost 5% by the start of 2011<sup>6</sup> while the premium for women increased by a similar amount over the same period.

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<sup>5</sup> Elliott R. F. and Duffus K., “What Has Been Happening to Pay in the Public Service Sector of the British Economy? Developments Over the Period 1970-1992”, *British Journal of Industrial Relations*, Vol. 34, No. 1, 1996, p 51-86.

<sup>6</sup> IFS caution that a concern with the use of LFS data, which relies on self reported pay and sector of employment, might be the possible inclusion over time of parts of the financial sector in the public sector after the financial crisis. However they note that the proportion of public sector workers reporting that they worked in banking and finance increased from 2.8% in 2008Q2 to 3.5% in 2009Q2, but their average pay was only £1 an hour higher than the mean public sector pay.

**Figure 14: Estimated average public–private wage differentials over time**



Source IFS 2012 Figure 5.6 The dashed lines represent 95% confidence intervals. Each data point is based on a four-quarter LFS sample, ending in the labelled quarter.

In 2010, the UK government announced a two year public sector pay freeze and in 2011 it proposed further constraints in the two years following the end of that freeze. The IFS has estimated that if private sector pay growth recovers, the public sector premium is likely to disappear gradually for men. Table 2 below, reproduced from the IFS Green Budget for 2012, reports the OBR’s forecasts for public and private sector pay, taking into account the planned public sector pay squeeze. This shows that the public–private pay differential is forecast to fall by 4.4 percentage points between 2010–11 and 2014–15 and by a total of 6.1 percentage points by 2015–16. These IFS estimates suggest that the average public sector premium for men is likely to return to its pre-crisis level by 2014–15, which was close to zero. The female premium is also likely to fall back to its pre-crisis level. Of course, such conjectures depend heavily on the OBR’s assumptions and forecasts of future earnings growth.

Such a change in the wage structure is consistent with the rebalancing of the economy that is intended to occur in the next few years, which imply that both the public sector account (government spending and taxation) and the external account (imports and exports) should more closely balance. Resources will not be attracted into the private sector and to activities that focus on external demand, unless the wage structure is consistent with these objectives.

**Table 2. Implications of the pay squeeze for public–private pay differentials**

	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17
<i>OBR assumptions</i>						
Total employment (million) <sup>a</sup>	29.2	29.1	29.3	29.5	29.8	30.0
GG employment (million) <sup>b</sup>	5.5	5.4	5.3	5.1	4.9	4.8
GG employment (share)	18.6%	18.6%	18.1%	17.4%	16.5%	15.8%
<i>Average growth in:</i>						
Earnings <sup>c</sup>	1.6%	2.2%	3.6%	4.4%	4.5%	4.5%
Public sector pay <sup>b</sup>	2.0%	0.8%	2.6%	2.6%	3.1%	3.1%
Private sector pay <sup>d</sup>	1.4%	2.5%	3.8%	4.8%	4.8%	4.8%
<i>Change in public sector pay differential<sup>e</sup> (cumulative ppts)</i>	+0.5ppts	–1.1ppts	–2.3ppts	–4.4ppts	–6.1ppts	–7.8ppts

Source IFS green budget 2012 table 5.5

<sup>a</sup> Weighted average of OBR's employment forecasts from table 3.6 of <http://budgetresponsibility.independent.gov.uk/pubs/Autumn-2011-EFO-Charts-Tables129467.xls>.

<sup>b</sup> GG = general government. GG employment growth is calculated from total public sector pay bill and pay bill per head. Public sector pay bill per head is directly from table 2.20 of OBR's fiscal supplementary tables published with *Economic and Fiscal Outlook*, November 2011, available at <http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/>. Our calculations assume that public sector pay growth is the same as the OBR's forecast for GG pay growth.

<sup>c</sup> Source: IFS Chart C3.31 of <http://budgetresponsibility.independent.gov.uk/pubs/Autumn-2011-EFO-Charts-Tables129467.xls>.

<sup>d</sup> IFS calculate this line from the three lines above assuming that the share of general government in the UK workforce will follow OBR employment assumptions.

<sup>e</sup> Estimated from average growth in public sector pay less average growth in private sector pay.

The IFS also argues that the recent increase in the pay premium was the consequence of the recession and as such unintended. Though this may be true of the average differential there have been persistent differences in the pay premium at different points in the pay distribution. Differences in the public sector premium can also result from changes in the extent of overpayment at the bottom of the earnings distribution and underpayment at the top. Most importantly eliminating the mean difference through a policy that imposes uniform pay restraint at all points on the pay distribution does nothing to address the issue of differences in the wage distributions in the two sectors. When compared with the private sector, the public sector pay structure appears to be too compressed.

Compression was recognised as an issue in the period before the recent recession. Seeking to address issues of underpayment at the top of the public sector pay distribution, the previous Labour administration set out quite deliberately to change the public sector wage structure. It offered higher rewards to some public servants in the most senior positions. The pay of head teachers in England and the most experienced and skilled hospital doctors was increased.

Some of these adjustments to the public sector pay structure, those for hospital doctors carried through to Scotland but not all. Changing the public sector pay structure is a vital issue confronting Scottish Governments, irrespective of the constitutional settlement.

## 9. Pay Compression and union membership

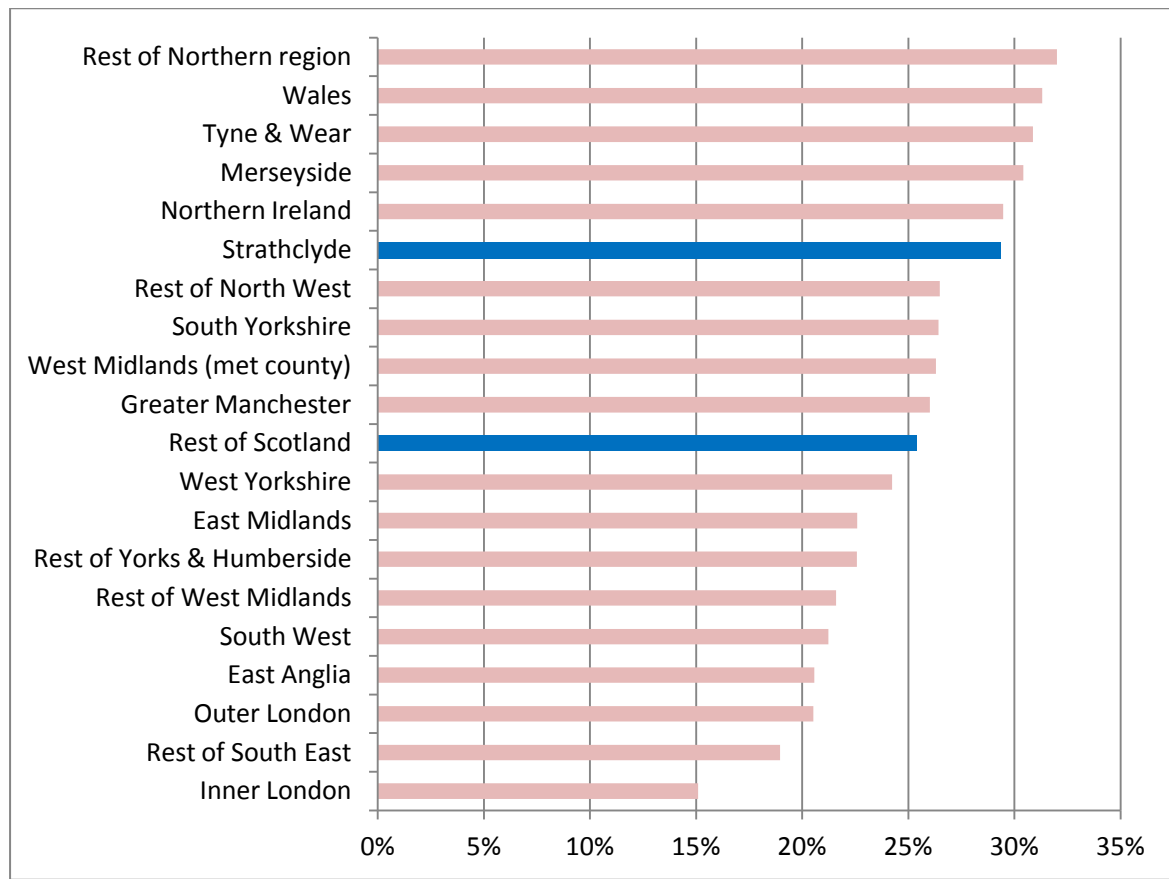
The explanation usually offered for the more compressed pay structure in the public sector is that pay is set by institutions and not the market. These institutions are trade unions, when pay is set through collective bargaining, and Pay Review Bodies; both appear to emphasise considerations of equity and fairness when setting wages. Union membership is higher in the public sector than in the private sector in Scotland as Table 3 shows. Scotland also has higher union membership than England and Strathclyde has one of the higher rates of unionisation in the UK, as shown in Figure 15

**Table 3: Private and Other (including Public Sector) Union Membership Rates 2011**

	Private Sector	Other (inc. Public Sector)
Strathclyde	15.1%	66.1%
Rest of Scotland	15.1%	43.9%
All of Scotland	14.6%	58.9%
England	12.2%	54.3%

*Source: Labour Force Survey*

**Figure 15: Union Membership Rates 2011**



Source: Labour Force Survey

There are other ‘institutions’ affecting the wage structure in the public sector; public opinion mediated by the actions of politicians also influences wage setting. As recent discussion of rewards for Chief Executives in Local Authorities and public sector banks bear witness, the public appear to have an aversion to high rewards for senior public servants. There is a widespread view that those in the most senior public sector jobs should not be rewarded at levels similar to their private sector counterparts. In this respect unions policy and public sentiment align.

It is noteworthy that the public sector wage structure in Scotland is more compressed than that in the private sector and more compressed than that in the public sector in England. Table 4 shows that the ratio of pay at the highest decile to pay in the lowest decile is much smaller in the public sector, between 4.75 and 5.83 depending on the data source and year used, than it is in the private sector where it is between 7.6 and 8.24. Pay is more compressed in the public sector, or, put another way, there is much greater pay inequality in the private sector. Pay inequality is another potentially difficult issue for the Scottish Government.

**Table 4: Dispersion of Gross Weekly Pay: Private and Public Sectors in 2011**

	<i>Ratio of Highest to Lowest Decile in the :</i>	
	<i>Public Sector</i>	<i>Private Sector</i>
<b><i>Scotland</i></b>		
<i>LFS 2003</i>	5.18	7.74
<i>LFS 2010</i>	4.75	8.24
<i>ASHE 2011</i>	5.25	7.60
<b><i>United Kingdom</i></b>		
<i>ASHE 2011</i>	5.83	8.16

Sources: Labour Force Survey and Annual Survey of Hours and Earnings April 2011

## Conclusions

An independent Scottish government would have to play a much more prominent role in the setting of public sector pay. Indeed it would have to take a much greater interest than does the current government in the determination of pay generally. Our chapter has revealed a number of important issues: first, the Scottish government would have to take control over pay determination in areas such as the health service, police and the fire service. It would also have to take responsibility for the setting of pension contributions and the payment of pensions across the whole of the public sector. This would mean it will have to take a more responsible attitude to discussions of pensions, just as greater responsibility over taxation will force it to evaluate more carefully the costs and benefits of varying tax rates.

Second, there is the issue of pay compression. At the lower end of the pay distribution, this concerns the relatively large premium associated with working in the public sector. Higher wages in the public sector makes it more difficult for the private sector to attract workers. This might be alleviated if the private sector was more productive. There is certainly a compelling case for implementing cost-effective policies that promote such productivity improvements but if such intervention fails to bear fruit, the Scottish government would have to be clear with the public about the taxpayer costs involved in maintaining the public sector premium at the lower end of the earnings distribution. The Scottish Government has opposed local market facing pay arguing that it would be damaging to local economies across Scotland and place further pressure on family incomes. However it can also be argued that the existence of this premium favours a particular group of workers in the public sector over workers with equivalent characteristics in the private sector and may inhibit the long-run fiscal rebalancing of the economy which seems inevitable for both Scotland and the UK, given the size of recent fiscal deficits.

At the other end of the wage spectrum, relative rewards to public sector employees are apparently less generous. However, one should be careful about assuming that rewards for “high-fliers” in the private sector necessarily reflect market rates. There has been considerable disquiet about rewards to those at the top of private sector organisations in the recent past.

The UK Government commissioned Will Hutton to look into the so-called “rewards for failure” culture that seemed to exist in many private sector companies.

It is clear that rewards to directors in the private sector have increased much more rapidly than have returns to shareholders. Hence the differentials in pay between the private and public sectors at the extreme upper end of the distribution have to be interpreted with care. However, this again is an area for which the Scottish government has not taken responsibility in the past, but in which political pressure would be likely to force it into taking a position.

Many of the institutions that deliver Scottish public services are now quite distinct from those in the other territories of the UK and independence would inevitably be accompanied by a further redesign and refocusing of Scotland’s public services. This would need to be accompanied by pay reform which would need to pay close attention to the structure of rewards in the public sector. The motivation for pay reform would be to improve outcomes for citizens. Indeed if levels of service are to be maintained in the face of the current severe fiscal austerity, it appears unavoidable that public sector pay setting in Scotland will need to be reformed. Reform will not succeed unless public sector wages meet the objectives elucidated by the IFS and listed earlier in this chapter.

This chapter has suggested a range of additional areas relating to public sector pay which a responsible Scottish government, irrespective of the constitutional arrangements, could not afford to ignore. There are clearly many difficult issues, both economic and political. Scottish government policy in relation to public sector pay will be an important political indicator. But it will also reflect the commitment to improve the delivery of public services during a time of severe financial pressures and a rebalancing of the economy.





## **Public Sector Pay Bargaining Arrangements and Grade Structures**

**Alastair Hatchett**

Over the past decade we have seen substantial changes to pay systems and grade structures in the public services across the UK, with pay modernisation changes taking place in the NHS, local government, higher education and elsewhere. As a result of these changes there have been pressures on existing bargaining arrangements but the overall picture is still one dominated either by the Pay Review Body process or by national collective bargaining arrangements.

Subsequently these bargaining arrangements and grade structures have come under increased pressure because of the four-year incomes policy for the public sector set by the Coalition from April 2011 with a two-year pay freeze followed by two years with a pay cap of 1 per cent. As yet it is unclear what the long-term implications of this policy will be on industrial relations in the public sector, with much of the existing bargaining machinery put on ice for a considerable period.

For historic reasons not all bargaining arrangements cover the same geographical regions or nations of the UK. Some pay arrangements currently cover the whole of the UK, some cover England and Wales, and a number cover Scotland only. The Pay Review Bodies only cover employees in Scotland if they are in UK-wide organisations such as the NHS. Scotland has separate bargaining arrangements for school teachers, local government workers, the Scottish prison service and civil servants working for separate departments or agencies that are solely Scotland based, such as the Scottish Executive and the Scottish Courts Service.

### **Pay modernisation**

A move towards what became known as pay modernisation began at the end of the 1990s with agreement to reach single status arrangements in local government and a new national pay scheme in the NHS. The focus at the beginning of the 2000s was on developing new national pay structures with differing degrees of local flexibility in each case. In parallel developments, such schemes were developed and then implemented in the NHS, local government in England and Wales and in Scotland and in higher education.

This involved a new job evaluated grading structure for the NHS called Agenda for Change, initially discussed in 1997/98. It was developed centrally and then implemented throughout the health service in each trust. This was done through national and local level collective bargaining. With the system in place by 2005, annual pay uplifts have been the responsibility of the NHS review bodies including the Doctors and Dentists' Review Body.

In local government agreements to reach single status were reached in 1997, with implementation taking place over the next decade. This involved negotiating a national pay spine in England and Wales with local-level grading to place staff on the spine at each council. There were parallel negotiations in Scotland to achieve single status in local government over the early 2000s. In higher education a national framework was agreed across the UK, with a national pay spine and substantial freedoms to place staff on the spine at each institution, depending on local determination.

Much of this emphasis on new national, but flexible, arrangements came as a reaction to the 1990s when the Conservative administration pursued a local pay strategy.

There had been calls for the abolition of national pay bargaining in the public sector in the late 1980s. A number of changes took place over the period 1992/94 which involved devolved bargaining in the civil service, local bargaining in the NHS and the abolition of the Wages Councils.

National pay bargaining for the entire civil service was ended in the early 1990s and devolved bargaining introduced, with pay being set via joint bargaining arrangements across each department or agency. This led to over 150 new joint bargaining bodies throughout the civil service, varying considerably by size, the largest being in the DWP.

Over the period from 1993 to 1995, the government moved to local pay bargaining in the NHS with the idea that each trust would follow an independent route. In the event, after three or four years, this experiment was deemed a failure as almost all trusts agreed the same pay rise. As a consequence, a countervailing pressure developed to replace local bargaining with a nationally agreed job evaluated structure which became 'Agenda for Change', covering all of the NHS across England, Scotland, Wales and Northern Ireland.

### **Equal pay issues**

Many of the moves towards pay reform and modernisation were driven by issues to do with equal pay inherited from the previous period. Men and women were being paid different wages and salaries for doing like work. Hence the emphasis on new pay spines that had job evaluated grade structures and the moves to single status in the early 2000s.

### **The Pay Review Body System**

The Pay Review Body system has spread to more groups of employees over the past twenty years. The most recent addition was the Prison Service in 2002, covering prison officers in England, Wales and Northern Ireland. The system was further extended in 2004 to include all of the NHS staff, bringing in the support staff and administrative grades, who had been brought on to the Agenda for Change terms and structure (the NHSPRB). Prior to this the Pay Review Body for NHS staff covered nurses, midwives and the professions allied to medicine.

The inquiry into police pay conducted by Sir Clive Booth in 2007 recommended that the police have their pay determined by a review body but this was kicked into the long grass. The Police Federation had noted that the Prison Officers' Association had given the Pay Review Body system very critical reviews. Currently, police pay is set by the Police Negotiating Board (PNB), the previous indexation systems having been ended by the last Labour Government. Currently, the pay system for the police covers the whole of the UK. The latest inquiry into police pay under Tom Winsor (2012) again suggests that the PNB be replaced by a Pay Review Body.

The NHSPRB covers around 1.5 million NHS staff. The School Teachers Review Body (STRB) sets the pay arrangements for around 480,000 teachers in England and Wales. Teachers in Scotland have separate national collective bargaining. The Armed Forces PRB (AFPRB) sets pay for all of the UK armed forces amounting to 175,000 people. The Doctors and Dentists PRB sets the broad terms of pay for 186,000 doctors, dentists and salaried GPs across the UK. The Senior Salaries Review Body sets the pay of 4,000 senior civil servants across the UK.

Pay Review Body pay determination can be seen as a form of tripartite pay bargaining with the Treasury, the employers and the unions making submissions to an independent body. It is similar to collective bargaining but not quite the same, but does involve an evidence-based approach to the outcomes.

In the past, the Treasury frequently staged Review Body pay awards, considering them to be too high. However in the last decade the Treasury has increased its grip on the system and demanded increasingly tight pay budgets.

A dominant theme in the period 2005 to 2012 has been the challenge to the independence of the Pay Review Body system. Criticism of the lack of independence has been raised, in particular, by the British Medical Association and the Prison Officers' Association, both of whom have been unhappy about increasing Treasury control of the process and the changes to the remit which came to stress affordability above all other considerations.

Increasingly through the period 2005 to 2012, the Treasury – first under Labour and then under the Coalition – has set increasingly tight constraints on pay rises, culminating in the unprecedented two-year pay freeze from 2011 to 2013 which has been followed to the letter by the Pay Review Bodies, calling for increases to average no more than 1 per cent in the two years from 2013 to 2015. This incomes policy for the public sector has left the unions and the royal colleges questioning the future of the Pay Review body system.

### **National collective bargaining arrangements**

National Joint Councils negotiate pay rises for local government employees in England and Wales and separately for local government employees in Scotland. In higher education there are UK-wide pay arrangements whereby a nationally set rise is applied to the new single pay spine under the national Framework Agreement. In further education there are separate national pay bargaining arrangements in England, Wales and Northern Ireland. In Scotland, there has been no national pay agreement in FE since 1996 with salary levels decided by individual colleges.

There is a UK-wide pay structure for the fire brigades with an NJC for Local Authority Fire and Rescue Services. Like the police, the fire service previously had pay determined by indexation following the resolution of a pay dispute in 1978. This annual indexation process was ended by the Labour Government in 2007/08. The future of pay arrangements for the fire service is yet to be defined.

Police support staff have pay set via national collective bargaining with separate systems and structures for England and Wales on the one hand and Scotland on the other. There was to have been a national pay body for all school support staff – the School Support Staff Negotiating Body – but this was abolished by the Coalition government before it had had a chance to begin its work.

### **Mistaken assumptions about Government control of pay**

The Chancellor of the Exchequer, George Osborne, had previously announced pay freezes for two years across the public sector in the UK. He can do so as an instruction to the civil service and to the Pay Review Bodies. However, he has no formal powers to bring this into effect in local government or the university sector, but this can be achieved via cuts in funding. Participation in multi-employer national pay bargaining is voluntary on the part of local authorities and universities (and higher education generally) and in both sectors there are some employers who choose to vary pay locally. Around 30 local councils in the south east of England left the NJC for local government in the late 1980s – mostly to pay more in a period of tight labour markets.

The local government employers in England and Wales have frozen pay from April 2010 and April 2011, but did not follow Government policy as they did not pay an underpinning £250 to those earning below £21,000 a year. They are intending to freeze pay again for a third year from April 2012.

A small number of councils have acted at local level to cut pay rates by up to 4 per cent. Substantial cuts in funding have also meant large-scale job cuts in local government and changes to other terms and conditions.

### **Higher education institutions**

In the higher education sector, the Government is not party to pay determination and the sector is not formally covered by Government policy. In fact modest (very modest) pay rises have been offered and reluctantly accepted in each of the past three years, when other bodies have had pay freezes. Individual universities can choose whether to be included in national – effectively multi-employer – negotiations between the University and College Employers Association (UCEA) and the unions in the HE sector. Pay bargaining in the HE sector covers all the nations within the UK and although individual institutions sometimes express frustration with the process the vast majority has continued to stay within the national framework set by UCEA and the unions.

### **New pressures for change**

In Chancellor Osborne's Autumn Statement on 29 November 2011 he raised the perennial issue of regional or local pay. He announced that: 'We are asking the independent Pay Review Bodies to consider how public sector pay can be made more responsible to local labour markets – and we will ask them to report back by July next year.' Mrs Thatcher tried this, as did Mr Major. Local pay bargaining was tried in the NHS in the mid-1990s and was deemed by all concerned to have been a complete failure. Mr Gordon Brown, while Chancellor, pushed the idea of regional and local pay and even tried to construct regional prices indices to assist with this, but this project was shelved.

There is a mistaken belief in HM Treasury that all private sector companies set pay with reference to local labour markets. The Autumn statement said that: 'While private sector pay is set in accordance with local labour markets, public sector pay is usually set on a national basis.' The truth is that large companies that operate on a multi-site basis, and are therefore a proxy for large public sector organisations, operate with national pay structures, set centrally. These large multi-site firms, such as banks and supermarkets operate with a limited number of London and South East allowances or pay zones. Large retailers tend to operate with four or five pay zones across the UK and find that outside the South East there is much more similarity than difference in pay levels and labour markets. Most companies find skill levels much more important than geography.

By March 2012 the Treasury had changed its view, in part due to research by IDS challenging the Treasury's view of pay setting in large multi-site companies in the private sector. In its evidence to the Pay Review Bodies in March, the Treasury said: 'While large private sector employers tend to retain a national bargaining structure, they often create a number of zones to gain greater wage efficiency.'

Experiments in the direction of zonal pay arrangements have been made for school teachers in England and Wales and for the staff at the Ministry of Justice. The School Teachers Pay Review Body (STRB) changed the pay system from one with inner London, outer London and South East allowances sitting on top of a national pay structure for England and Wales to one with four pay zones which mapped across to the previous national structure with the three sets of allowances. Unlike zonal systems in the private sector, the STRB stopped short of allowing schools to apply to change zone for higher pay to respond to high staff turnover or problems in recruiting.

It was originally (in 2004) wary of producing a system that would allow pay leapfrogging between schools or create a market for teachers that would follow the money. However, in 2008 it suggested that some movement between the zones might be appropriate.

The Coalition has also called for a review of how more local, market-facing pay could be introduced for civil service departments, for civil servants below the senior civil service.

One consequence of devolved pay bargaining across the departments and agencies is that huge differences, sometimes of several thousand pounds, have developed between people on the same grade and doing like work. Not only does this sit badly with the fairness agenda and is open to equal pay challenges, it does not fit well with the notion of market pay benchmarking.

The debate on regional or local pay ebbs and flows. After evidence presented to the Treasury from IDS in 2002/03 the Treasury went rather cautious: ‘At the extreme, local pay in theory could mean devolving pay...to local bodies. In practice, extremely devolved arrangements are not desirable. There are risks of workers being treated differently for no good reason. There could be dangers of leapfrogging and parts of the public sector competing against each other for the best staff.’ There is a good deal of sense in this comment that current policy makers might think about. Varying pay ‘for no good reason’ will not pass the equal pay test. Creating markets in teachers, nurses or social workers might have unintended consequences that policy makers might regret.

## **Conclusions**

Existing pay bargaining arrangements covering all or the different nations within the UK have evolved over many years. It may be that these arrangements continue in the short to medium term. Separate bargaining machinery exists in Scotland for local government and for school teachers. The NHS Employers, in evidence to the NHS pay Review Body on the question of regional pay (2012), say that they favour retention of a UK wide pay system – Agenda for Change. Changes to introduce more ‘market-facing’ pay in the civil service might mean a more regional or zonal focus, but that might have industrial relations consequences that might create internal labour market tensions in Scotland, as opposed to intra-national tensions within the UK.



## Public Sector Remuneration In Scotland After The Referendum The Employers' Perspective

Eddie Frizzell and Bill Howat

### Introduction

Public sector remuneration is important. The public is entitled to high quality evidence-based policy making and first class, efficient services. The public service therefore needs to be able to attract high quality staff and retain and motivate them to do a good job. Public sector employers compete with the other sectors whose success also depends on having a qualified and motivated workforce. But staff costs are a high proportion of the cost of most public services: pay accounted for half of the Scottish Budget according to Audit Scotland<sup>1</sup> in 2009, so control over the public sector wage bill always matters, and is essential at a time of severe public expenditure restraint.

Public sector remuneration is also a political issue. This is especially true in Scotland where the public sector has relatively greater rates of union membership (as highlighted in the Bell/Elliott paper). Moreover, while the public may consider that 'front-line' workers should be adequately remunerated, there appears to be low tolerance of what they are told by the media are overpaid bureaucrats and managers. As Will Hutton observed in his Fair Pay Review: "while the British public is very sympathetic to front line delivery staff, it is hostile to the public sector managers responsible and accountable for the effective deployment of resources – and even more hostile to their pay. In the eyes of some, they are the quintessential 'burdens' on the rest of us".<sup>2</sup> We shall leave open the definition of 'front line' in this paper.

This hostility has been exacerbated by the banking crisis. Bonuses and salaries in the public sector attract attention and Hutton notes the perception, despite evidence to the contrary, that the public sector is no less awash with 'fat cats' than the private sector. We shall consider later the question of bonuses: let us simply note at this point that as they are a media obsession, politicians have felt compelled to take a populist view. Informed debate appears impossible.

None of this is particularly new, or unique to Scotland. But given the numbers employed in the public sector and the proportion of the Scottish budget accounted for by pay, political and financial considerations will be significant in an independent Scotland or one in which the Scottish Government otherwise becomes responsible for raising most of, or all, the money it spends<sup>3</sup>. There are trade-offs between jobs and remuneration and there is also a regional dimension as the proportion of public sector jobs increases with remoteness, and in more remote areas public sector jobs also offer greater security (see Bell/Elliott, figure 4).

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<sup>1</sup> Scotland's Public Finances Preparing for the Future. Audit Scotland, November 2009

<sup>2</sup> Hutton Review of Fair Pay in the public sector: Final Report, March 2011

<sup>3</sup> Let us call this "devomax" as a convenient shorthand

The importance of public sector jobs has been highlighted by the Scottish Government's promotion of a 'no compulsory redundancy' policy in dealing with the austerity measures. That, in turn, has encouraged a more realistic approach from public sector unions towards the pay freeze, at least in the short term. After the referendum, the politics and costs of public sector jobs and remuneration will loom large and will pose difficult challenges for Ministers as policy makers, paymasters and direct employers of staff (the civil service) themselves.

How challenging will depend on the state of the public finances in Scotland under independence or devomax, which is in turn dependent on the performance of the Scottish economy. This will continue to be much considered in the independence debate, and this paper is not the place to enter that fray. Suffice to suggest that, whatever the long term prospects, the economic outlook does not indicate that any transition to independence or devomax sometime after 2014 will take place in the most propitious financial circumstances. Nor is any oil-related, low corporation tax-based, boom of the kind predicted by proponents of more fiscal autonomy likely to materialise any time soon.

There will be no quick fixes, before or after 2014, and a more benign public expenditure climate is some way off. In 2010 the Scottish Government's then Chief Economic Adviser suggested that a return to spending growth in line with growth in the wider economy was unlikely before 2016-17 (the year of the first post-referendum Scottish Parliament Election)<sup>4</sup>. The current Chief Economic Adviser notes that Scottish public spending is not expected to grow again in real terms until 2017-18, and confirms previous advice that it could take until the mid-2020s for the Scottish budget to return to its 2009-10 peak in real terms<sup>5</sup>. So public sector remuneration will be a continuing issue, and for employers questions arise as to what freedom they will have up to, and beyond, independence or devomax to tailor reward and remuneration to the requirements of their organisations, what bargaining arrangements will be involved, and whether they will be able to recruit, retain and motivate the people they need.

### **The Civil Service in Scotland**

Governments determine public sector pay policy and are employers in their own right. They face challenges similar to other public sector employers. On the other hand, when the squeeze is on, the pay and conditions of their own workforce are the softest targets. In Scotland the remuneration of civil servants below the Senior Civil Service (SCS) – Deputy Director level – was devolved from Whitehall long ago. For many years, therefore, negotiations on the remuneration of almost all Scottish Government employees have taken place within a pay remit set by Scottish Ministers, with a nod to wider UK public pay policy. This usually allowed some flexibility within the overall cost envelope, but Ministers have had the final say on agreements reached.

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<sup>4</sup> Outlook for Scottish Government Expenditure: Emergency Budget Update. The Scottish Government, July 2010

<sup>5</sup> The State of the Economy. The Scottish Government, Office of the Chief Economic Adviser, March 2012



The 2012-13 Scottish Government Pay Policy for its own staff continues the previous year's pay freeze and withdraws access to non-consolidated (i.e. non-pensionable or bonus) payments, but requires the payment of a "Scottish Living Wage" and permits flat rate payments of at least £250 for staff earning below £21,000. It allows "exceptional and modest" pay increases for staff whose base salary is just above £21,000, and limited flexibility to ensure that these measures "do not undermine the structure of organisational pay scales"<sup>6</sup>.

The arrangements for civil service pay bargaining in the Scottish Government would not have to change in an independent Scotland, far less a devomax model. But independence would bring three developments. First, the Scottish Government would have to implement its 2007 Manifesto commitment to having a Scottish civil service, to which its existing workforce would transfer, as the option of remaining in the UK civil service and redeploying to Whitehall Departments would be unlikely to arise.

Second, this workforce would be swelled by the importation of much of the currently reserved civil service workforce in Scotland (currently around 30,000)<sup>7</sup>, following the transfer of functions from the Westminster Government. It is difficult to forecast the precise numbers this would add to the roughly 17,000 currently employed in the Scottish Government and its agencies, but one might anticipate the transfer of UK Border Agency personnel plus up to 20,000 staff in HMRC and DWP/Jobcentreplus already based north of the border, as an independent Scotland would need to collect its own taxes and pay its own benefits.

Nor is it clear what proportion of the approximately 12,000 armed forces personnel, and other MOD jobs would transfer, or indeed what the staffing requirement for a Scottish Diplomatic Service and beefed up Finance/Treasury function might be. However, the potential doubling, or more, of the number of civil servants and a substantial increase in the proportion delivering frontline public services will change the dynamic of pay bargaining. This will add a new dimension to the pressures on the Scottish Budget and Ministers as employers, and will require senior managers involved in pay negotiations to raise their game.

Third, the remuneration arrangements for senior managers themselves would change, with the Scottish Government taking responsibility for setting the pay of the Senior Civil Service (SCS), currently determined by the Cabinet Office, informed by the Review Body on Senior Salaries (RBSS). As the size of the SCS in Scotland is small and reducing, and as its pay accounts for less than 0.5% of the Scottish public sector paybill, this new responsibility is unlikely to be a burden, either for negotiators or taxpayers. A decision would however be required in an independent Scotland on any continuing role for the RBSS, including in determining senior pay of its other remit groups – notably the judiciary and the armed forces, if an independent Scotland were to have its own military.

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<sup>6</sup> Public Sector Pay Policy for Staff Pay Remits 2012-13. The Scottish Government, September 2011

<sup>7</sup> Public Sector Employment in Scotland, The Scottish Government and National Statistics Publication for Scotland, December 2011

## **Non Departmental Public Bodies (NDPBs)**

The Scottish Government pay policy currently applies to all NDPBs, almost all devolved Public Corporations, and top NHS managers. To a large extent NDPBs have had flexibility to set pay structures and remuneration on the basis of affordability and a running cost envelope which Ministers considered acceptable on financial and presentational terms, but the rules are now tighter. To all intents and purposes Board and management discretion over pay has been withdrawn.

The policy also applies to senior managers. The Scottish Government has moved decisively to bear down on Chief Executive salaries. While NDPB Chief Executive appointments, including initial remuneration, have always required Ministerial approval, the Scottish Government has strengthened the role of its Remuneration Committee – chaired by a non-Executive Director on the Permanent Secretary’s Strategy Board – and given it oversight of a defined Framework for the remuneration of Chief Executives on appointment.

In addition to the presumption that new NDPB Chief Executives will be paid at least 10% less than the previous incumbent, the Framework lays down pay bands and maximum and minimum salaries, and sets out Ministers’ ‘expectations’ on a range of detailed matters that would previously have been left to the employer, including that any bonus arrangement in a Chief Executive’s contract will be removed when an appropriate opportunity arises.

NDPBs are required to submit a formal business case for Ministerial approval before any Chief Executive post is advertised. For remuneration, Boards are required to take account of comparable posts in other relevant parts of the labour market, defined as the Scottish public sector labour market “which includes Scottish public body Chief Executives in the same Pay Band”<sup>8</sup>. Boards are also required by the Policy to consider the relationship and pay differentials between the remuneration of the Chief Executive and that of members of the senior management team.

The setting of a Framework for Chief Executive appointments goes with the grain of proposals in the Hutton Review and it remains to be seen whether in future Scottish Ministers would wish to impose pay caps (an option rejected by Hutton) or require public bodies to have regard (as Hutton proposes) to the ratio of the Chief Executive’s remuneration to the median within the organisation. Nor is it clear what the future holds for performance pay and bonuses, an issue to which we return below. However, having tightened the screw on public body pay arrangements generally and senior appointments in particular, it would be surprising if a future Scottish Government would readily contemplate a return to a more relaxed and empowering regime. This could impact negatively on NDPB Boards’ ability in future to recruit and retain senior managers<sup>9</sup>.

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<sup>8</sup> Public Sector Pay Policy for senior appointments 2011-12: Technical Guide. The Scottish Government, January 2011.

<sup>9</sup> The policy may also have implications for the ability of Ministers to recruit Board members, as their remuneration is also being curtailed (but that is not a matter for this paper).

Detailed and prescriptive though these controls may be, they cover less than 10% of the devolved Scottish public sector pay bill,<sup>10</sup> so the presentational benefit for Ministers is perhaps greater than the impact on total public sector wage costs. In fact, by far the biggest proportion of public sector remuneration (between 80% and 90%) is either subject to arrangements which involve UK-wide independent pay review bodies or national Scotland-wide negotiating frameworks in which there are others who also have a say, or – as in the case of local government – is at present beyond the scope of central government pay policy.

### **The National Health Service Scotland (NHSS)**

The pay of NHSS staff other than very senior managers is determined on a UK basis through UK negotiating bodies. The Review Body on Doctors' and Dentists' Remuneration makes recommendations on hospital doctors and dentists, public and community health doctors, ophthalmic medical practitioners, general medical practitioners, general dental practitioners, and community dental and dental public health staff, while the NHS Pay Review Body (NHSPRB) covers all other staff in the NHS, except very senior managers. These bodies are serviced by The Office of Manpower Economics (OME), a non-statutory body independent of Government in its operational, delivery and support roles, but staffed by UK civil servants.

It is open to government on either side of the border to accept or reject Review Body recommendations, or to accept them in part. In Scotland Ministers, including SNP Ministers, have generally not wished to see a divergence in Scotland from England and Wales, and recommendations from NHS Review Bodies accepted by Westminster have been applied in Scotland, albeit on both sides of the border with some scope for local negotiation on specific issues. In 2012-13 NHSS clinical and other staff earning over £21,000 a year are subject to a pay freeze similar to that applying across the public sector.

In an independent or devomax Scotland Ministers would as now have to consider whether they could afford to apply settlements similar to the rest of the UK, but without the budget revenue from Barnett formula consequentials. Affordability aside, Ministers in an independent Scotland would also have to decide whether it was appropriate to rely on arrangements serviced by a body (OME) staffed by employees of a foreign (albeit Commonwealth) government, and - more importantly - whether they wished an analysis increasingly informed by the needs of a service likely to be evolving differently from NHSS.

This is already in Scottish Ministers' minds. The Cabinet Secretary for Health and Wellbeing announced towards the end of 2011 that the time was now right to ask whether the UK basis for negotiating the work contract for Scottish GPs was still appropriate. This was because she considered the NHS reforms in England to be a threat to the contract's ability to ensure Scottish patients received quality care. Her proposal was not to “recast the structure of the contract but instead to repatriate aspects of the annual negotiation in order to introduce change in some important areas.”<sup>11</sup>

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<sup>10</sup> The Independent Budget Review (The Scottish Government, July 2010) presents in Chapter 4 and at Table 4.2 a useful breakdown of the key components of the Scottish Public Sector pay bill in 2010-11.

<sup>11</sup> More Scottish Focused GP contract. Scottish Government News Release, 18 December 2011

On the other hand the Cabinet Secretary for Finance and Sustainable Growth set out his objections to regional pay differentials in a letter to the OME<sup>12</sup> in the run up to the Chancellor of the Exchequer's Budget Speech announcement<sup>13</sup> that he was minded to introduce regional pay for the UK (reserved) civil service and was seeking advice from UK Pay Review bodies, other than - at least for the time being - those covering doctors and dentists, and the police, by July 2012

The Cabinet Secretary's objections focused on the issue of regional pay within Scotland, and noted the risks of pay competition and recruitment issues. It remains to be seen where all this will lead, but independence would make the logic of a break from the current system of UK review/negotiating bodies very difficult to resist. As an alternative, Ministers could decide to set up Scottish review/negotiating bodies, or leave it to Scottish Health Boards collectively to negotiate terms and conditions and changes to pay within a Framework and pay remit set by the Scottish Government. Direct negotiation would have the advantage for employers and Government of removing the potential problem of independent bodies recommending pay increases higher than the Government wished, or was able, to fund. The disadvantage for the Government would be the loss of a helpful shelter behind which to hide. For both employers and staff, the downside of a break in the link with the rest of the UK would be the prospect of pay in NHSS falling behind pay elsewhere. In that event employers could find it harder to recruit, and might over time see their ablest and most mobile staff leaving for jobs south of the border. This would potentially have an impact on services in Scotland.

### **Local Government**

Local authority staff costs (other than Police, Fire and Teachers) account for about 30% of the public sector pay bill (see Table 1 Bell/Elliott). The Scottish Government Public Sector Pay Policy for Staff Pay Remits explicitly excludes local government, though, as elsewhere in the public sector, local authority employees are at present subject to a pay freeze. That is hardly surprising when the average percentage of councils' revenue spending funded by grant from the Scottish Government is over 85%, and growing. That is one of several factors that constrain councils in pay bargaining and have created conditions that one negotiator on the employers' side described as 'the Perfect Storm', and one that will not blow over soon.

The first set of factors relates to structures. The current 32 unitary authorities established in 1996 inherited widely disparate pay arrangements, terms and conditions, and an early priority was 'harmonisation' across all the grades (excluding senior managers, teachers, police and fire), and especially between 'blue' and 'white collar' jobs. The exercise affected around 250,000 staff (approximately 75% at that time). The Convention of Scottish Local Authorities (COSLA) took the lead in negotiating an agreement with the unions to achieve this aim. The so-called 'Single Status' agreement in 1997 recognised the realities of reorganisation by setting a lengthy timescale for the harmonisation process that had regard to the separate status of each of the 32 councils as employers, the dominance of wage-related costs in council budgets, the economic and social significance of council jobs at both national and local level and the higher levels of unionisation and political activity in councils.

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<sup>12</sup> Letter to OME dated 16 March 2012, Scottish Government website

<sup>13</sup> Speech on 21 March 2012, HM Treasury website

The second set of factors flows from the implementation of the Single Status agreement. When councils began the process of job evaluation within a national framework recommended by COSLA, major anomalies emerged: for example blue collar male workers were found to be much better paid than equivalent female workers, largely due to bonus schemes. Disparities eventually led to legal claims for equal pay that delayed Single Status implementation and left every council facing claims. The current estimate is that approximately 36,000 cases are still in train and councils face a contingent liability that might reach £1 billion, equivalent to 8% of annual spending. Some of the claims are against both councils and unions accused by some of being complicit in delays. In the run up to the independence referendum it is likely that every council will succeed in adopting a Single Status agreement but finalisation will be contingent on the settlement of the outstanding equal pay claims. Moreover, industrial relations have been severely affected by the lengthy, contentious process with some forecasting that they may take a generation to settle.

The third set of factors arises from the external pressures affecting councils. After 7 years of relative 'plenty' – when Single Status could be taken at a leisurely pace – councils now face years of austerity. To maintain their grant level from the Scottish Government, councils have also agreed to freeze council tax for the current Parliamentary session (though that might change after the 2012 council elections) and have tried to comply with the Scottish Government policy of 'no compulsory redundancies'. They have largely succeeded in this through freezing pay and voluntary redundancy schemes. Although finance is increasingly constrained, demands for and expectations of council services continue to increase. COSLA's evidence to the Scottish Parliament on the draft Budget estimated a 'funding gap' of £3.7bn by 2016/17 (based on a model jointly developed by central and local government officials for the 2010 Spending Review, and subsequently updated)<sup>14</sup>. The 'Perfect Storm' will still be blowing post-referendum for the bulk of council workers' pay bargaining.

These developments coincide with continuing pressure to reform public services. The initial belief of the Scottish Government, at least until 2011, was that much could be achieved within existing local government structures, and by reducing the number of public bodies. The proposal to create and 'quango-ise' single national forces for police and fire services goes further, and suggests the Scottish Government may be willing to consider further structural changes. The services widely seen as most suitable for transfer from councils are education and care services. Any such changes would inevitably impact on the residual services, including 'back office' support. There would also be implications for employees and for the new employers, who would potentially fall within the remit of future Scottish Government pay policy.

There is, however, no indication at this stage that independence or devomax would lead directly to major shifts in responsibilities from councils. Nevertheless, the current pressures arise from financial constraints which are unlikely to ease soon, and may yet open the door to further shifts in functions. Full scale local government reorganisation, ruled out in the Concordat<sup>15</sup> in 2007, also seems unlikely post-referendum, carrying as it would a further short-term cost pressure on the Scottish budget.

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<sup>14</sup> COSLA evidence to The Scottish Parliament Local Government and Regeneration Committee, November 2011

<sup>15</sup> Concordat between the Scottish Government and local government, November 2007

Also, the ‘Perfect Storm’ around pay, terms and conditions might well dissuade any Government from considering such a change at least until the 32 existing local authority employers had dealt with the fall-out from equal pay and pay restraint, and a difficult industrial relations climate.

### **Chief Officers**

As for the bulk of staff, the pay of Chief Executives and other senior managers is a matter for each council. There is a national scheme for chief executives recommended by COSLA and the Association of Local Authority Chief Executives (ALACE) based on a review carried out in 2001-02. Most councils follow that with some variations and exceptions. The most recent pay settlements, involving a freeze for most staff, led to the Scottish branch of the Society of Local Authority Chief Executives (SOLACE) recommending that members should not take cost of living or scale increases, and this is likely to continue for the foreseeable future.

The approach by SOLACE Scotland appears to have pre-empted media criticism. It may also have helped dampen media interest in the fact that performance pay and bonuses are not part of the current pay scheme and have never featured significantly. The longer term implications of the current situation are however potentially serious as inconsistencies linger, and in some cases may worsen. Like the rest of council staff, Chief Executives and senior managers will see the austerity packages bite while expectations that they will deliver more services with less resource will not diminish. Sooner or later morale seems bound to suffer not least as some savings are being achieved by cutting senior posts. It seems unlikely the outcome of the referendum will affect their position in the short term, but the prospect of the 2012 council elections is a source of uncertainty, and some see a potential threat from councils falling into the control of one party.

The 2007 local authority elections were the first to use proportional representation and only two councils returned a clear majority for one party. Although some others have had periods of single party control since then, the resulting consensus and stability meant Chief Executive/senior manager pay was not an issue, partly because changes in staffing structures were used to achieve savings. Councils have now ‘streamlined’ their senior staff, thus taking the ‘easy’ savings. But a significant change in the balance of power across councils could lead to further pressures for cost reductions, bearing directly on senior pay and conditions. In the longer term, a potential question in an independent Scotland might be whether individual services require to have their own cadre of senior managers, or whether there might be a case for absorbing the SCS, council, NHS and NDPB Chief Executives/senior managers into a single “Scottish Public Sector Senior Manager Service” with standardised pay, conditions and performance management arrangements, and all subject to the Government’s pay policies for senior staff.

## **Teachers**

Teachers' pay accounts for around 16% of the Scottish public sector paybill. The McCrone Inquiry<sup>16</sup> led to the creation of the Scottish Negotiating Committee for Teachers (SNCT), a tripartite arrangement involving the teaching unions, COSLA and the Scottish Government. In 2011 the McCormac Review<sup>17</sup> concluded that the SNCT had generally worked effectively and that change was not necessary. It also considered arrangements for local level negotiation had worked effectively and recommended no change.

Unless in an independent or devomax Scotland schools education were to be removed from local authority control, a change to the negotiating arrangements for teachers' pay is not indicated. For local authority employers the key concern would no doubt be the extent to which the Scottish Government was willing to reflect fully in the overall local authority funding settlement the cost of deals struck at national level. Failure to do so would carry no different risks from the current position – industrial action or over time the possible loss of skills to elsewhere in the British Isles.

## **Police**

Police pay and conditions of service are determined through the UK-wide Police Negotiating Board (PNB), which is also serviced by the OME. As with health workers, the logic of maintaining under independence the link between police pay in Scotland and elsewhere in the British Isles would be weakened, though it would be important that any change did not undermine cross-border mutual aid arrangements of the kind deployed at the G20 in Scotland in 2005 and the summer riots in England in 2011. In planning for a Scottish Police Authority (SPA) and a single Police Service of Scotland (PSS) the Scottish Government considered putting in place a separate PNB for Scotland, but decided against it.<sup>18</sup> The Scottish Government however wishes to work with the chair of the PNB to ensure it operates effectively in Scotland and meets the needs of Scottish policing, and will also take account of any recommendations from Part 2 of the Winsor Review<sup>19</sup>.

Irrespective of Winsor's review it is hard to see how UK-wide negotiations would be appropriate in an independent Scotland. It seems likely therefore that if independence happens Ministers will have to reconsider whether there should be a Scotland-wide negotiating body, or whether pay bargaining should be left to the SPA and the recognised police unions and associations. As a public body the SPA/PSS would in principle fall within the Public Sector Pay Policy for Staff Pay Remits applicable to NDPBs, perhaps an unappealing prospect for senior officers as much as the rank and file.

## **Fire and Rescue Services**

The pay of Fire and Rescue Services (up to area manager level) is mainly determined under the auspices of the UK National Joint Council for Local Authority Fire and Rescue Services.

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<sup>16</sup> A Teaching Profession for the 21st Century: Report and Appendices (McCrone Inquiry, 2000) The Scottish Executive, 2000

<sup>17</sup> Advancing Professionalism in Teaching: The Report of the Review of Teacher Employment in Scotland. The Scottish Government, September 2011

<sup>18</sup> Police and Fire Reform (Scotland) Bill (SP Bill 8) introduced on 16 January 2012 – Policy Memorandum

<sup>19</sup> Independent Review of Police Officer and Staff Remuneration and Conditions. Thomas P Winsor

The Scottish Government is creating a unified Scottish Fire and Rescue Service (SFRS) overseen by a single Board, and says it has no plans to change existing arrangements during the transition to the single service. Ministers considered setting up Scottish arrangements for negotiating pay and conditions to replace the existing UK wide arrangements but decided that “decisions on how best to review future arrangements are best made by the SFRS Board in due course”<sup>20</sup>.

This is on the face of it more “independence friendly” than in the case of the police, but may be an indication of a direction of travel which if set now for the SPA risks frightening the police horses. Like the SPA, the SFRS Board would in principle be subject to the Scottish Government’s Public Sector Pay Policy for Staff Pay Remits in determining pay and conditions.

### **Further Education (FE)**

Since FE colleges were removed from local authority control in 1992 salaries and terms and conditions have been negotiated by individual institutions. The Griggs Report of January 2012<sup>21</sup> recommends a return to national bargaining, and proposes the creation of a Scottish Negotiating Committee for Further Education (SNCFE), and national harmonisation of pay and conditions. Scottish Ministers are considering the Griggs report. However, as the teaching unions have campaigned on and off over two decades for a return to national bargaining, it is unlikely that this is a recommendation Ministers will reject. As it will strengthen union bargaining power, employers may not see it as a helpful development, and harmonisation will tend to drive up, rather than reduce, staff costs. Independence or devomax would have no effect on new arrangements.

### **Higher Education (HE)**

It will be argued by some that Universities, despite most institutions’ strong dependence on public funds, are not public bodies and should not feature in any discussion of public sector pay. It appears that Scottish Ministers do not agree, and legislation to give them more locus in HE provision and governance is very much on the cards. At present salaries in HE up to Professor are determined in negotiations at UK level through the Joint Negotiating Committee for Higher Education Staff (JNCHES), within a Framework designed to ensure a consistent approach to equal pay for equal value across all staff groups.

This is now subject to strain as the balance of funding of HE in England and Wales is switching from Government grant to student fees. HE employers in Scotland may in future feel the financial pressure of pay settlements supported by a more generously funded HE sector south of the border. The cut in Barnett consequentials means this is already a potential problem. In an independent or devomax Scotland, the HE sector in Scotland may itself, without Government intervention, be forced to break the link on pay and consider bargaining arrangements more attuned to what it can afford. If as a result academic salaries in Scotland fell behind those elsewhere in the UK, employers could over time face recruitment and retention problems for academic staff.

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<sup>20</sup> Police and Fire Reform (Scotland) Bill (SP Bill 8) introduced on 16 January 2012 – Policy Memorandum

<sup>21</sup> Report of the Review of Further Education Governance in Scotland, Professor Russel Griggs, January 2012



Government intervention in Principals' pay is certainly on the agenda. Scottish Ministers are exercised by what they perceive as unreasonably high salaries and by the manner in which they are determined by University Courts. A review<sup>22</sup> of University governance recommends greater alignment between pay increases and bonus arrangements for Principals and other staff, and proposes that the Scottish Government investigates whether the existing UK pay Framework might in Scotland be extended to include all staff including Principals. Ministers are considering the Review's recommendations. If implemented they would be an unprecedented incursion into University autonomy and the thin end of a wedge for future administrations to hammer home.

### **The Third Sector**

Defining the "Third Sector" is, as a Scottish Government paper notes,<sup>23</sup> no easy task and attempts at universal definitions are fraught with problems. That being so, it is difficult to take more than a very broad overview of the main issues for employers in the wide range of charitable, voluntary and other not-for-profit organisations it comprises. Austerity is already causing problems as funding streams dry up, and these are likely to continue up to and beyond the referendum. In the longer term, whether under independence or devomax, the health of the sector will, like the public sector, depend on the performance of the economy as a whole and the profitability of private sector business and commerce. A major challenge for many employers will be to hold on to key staff and to weather what are likely to be continuing storms.

Hard statistics on the number of charities and other voluntary bodies are hard to find but the most recent estimates for the 'sector' by the Scottish Council of Voluntary Organisations (SCVO), suggest that in 2008-09 there were 45,000 voluntary organisations in Scotland with total turnover of £4.4 billion, and 137,000 employees (93,000 full time equivalent), who account for about 50% of total costs.<sup>24</sup> On the other hand, the Annual Population Survey<sup>25</sup> states that there were 73,900 employed in the "third sector" in 2008, and 79,400 in 2010. Whatever the figures, it seems likely that employee numbers will be declining as austerity measures work through the economy. In determining pay and numbers the Boards of the many bodies involved need to consider several factors.

First, the range of skills and qualifications of employees reflects the diversity of the bodies and their services. In many cases this means employers seek people who could equally well work in the public or private sectors. Many bodies focus on care for infirm, elderly or vulnerable groups and employ professionals, often with the same qualifications as those in public bodies delivering health and social care. Their pay and terms must therefore reflect those of the relevant profession if staff are to be recruited and retained. Similarly, many in social enterprises have skills very close to FE teachers, business advisors and employment counsellors found in the public services.

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<sup>22</sup> Report of the Review of Higher Education Governance in Scotland. Professor Ferdinand von Prondzynski, Jan 2012

<sup>23</sup> The Evidence Base for Third Sector Policy in Scotland: A Review of Selected Recent Literature, The Scottish Government, October 2009

<sup>24</sup> Voluntary Sector Statistics, SCVO, May 2010

<sup>25</sup> Annual Population Survey, The Scottish Government

So pay in the ‘sector’ has to reflect the conditions in other sectors, without necessarily being formally tied to them.

Second, although, according to SCVO, 45% of funding was self-generated in 2008-09, the revenues for the ‘sector’ and local bodies in particular, are closely tied to public expenditure. Reductions in public spending in the past usually fell very quickly - some argued disproportionately - on this ‘sector’, and councils in particular were often accused of cutting the grants to local bodies to secure their own employment. This accusation has not been heard so much as the current austerity measures bite.

In part, that is due to a better understanding of the interrelationships between the public and ‘third’ sectors, noted in the Christie Commission report<sup>26</sup>. In part, it is changes in the funding arrangements that have driven greater partnership working, with public sector bodies now understanding that by working with ‘third sector’ bodies and making a small contribution to a project or programme, additional funds can be leveraged.

In addition, the movement from grant funding to procurement by open competition for services, led by the Scottish Government, is likely to lead to significant changes, with some arguing that it will lead to greater involvement of the private sector. There is already evidence of private sector engagement with ‘third sector’ bodies to bid for new contracts through Private Public Partnerships. Capita is holding a national conference in Spring 2012 to develop partnerships with ‘social enterprises’ bidding for public sector contracts. Ingeus (50% owned by Deloitte) last year won the major DWP contract to deliver The Work Programme in seven areas of the UK, including Scotland, and is now building links with many of the social enterprises which previously delivered the programmes. It is too early to say what impact this may have on third sector bodies, least of all on pay.

Third, the ‘sector’ is subject to the same increasing burden of regulation and inspection as other sectors. The larger bodies, especially those operating at UK level, such as the Red Cross or Barnardo’s, are geared up to deal with this. That is not the case for the many small to medium size bodies, many of whom will face tough choices if they are to balance the books, pay staff a decent wage, and comply with the growing regulatory burden.

At this stage there is no indication that the outcome of the referendum will influence or change the pay arrangements in the ‘third sector’. There are much greater issues - funding, contracting, and regulation - to be faced than the question of independence. These issues may well force major changes, including the demise of many smaller bodies, in the near future. In the longer term, particularly if contracting leads to significant growth in Public Private Partnerships, the concept of different sectors might have less practical meaning.

## **Conclusion**

The Scottish Government has moved decisively to tighten control over public sector remuneration where it can, as has the UK Government. This is in response partly to the squeeze on public expenditure, and partly to concern about senior executive pay, where there is in the public’s mind an unjustified read-across from the excesses of the financial sector. It is likely to have staying power: when governments tighten controls they do not readily relax them later.

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<sup>26</sup> Commission on the Future Delivery of Public Services, June 2011

Meanwhile, reforms to the Police and Fire and Rescue Services in Scotland provide an opportunity to consider whether their existing UK wide negotiating arrangements are appropriate. While no immediate changes have been proposed, if Scotland became an independent country, it would seem illogical, and possibly impractical, for them to continue.

The scale of the ‘Scotland only’ public sector might militate against replicating the current UK review/negotiating arrangements, though a new Government might be tempted to create a much broader senior public service to weaken direct comparisons at the top level, while providing the necessary size to be meaningful. With devomax only, UK-wide review/negotiating bodies would not be problematic in principle, but they might put undue pressure on the Scottish Budget, and a potential divergence in the way the NHS develops north and south of the border risks such arrangements in the health sector becoming less responsive to Scotland’s needs. The proposal to review the arrangements for determining GP remuneration reflects that risk. As with the Police and Fire Services, independence would strengthen the case for separate Scottish arrangements. It might also accelerate the trend set by the current Scottish Government to rationalise public services through reorganisation – for example, in local government - despite its current stance against top-down major changes.

Whether new arrangements would involve Scotland-only Pay review/negotiating bodies cannot easily be judged. There are advantages and disadvantages of independent pay review. An argument in its favour is that review bodies take an evidence-based independent view, free from political interference, and propose settlements which might be regarded by the client groups and the public, as fair; but the downside may be pay deals that employers cannot afford and which Governments are reluctant to fund. For employers, to be unconstrained by review body recommendations might be the preferable option, but if the alternative were to be direct negotiations on a collective all-Scotland basis, they would almost certainly find themselves bound by tight Ministerial pay remits and controls. This could in the long term make it difficult to recruit skilled managers and other staff, and indeed to reduce staff numbers through compulsory redundancy where that was necessary to meet efficiency targets or budget constraints.

An important issue is the future of performance-related pay and bonuses in Scotland. The Hutton Fair Pay Review seeks to dispel myths about the size of bonuses in the public sector, but this is an area of discourse where facts have little traction. There are few public servants who would prefer one-off bonuses to an increase in pensionable pay, or would shed many tears over their demise. One-off performance bonuses were backed by Conservative and Labour Governments because Ministers, beguiled by private sector practice, thought they would motivate public servants, and because they helped constrain pensionable pay, with consequential benefits to the public pension bill in future years – a consideration that implies that non-pensionable bonuses, far from being outlawed, should constitute a substantially larger proportion of public servants’ pay packets than has been the case to date.

The Hutton Review is against jettisoning performance-related pay but favours the concept of “earn-back” whereby a proportion of base pay would be put “at risk” and would be deducted if certain performance requirements were not met. Bonuses would then be for truly exceptional performance. It is not yet clear whether at UK or Scotland level Ministers will wish to take forward those ideas, but in early 2012 the prospect of bonuses continuing to feature in public sector pay looks slim.

The concept of “earn-back” may be difficult to sell to employees, but for public sector employers arrangements along the lines proposed by Hutton for senior managers would probably be preferable to a blanket ban on performance-related bonuses. They would however require an extension of individual performance management and appraisal to those parts of the public sector which have so far managed to avoid it.

The extent of prescription in the public sector pay policy of a future Scottish Government, whether under independence or devomax, would, as previously noted, depend on the economic circumstances of the day and the state of the public finances. The current performance of the UK and Scottish economies and the problems of the Eurozone do not indicate early relief from the need to keep a strict control of the public sector paybill. It seems clear that the referendum on Scottish independence will not take place against a background of strong economic growth, and that any transition to independence or devomax will not take place in the most helpful financial climate. Prescription seems to be here to stay and there are signs that majority Government in Scotland is increasing the trend towards greater central control. In the short to medium term employers will face the challenge of the build-up of pressure following pay restraint, job losses and disenchantment over changes in public sector pensions, with potentially very little wriggle room. In the longer term, control over public sector remuneration will continue to exercise Scottish Ministers, and employers must hope for a pay and bargaining framework that is seen as fair and at the same time does not result in a flight of potential talent south of the border.

However, it is possible to overstate the risk of this, whether in an independent Scotland or even under the status quo. While public servants expect - and are entitled to - ‘fair’ pay, they do not in general join the public sector to ‘make money’. For many, if not most, public employees, public service and satisfaction with ‘making a contribution’ are significant motivators, whatever their critics may say. Whether or not that is the case, the fact is that for the majority of existing public sector employees there are for the foreseeable future likely to be few places to run. The private sector in Scotland is not yet capable of absorbing significant numbers of public service workers, and, as recruitment consultants will confirm, is hesitant about taking them on. Nor is flight to the south an option when family commitments and selling one’s house are a major consideration.

The biggest recruitment and retention risk is likely to be at the most senior levels in public bodies and in the NHS where UK-wide mobility is more of a practical proposition. Pay policies which saw a growing gap in senior pay between Scotland and the rest of the UK could therefore put employers in an independent Scotland at a disadvantage in retaining and recruiting the most able managers and clinicians. Similarly, tight and continuing control over pay and prospects might well prove a deterrent to the recruitment of the best youngsters, a group that past experience shows is more mobile in terms of potential relocation to the south, and for whom career prospects matter.

While the risk of a substantial ‘brain drain’ may, at least in the immediate aftermath of the referendum or independence, not be much greater than it is now, the risk of industrial action by public sector workers is likely to grow, and employers must hope for sufficient flexibility within pay policy to deal with the main pressure points. Otherwise, in the long run, recruitment and retention will suffer. Ministers will also have to consider their relationship with councils as the largest single public sector employer, not least as the 9 year freeze on council tax will increase the dependence of councils on Government grant.

Depending on the outcome of the 2012 council elections, Ministers may face increasing calls from councils for greater fiscal autonomy just as they are seeking for Holyrood from Westminster. Councils will also not be slow to point to their dependence on the Scottish Government for funding when facing the next, probably contentious, round of pay bargaining.

It is unlikely that a future Scottish Government would be blind to the risks. With an electorate of around 4 million (of which around half usually turn out to vote in Scottish Parliament elections), a 'devolved' public sector workforce of around 0.5 million plus their dependents constitutes a bloc of voters no government can safely disregard. In other words, as Scottish Ministers will be represented as being in charge of all public sector pay – not just their 'own' employees - they will have to tread a difficult path between bearing down on public sector remuneration to balance the books (with or without independence or devomax) and keeping half a million public sector employees, whose votes could make or break any Scottish administration, happy. That may prove to be the biggest challenge of all.



## Public Sector Remuneration – A Trade Union Perspective

Stephen Boyd

### Introduction

*“The wage bill in the public sector, expected to be £178bn in 2010, has to come down by 20 per cent. The typical public sector worker now earns 15 per cent more than one in the private sector, and enjoys far superior pension rights. Wage cuts at the top can be much bigger than wage cuts at the bottom. Leave it to individual outfits to work out how to do it”.* **Paul Ormerod, economist, Prospect Magazine March 2010<sup>1</sup>**

The above quote from one of Britain’s most eminent economists helpfully reflects a number of the assumptions dominating contemporary debate on public sector remuneration:

- The ‘typical’ public sector worker earns more than the ‘typical’ private sector worker and this is a bad thing (so why bother interrogating the validity of such comparisons?);
- The gap in public and private sector remuneration must be narrowed (or closed altogether, or turned to the private sector’s benefit) by reducing public sector pay and pension entitlements; not by raising private sector pay which will only serve to lower competitiveness;
- Cutting public sector pay and pensions will produce significant macroeconomic benefits the most important of which is the contribution it will make to consolidating the public finances. Negative consequences are rarely if ever mentioned;
- Pay at the ‘top’ of the public sector is out of control and therefore requisite savings can be achieved without harming those at the bottom; and,
- Regional (or even workplace?) bargaining in the public sector would be more efficient and help to level the playing field for the private sector which bargains exclusively in regional local labour markets.

Consistent with the anti-intellectual zeitgeist, these increasingly orthodox views on public sector remuneration as rehearsed by economists, media commentators and politicians tend to be asserted; rarely are they justified by recourse to evidence. Commentators seldom pause to reflect on whether the concept of ‘typical’ worker in either sector is even appropriate in analytical terms or helpful in developing public policy. Rarer still is consideration of potential negative macroeconomic effects flowing from falling public sector remuneration.

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<sup>1</sup> ‘How to really save £100bn’, Prospect, Issue 169, 22 March 2010

As Will Hutton notes in the introduction to his recent report, the banking crisis provoked a focus on, and hostility to, high pay in both private and public sectors. This he argues has condemned the debate to be conducted in an ‘increasingly febrile atmosphere’<sup>2</sup>.

The deterioration in the public finances since 2008, and the high proportion of spending accounted for by wages, has also provided cover for those who wish to undermine both spending and public sector remuneration for ideological reasons; their ideology is now presented as a pragmatic response to pending fiscal crisis.

The ubiquity of such views disguises their irrelevance and diverts attention from the factors that have conflated to create the current trends in public and private sector remuneration. The STUC has discussed these trends elsewhere<sup>3</sup> and the purpose of this essay is not to join battle once again with the more excitable elements of the anti-public sector brigade.

Rather it is to offer some thoughts on the merits of the current system of collective bargaining in the public sector, highlight the dangers of establishing a policy framework which extends and exacerbates the decline of wages as a share of GDP (the falling wage share) and to explain why certain proposals for ‘reform’ are derived from fundamental misunderstandings about the nature of the services provided by the public sector and therefore doomed to fail.

### **Public/Private sector comparisons**

Simple comparisons of pay, pensions and productivity between the *whole* public sector and the *whole* private sector are misleading and, if the goal of such comparisons is to inform development of better public policy, ultimately worse than useless.

As Income Data Services<sup>4</sup> (IDS) among others have noted, the workforce profiles of the two sectors are very different. The public sector is smaller in size (23.8% of total employment in Scotland; falling to 22.5% if the public sector financial institutions are excluded<sup>5</sup>) and includes amongst its workforce a far higher proportion of professional and specialised staff. By contrast, the private sector is larger and much more polarised in terms of jobs and pay: it has a greater concentration of both very low paid workers at the bottom (many of whom will have formerly worked in the public sector until their jobs were privatised or outsourced) and extravagantly rewarded people (whose pay and pensions are much higher than their public sector counterparts) at the top. These different workforce profiles are one of the major influences on the very different distribution of earnings in each of these two areas of the economy.

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<sup>2</sup> Pg 4, Hutton Report of Fair Pay in the Public Sector, HMT, March 2011

<sup>3</sup> See for instance evidence to the Independent Budget Review (2010) and Commission on the Future delivery of Public Services (‘Christie Commission’) (2011)

<sup>4</sup> IDS, Pay in the Public Services, March 2010

<sup>5</sup> Pg 6, Public Sector Employment for Scotland Statistics for 4<sup>th</sup> Quarter 2011, National Statistics Publication for Scotland, 14 March 2012



Recognising this complex picture, the Independent Budget Review<sup>6</sup> analysed recent studies by the IFS and others of trends in public and private sector pay and pensions and presented 7 key findings:

- The trends in earnings growth rates of public and private sector workers are sensitive to the time period selected;
- Meaningful comparisons of public and private sector pay cannot be based on average values across the public and private sectors;
- After adjusting for the differences between the two sectors (e.g. education, age, qualifications) there is a substantial reduction in the wage differential between the public and private sectors;
- The gap between public and private sector wages is more pronounced for females;
- Pay differentials are significantly more compressed than in the private sector;
- Significant sectoral and regional differences exist in public and private sector pay; and,
- Pensions in the public sector are more generous than in the private sector, and the public/private sector differential has been growing.

This mature assessment<sup>7</sup> should serve as the starting point for discussion about whether reforms are necessary in either public or private wage setting and, if so, what these reforms should look like.

It is necessary to carefully examine the trends identified above and to be rigorous in determining their origins i.e. public/private pension differential has been growing due to declining benefits provided in the private sector; not to public sector schemes becoming more generous. Indeed, public sector schemes have already been substantially reformed<sup>8</sup>.

### **Labour market regulation**

Scotland is commonly presented as an over-regulated, over-taxed and over-bureaucratic business dystopia. Labour market regulation is a particular bugbear:

*“For anybody who employs anyone, the red tape is horrific. My view is that the Chancellor of the Exchequer should be forced to employ someone personally, and have to fill in all the paperwork. If that were to happen, we would see radical change. I am not sure whether members of the Scottish Parliament employ anyone personally. It is a frightening exercise”.* Sir George Mathewson, ex-Chair of the First Minister’s Council of Economic Advisers<sup>9</sup>

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<sup>6</sup> Pgs 59-62, Independent Budget Review, Final Report July 2010

<sup>7</sup> Unfortunately, the IBR’s approach was inconsistent. Their mature assessment of pay in the public and private sectors was not repeated in its analysis of sickness absence which failed to control for size of organisation; a basic error.

<sup>8</sup> See for instance STUC submissions referenced at 3 above. The TUC’s submission and response to the Independent Public Service Pensions Commission contain much relevant background and analysis.

<sup>9</sup> Oral evidence provided to the Scottish Parliament’s Economy, Energy and Tourism Committee on 24 October 2007

However, a large and accumulating body of evidence confirms the opposite to be true: Scotland as part of the UK is, by any reckoning, a very lightly regulated labour market (*please note, this is a statement of fact only and does not imply a position regarding Scotland's constitutional status!*). The UK labour market is the third least stringently regulated in the OECD's analysis of 30 nations; well below the OECD average and significantly below nations like Germany commonly perceived to have reformed their labour market institutions<sup>10</sup>.

Is the level of employment regulation relevant to the discussion around relative remuneration in the public and private sectors? Yes, in two ways: it helps explain the decline in conditions in the private sector and provides the institutional context for a discussion on the pay bargaining systems which have produced the outcomes which concern so many. (It also suggests that the employment benefits flowing from the various labour market reforms currently being considered by the UK Government will at best be extremely modest).

### **Collective bargaining**

The social case for collective bargaining is well recognised and acknowledged by all the main international institutions. Studies<sup>11</sup> have found that more inclusive employment relations systems with high levels of employment protection and collective bargaining coverage, such as those found in Scandinavia, produce greater wage equality across the workforce, higher job quality and greater opportunities for career and skills development and in-work learning. These are all objectives of the both the Scottish Government and main opposition party.

By contrast, countries with more market based systems with lower collective bargaining coverage and weaker and more individualised protections for workers, such as the UK, tend to perform much worse on these measures.

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<sup>10</sup> Employment Protection in OECD and Selected non-OECD Countries 2008, OECD Indicators of Employment Protection, OECD website  
[http://www.oecd.org/document/11/0,3746,en\\_2649\\_37457\\_42695243\\_1\\_1\\_1\\_37457,00.html](http://www.oecd.org/document/11/0,3746,en_2649_37457_42695243_1_1_1_37457,00.html) The OECD measures 1) protection of permanent workers against (individual) dismissal; 2) specific requirements for collective dismissal; and, 3) regulation on temporary forms of employment.

See also STUC analysis of the World Economic Forum's Global Competitiveness Report which demonstrates that the UK labour market is very lightly regulated; even compared to nations scoring higher on the competitiveness index:  
<http://www.stuc.org.uk/files/Congress%202011/Wrong%20Plan%20for%20Growth%20Final.pdf>

<sup>11</sup> Employment Regimes and the Quality of Work, Duncan Gallie, 2007 (Oxford University Press); Jerome Gautie & John Schmitt, *Low Wage Work in the Wealthy World*, 2010 (Russell Sage Foundation); Caroline Lloyd and Ken Mayhew, 'Skill: the solution to low paid work?' *Industrial Relations Journal* 2010, volume 41, issue 5; Toke Aidt and Zafiris Tzannatos, 'The costs and benefits of collective bargaining' 2005, Cambridge Working Papers in Economics

Indeed the decline of collective bargaining coverage has been singled-out as a key reason for rising inequality over the past three decades<sup>12</sup>. The number of workers that were classified as ‘low-paid’ (i.e. earning less than two-thirds of median income) was 13% in 1979 when collective bargaining coverage was near its peak, but has since risen to 22%<sup>13</sup>.

While unions can point to the social benefits of collective bargaining, the economic case is more complicated. But here the Scandinavian examples are most informative. Various studies on the economic impact of collective bargaining have produced rather mixed findings, with many claiming that it can actually worsen unemployment and inflation. However, there is considerable agreement<sup>14</sup> within the academic community that highly ‘coordinated’ systems of collective bargaining have a more positive impact than ‘uncoordinated’ or ‘fragmented’ systems. In other words, it is not how many or how few workers are covered by collective agreements, but rather the extent to which bargaining is coordinated that matters most in assessing whether collective bargaining systems have a positive or negative macroeconomic impact.

### **Pay bargaining in Scotland**

As well as being a lightly regulated labour market, Scotland as part of the UK also has a highly decentralised and uncoordinated approach to collective bargaining in the private sector. Economic theory suggests that such a system should be more efficient in reacting to local labour market conditions and adjusting to shocks but, as in so many areas of economics, the theoretical ideal does not always deliver real world benefits.

Arrangements for pay bargaining in the Scottish public sector are described elsewhere in this publication as ‘extremely complicated’ (see Bell/Elliott). Applying as they do to around 554,000<sup>15</sup> people in a range of occupations from nurse to teacher to hospital porter to research scientist, they could just as legitimately be described as sensible and proportionate. Indeed, the absence of specific credible proposals to reorganise this bargaining structure perhaps implies that what at first blush may appear unnecessarily complex arrangements may in fact be appropriate.

Past attempts to reorganise bargaining structures (the decentralisation of pay in the further education sector being a prime example) have only served to prove that the previous model was robust.

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<sup>12</sup> See for instance *The Cost of Inequality*, Stewart Lansley, Gibson Square 2011. An accessible introduction to the international context is provided by ‘*The Conscience of a Liberal*’, Paul Krugman, Norton & Co. 2007. An detailed academic explanation of the relevance of changing norms and institutions to rising economic inequality is provided by *Inequality and Institutions in 20th Century America*, Levy and Temin, MIT Department of Economics Working Paper 2007

<sup>13</sup> Ibid Lloyd and Mayhew

<sup>14</sup> Pg 85, OECD Employment Outlook 2006 states that a ‘majority of the cross-country regression studies summarised have concluded that a high degree of corporatism (i.e. high centralisation and/or co-ordination of wage bargaining) is associated with lower unemployment’.

<sup>15</sup> Pg 6, Public Sector Employment for Scotland Statistics for 4<sup>th</sup> Quarter 2011, National Statistics Publication for Scotland, 14 March 2012. This figure is total public sector employment minus the public sector financial institutions.

It must also be emphasised that the context for bargaining in the reserved and devolved public sectors is set by the Scottish and UK Governments; negotiations take place within a well-defined envelope. It is simply not possible for the negotiating bodies to reach settlements deemed unaffordable by Government.

### **Regional pay bargaining**

The one proposal currently on the table to reform public sector bargaining is the UK Government's intention to move away from national pay bargaining to a more regional set up. The Chancellor's 2011 Autumn Statement argued that while,

*“Public and private sector organisations compete for employees in different markets across the UK...private sector pay is set in accordance with local labour markets but public sector pay is set on a national basis. As a result, public sector pay does not reflect local labour market conditions”.*

The statement then commits the Government to asking ‘*Independent Pay Review Bodies to consider how public sector pay can be made more responsive to local labour markets*’.

The analysis from which this commitment flows is seriously flawed. Pay bargaining structures in both public and private sectors do not conform to the stereotype described in the Autumn Statement. As Income Data Services<sup>16</sup> has argued:

- most large, multi-site private sector companies have national pay structures. For instance retailers, banks and utilities are large, multi-site organisations with national pay structures and therefore similar to many public sector organisations;
- large, multi-site private sector companies operate with up to 4 or 5 bands or zones within a national framework. Typically these bands or zones are based on the established pattern of inner London, outer-London, South East and large city allowances. Zonal systems, widespread in the retail sector, allow for a store to be moved to a higher paying zone if labour market conditions require this;
- In reality there is much less regional pay variation than is commonly imagined. There is much more similarity than difference. In practice, most of the retailers and banks that operate with zonal-type pay systems have national pay structures outside the South East that have worked well for them for some time, without seeking to differentiate between Newport, Newcastle or Nottingham;
- It is not true that local labour market/cost-of-living factors have displaced skill level, qualification and job weight in setting pay in the private sector. Even in smaller private sector organisations, skills and qualifications will be key factors. And there is plenty of evidence that international engineering companies with bases in Gloucestershire and Derbyshire will use international salary data on skills and qualifications rather than local data for recruitment purposes.

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<sup>16</sup> IDS Eye ‘*Growing Number of Myths about Local Pay Determination*’, 17 January 2012 and ‘*CBI adds to list of myths about regional pay*’, 21 March 2012

- There are other factors: local managers in large private sector firms have little discretion to vary pay; it is already more common for public sector pay to include local flexibility around national pay spines; industrial sector is a far more important determinant of pay levels than geographical location; zonal pay systems will provoke arguments over unfairness with potentially serious productivity outcomes. The costs involved in establishing a local bargaining infrastructure, pay information and dispute resolution process are also potentially of a scale that renders any savings insignificant or worse.

In short, there is nothing intrinsically better about regional pay structures. National pay structures provide simplicity, avoid the costs of duplication, allow better pay bill control, create consistency and avoid poaching and leapfrogging.

I will leave it open as to whether this measure is also designed to reduce trade union influence over bargaining.

### **Performance related pay**

If the case for regional bargaining is weak, then the case for performance related pay (PERP) is embarrassingly so. Greater rolling out of PERP across the public sector is routinely proposed as a mechanism to enhance efficiency and productivity. However the quality of the argument generally presented is reflected by one prominent Scottish entrepreneur who wants teachers' pay to be related to performance because *'everywhere else in the world, from commerce to government is subject to incentivisation. Why not teaching?'*<sup>17</sup>

It is important that public policy, particularly when it will have a direct material impact on the living standards of tens of thousands of working people, should be built on stronger foundations. *'Do it because everyone else is doing it'* is not a good argument in any sphere of life. The fact is that evidence in support of PERP is scant to say the least and 100 years of research tells us unambiguously that it will definitely not work for teachers.

The use of financial incentives is a subject filled with ideology and belief – and many of those beliefs have little or no evidence to support them. Many of the best performing companies have relatively flat pay distributions – *'by sending the signal that performance is a collective, not just an individual, endeavour, those companies are more likely to induce thought, creativity and effort on the part of their people'*<sup>18</sup> PERP is likely to work only where the tasks are readily learned and have little or no interdependence with other employees, where it is easy to measure and monitor quality and where employee goals are unambiguous and one-dimensional.

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<sup>17</sup> Cover story, Sunday Herald, 12 April 2009. Tom Hunter quoted through a spokesperson argues for the introduction of performance related pay into the teaching profession.

<sup>18</sup> Pg 131, Hard facts, Dangerous Half-truths and Total Nonsense, Pfeffer & Sutton, Harvard Business School Press 2006. See also pages 21-24 for an excellent summary of the issues around PERP for teachers.

The classic case of a merit pay system that worked was Ed Lazear's study<sup>19</sup> of Safelite Glass in Columbus, Ohio – installers of automobile glass. It is difficult to imagine an enterprise further removed from the education of our young people. In most modern workplaces both public and private, characterised by complexity and high levels of interdependence, there is *no evidence* to show that performance related pay achieves anything beyond incentivising bankers to disguise risk as value creation. On the contrary, research on motivation at work emphatically confirms the 50 year old dictum of psychologist Frederick Herzberg: if you want people to do a good job, give them a good job to do.

And isn't it interesting that those who continually preach austerity for the public sector would happily saddle the education system with the enormous transaction costs of designing, implementing, monitoring and evaluating a performance related pay system of extremely dubious benefit.

### **Productivity and Baumol's cost disease**

Many commentators who wish to attack public sector remuneration but do not wish to repeat the more absurd claims about pay, seek to do so on the basis of falling productivity. This from David Smith of the Sunday Times typifies the way in which the 'problem' is posited:

*“The other noteworthy development was the publication by the Office for National Statistics of new productivity estimates for the public sector. These showed that, despite a small improvement lately, productivity has fallen most years in the past decade. Calculating output is not easy, but the ONS thinks the average public-sector worker's output in 2007 was 3.2% lower than in 1998.*

*“Contrast that with the private or “market” sector. Over the same period, again according to the ONS, market-sector productivity rose 22.8%. The difference between the two sectors is striking”<sup>20</sup>.*

Such views are wholly unenlightening because they (deliberately?) fail to recognise some fundamental points:

- Comparing the public and private sectors as a whole is – again - not comparing like with like; any effective analysis would seek to compare, for instance, the productivity of similar labour intensive personal services in the public and private sectors (and even then they would have to control for what is actually being delivered i.e. comparing public and private health sectors in the UK would not be comparing like with like);
- Productivity growth in the private sector is largely driven by productivity improvements in manufacturing – there is no publicly owned manufacturing in the Scottish economy;

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<sup>19</sup> Performance Pay and Productivity, Lazear, The American Economic Review, Vol. 90, No. 5 (Dec., 2000), pp. 1346-1361

<sup>20</sup> *Tories Must End Public Sector Blight*, David Smith, Sunday Times, 14 June 2009

- Quality enhancing investment in the labour intensive personal services which dominate public sector employment *necessarily* leads to a lowering of productivity; and,
- Productivity is an inappropriate metric by which to judge the success and effectiveness of labour intensive personal services such as health and education.

It is perplexing that an eminent economist like Nick Crafts can produce a chapter on Scottish Public Services<sup>21</sup>, discuss relative productivity in public/private sectors yet choose to ignore these salient points. The ‘cost disease’ first identified by William Baumol more than forty years ago is rarely invoked<sup>22</sup>. Baumol established that the cost of providing labour intensive personal services (such as health and education, overwhelmingly provided by the public sector) would rise faster than productivity for a number of reasons: personal services are very labour intensive and likely to remain so and labour productivity grows very slowly in these sectors; there are few opportunities to speed processes up through standardisation (and where this is attempted i.e. through shared service large processing operations, inefficiencies are created); technological improvements tend to be quality improving rather than labour saving.

Most importantly, high quality personal services are often identified by, and defined in terms of, low labour productivity. If a teacher increases her productivity by increasing her class size, we see this as a decline in the quality of service provided, not an increase in productivity. Doctors, who improve their productivity by spending less time with each patient, but seeing more patients, are rarely applauded. Insofar as service quality is defined in terms of low labour productivity, productivity improvements are without quality reductions.

Together these factors explain the relatively low labour productivity in personal services compared with the rest of the economy. Inevitably pay in the personal service sector must remain roughly in line with the rest of the economy – but productivity in this sector lags behind, so the price of personal services ends up rising much faster than the price of goods and services elsewhere in the economy. This is Baumol’s cost disease. The cost disease is completely independent of any increase in the demand for personal services.

The public private debate is irrelevant here. Personal services in the private sector suffer from relatively low labour productivity just as much as those in the public sector: the poor productivity arises from the nature of the services themselves, not from the fact that they are sometimes provided through the public sector. Indeed, much of the best evidence on poor productivity performance comes from the private health and higher education sectors in the US, because productivity is easier to measure for privately provided goods traded in markets. Personal services suffer from intrinsically low labour productivity, not public services.

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<sup>21</sup> Chapter entitled High Quality Public Services published in *New Wealth for Old Nations: Scotland’s Economic Prospects*, Princeton (2005)

<sup>22</sup> For an excellent overview of the issues the cost disease raises for both right and left see, ‘The Skeptical Economist’, Jonathan Aldred, Routledge (2009)

## Key issues

If the debate about public sector remuneration is to deliver better public policy, it would be helpful if the following issues, currently overlooked, start to inform thinking among all stakeholders:

- ***Emerging from the Great Recession*** – as this piece is being written the economy remains 3 – 4% below pre-recession output levels and 12% below the 2007 trend. Cutting public sector wages will prolong the depression and exacerbate the imbalances that contributed to the crisis.
- ***The falling wage share*** – a programme of undermining employment, pay and pensions in the public sector will exacerbate a key feature of the economy; one that has hitherto escaped serious examination but is escalating in prominence post banking crisis. The share of GDP going to wages has fallen from 65% in 1974 to 53% in 2011<sup>23</sup> with a concomitant rise in profits. The consequences? A larger pool of capital for destabilising speculative investment and a workforce increasingly reliant on debt.
- ***Economic strategy*** – the Scottish Government’s economic strategy has targets for cohesion and sustainability. Far from helping to achieve these targets, an approach that undermines public sector pay – perhaps significantly so in regional labour markets – will only exacerbate the trends that rendered them necessary. As the statistics provided elsewhere in this publication demonstrate, the public sector is hugely important to Scotland’s fragile remote regional economies.
- ***Public sector pay bargaining*** – is not overly complex or inefficient. Indeed, an approach that sought to learn from the most successful private sector models elsewhere would look pretty much like the centralised and co-ordinated framework that currently exists. Decentralising and atomising this structure will add costs, undermine the achievement of economic strategy targets and further undermine the wage share;
- ***Private sector pay bargaining*** – it is essential that the crude orthodox assessment of the UK labour market which simultaneously lauds flexibility while bemoaning excessive red-tape is consigned to the policy dustbin.

The adverse consequences of the flexible labour market for social cohesion and macroeconomic stability must be rigorously assessed. Rather than focusing on how public sector bargaining can more closely ape private sector structures, it would be more enlightening to assess how private sector structures can replicate more efficient models elsewhere.

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<sup>23</sup> For an overview of these issues see presentation provided by author and economist Stewart Lansley to the STUC – Economy, Energy and Tourism Committee joint seminar in February 2012. PP Presentation can be found here: <http://www.scottish.parliament.uk/parliamentarybusiness/CurrentCommittees/47772.aspx>

Video of the event is available here: <http://www.scottish.parliament.uk/newsandmediacentre/41357.aspx>



The critics of bargaining in the public sector overlook the problems in the private sector where the distribution of income is distorted by monopoly, political power and other market failures (e.g. taking advantage of informational asymmetries to sell questionable assets to unsuspecting customers who are reassured by triple A ratings, and so on). Complacency and ideology ensures that those who consistently attack wage and pension levels in the public sector overlook state subsidy of low pay in the private sector.

An economy where the bargaining power of workers is undermined over a lengthy period is one that will not only be less fair and democratic, it will also be more unstable and more prone to systemic crisis<sup>24</sup>. Is this the kind of Scotland in which we want to live and work?

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<sup>24</sup> In 2009 over 200 prominent US economists signed a statement in support of the Employee Free Choice Act then going through the legislative process. The statement argued that '*a rising tide lifts all boats only when labor and management bargain on relatively equal terms*'. It is perhaps no surprise that the likes of Stiglitz, Blinder and DeLong signed the statement. However it was also signed by giants of the neoclassical school such as Kenneth Arrow and Robert Solow and enthusiastic supporters of free trade such as Jagdish Bhagwati. Unfortunately, a similar re-examination of the balance between capital and labour has yet to emerge in Scotland and the UK and therefore the consequences of higher inequality and instability are likely to remain with us for the foreseeable future.



## **Public Sector Pay Bargaining – Why Local Labour Market Conditions Should Prevail**

**David Lonsdale**

Levels of pay vary widely across different parts of both Scotland and the UK<sup>1</sup> – as does the cost of living. To be both fair and efficient, public sector remuneration should be responsive to local labour market conditions and able to pay differently in different areas according to need. The recent Government request to the Pay Review Bodies to consider how pay can be made more responsive covers just a fraction of public sector workers, and to fully realise the benefits of truly efficient local labour markets all public sector bodies should look to make their pay structures genuinely market-facing.

A transition from national to genuinely localised pay bargaining will be a gradual process. Local pay setting is vital to both long-term regional economic development and effective public service reform, but the case for it is not about deficit reduction. This measure is necessary for long-term economic rebalancing and taxpayer value, rather than immediate cost savings. Addressing public sector pay premiums<sup>2</sup> benefits both public and private sectors and promotes jobs and growth. Efficient – and that means local, responsive and flexible - labour markets will help both the public and private sectors become more productive, effective and efficient and help best target reward to where it is needed.

### **The average public-private wage differential in Scotland is 5.6 per cent for men and 19.9 per cent for women<sup>2</sup>**

- Across the UK average hourly wages in the public sector are 24.3 per cent higher than those found in the private sector.
- When differences in age, experience and qualifications are controlled for, the public sector wage premium – the additional pay received by a person for working in the public rather than private sector – is 8.3 per cent.
- In Scotland the average public-private wage differential is 5.6 per cent for men and 19.9 per cent for women.
- On average, public sector workers accrue pensions that are hugely more valuable than those found in the private sector and will continue to do so, even after the Hutton reforms. A ‘total reward’ approach which accounts for this value should be factored into considerations of public sector wages.

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

The recent recession showed the flexible and efficient labour market in action. One of the most striking features of the downturn was that unemployment did not rise as steeply as previous experience would have led us to expect.

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<sup>1</sup> Median gross hourly pay, work based travel to work area: UK - £11.20, Scotland - £11.09, Edinburgh - £12.67, Newton Stewart and Wigtown - £7.44. ONS ASHE, 2011

<sup>2</sup> IFS “Green budget 2012”

A major reason for this change is that businesses and employees cooperated to find ways to reduce costs and retain jobs and skills – with pay restraint, reduced overtime and flexible working all playing a part.<sup>3</sup> Such flexibility requires pay and conditions to be managed at a local level. Public sector employers have not been similarly responsive because they lack the tools. During the recession the public sector was insulated from the effects of adjustment to economic changes, and pay decoupled from labour markets. Now a public spending squeeze is in place, public sector employers do not have the ability to cope in the way private sector firms did because they do not ‘own’ the pay and conditions of their staff.

During the recession, average pay growth in the private sector slowed to almost zero, only slowly recovered, and is now standing at around two per cent.<sup>4</sup> Public sector pay continued to grow through the recession at pre-recession rates<sup>5</sup> and, although most public sector workers are now facing a basic pay award freeze, the data suggests annual total public sector pay continues to grow – averaging one and a half per cent.<sup>6</sup> As a result the public sector pay freeze which came into force in 2011 has not reduced the public sector pay premium substantially yet.<sup>7</sup> In truth, the full two years of pay freeze and two years of pay restraint that have been announced will be required just to eliminate the increase in the pay differential that has grown since 2007-08.<sup>8</sup>

Little of this has anything to do with the labour market. General freezes are blunt tools which may have positive overall effects but significant negative effects for certain roles. The same can be true for general rises. National wage bargaining prevents the kind of responsiveness and flexible use of resources that worked for the private sector during the recession – and preserved jobs and skills – from taking place in the public sector, as individual employers are prevented from implementing local changes. At a time when budgets are increasingly devolved to the local level it seems perverse that control over the biggest element of a budget – pay – is not similarly devolved.

The substantial changes in the relationship between employers and employees that have taken place in the private sector in the last two decades are manifested in a more flexible individual package of work and reward in the private sector.<sup>9</sup> Rigid pay structures are incompatible with the modern employment relationship – it remains the case that in many parts of the public sector pay structures remain inflexible, leaving pay largely dependent on factors such as grade and length of service rather than performance.

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<sup>3</sup> CBI/Hays -“Thinking positive: the 21<sup>st</sup> century employment relationship”

<sup>4</sup> ONS – Labour market statistics: March 2012

<sup>5</sup> IFS “Green budget 2012”

<sup>6</sup> OBR – “Economic and fiscal outlook”

<sup>7</sup> Policy Exchange – “Further analysis on the public sector pay premium”

<sup>8</sup> OBR – “Economic and fiscal outlook”

<sup>9</sup> CBI/Hays -“Thinking positive: the 21<sup>st</sup> century employment relationship”

Harnessing the benefits of an individualised employment relationship - employee engagement, choice and flexibility - benefits both employers and employees, and helps the UK best compete in the global economy. But these benefits are lost when national pay structures prevent individual agreements at a local level. Since the early 1990s Sweden has decentralised public sector pay, operating without national determinations of individuals' wages, allowing for managers to be genuinely flexible in creating posts and roles and allowing wages to reflect local circumstances and priorities.<sup>10</sup> Although local pay negotiations involve some trade-off in terms of administration, expense and time taken to negotiate at an individual level, these costs have been more than offset by benefits of allowing local managers to decide what is most efficient and effective.

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

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

In a competitive labour market pay should largely be a function of supply and demand, with pay structures responsive to the relevant labour markets in which they operate. To reflect local markets private sector employers might look to variables such as local pay rates, local levels of unemployment, local cost of living, employee turnover, response rates to advertised jobs, number of local competitors, premiums to attract people to a less convenient or attractive location and so on – with this data collected from various sources. Such data allows employers to establish efficient market-facing pay structures which meet their needs with regards to recruitment, retention and employee motivation.

Where there are national pay structures in place the public sector instead imposes a one-size-fits-all pay policy regardless of local labour market pressures. As a result the public sector faces deadweight costs from paying high cost public sector salaries in low pay areas, while simultaneously facing recruitment and retention challenges in areas where pay rates are not competitive. These costs also illustrate why, to be truly responsive, reforms should allow for genuinely local deals, as opposed to regionally set structures which will continue to impose barriers in some local labour markets.

Bargaining must be local, not regional or national, as differences in earnings are more often found within regions than between them. To minimise inefficiencies pay should be devolved to the lowest possible level – the employer. In the highest paying area of Scotland median gross hourly pay is 70 per cent higher than in the lowest paying area.<sup>11</sup> So although the average public-private wage differential across Scotland is 5.6 per cent for men and 19.9 per cent for women these figures hide further differences at local levels.

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

<sup>11</sup> Median gross hourly pay, work based travel to work area: Edinburgh - £12.67, Newton Stewart and Wigtown - £7.44. ONS ASHE, 2011

Freedom to set pay rates at a genuinely local level is also necessary to truly allow public sector pay structures to respond to fluctuating patterns of recruitment and retention flows. For example, supply-side crowding out effects will vary according to the relative size of the public sector across localities. The ratio of private to public sector employment varies from a high 3.1 in Aberdeen to a relatively low 2.2 in Edinburgh and a low of 1.4 in Dundee.<sup>12</sup> And although cities might face labour markets more similar to one another than to the outlying areas surrounding them, the urban areas that experience particularly high rates of unemployment are generally those with ‘post-industrial’ economies. Such differences mean that while unemployment is high in Glasgow it is low in Edinburgh,<sup>13</sup> with each city facing a very different labour market and levels of pay, but neither is without success and challenges – they are just different ones.

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

### ***...and improves the quality of public services***

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

Standardised rates of pay also prevent higher levels of compensation to incentivise people to work in particularly challenging areas. Public bodies should be free to target pay awards to where they are most needed to address particular problems or issues.

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<sup>12</sup> Centre for Cities - Cities Outlook – Ratio private to public sector employment

<sup>13</sup> CBI – “Mapping the route to growth - rebalancing employment”

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

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

For example rural areas may have recruitment difficulties – so while there is little variation in pay levels of pharmacists throughout the UK premiums are often paid in isolated areas such as the South West of England which have low earning levels and insufficient numbers of qualified candidates.<sup>16</sup> Challenging roles may also need to offer a premium to attract staff. Schools in deprived neighbourhoods, for example, struggle to recruit the staff they need. Research has found that schools that educated the poorest children received almost thirty per cent more funding per pupil than the tenth of schools with the most affluent intake. But average teachers’ pay at the most challenging schools was less than two per cent higher than at the schools with the wealthiest pupils, and teacher-pupil ratios were almost identical.<sup>17</sup> Targeted and flexible pay rewards performance, promotes competition, and allows poorly performing services or difficult to recruit locations or fields to attract better workers to improve public service outcomes.

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

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

Business investment is needed to offset declining government spending, and regions must be able to utilise their comparative advantages in order to attract this investment – and this means local labour markets must be flexible and responsive. Over recent years investment growth has been dominated by the government – with government investment growing at more than twice the rate of business investment between 1990 and 2010. This trend was always unsustainable and is set to reverse – the Office for Budget Responsibility forecasts that government investment will decline by 16% between 2009 and 2015 in real terms – a compound annual growth rate of -3.4%.<sup>18</sup> The Scottish Government is committed to building and fostering a supportive business environment which encourages innovation, business creation and growth – recognising that prosperity and employment are dependent on business performance. The UK government is clear that supporting private sector growth is at the heart of its economic and growth strategies and that strong, sustainable and balanced growth must be more evenly shared across the country. Successful rebalancing of the economy must go hand in hand with rebalancing the UK labour market to avoid perpetuating long-standing problems of pockets of high long-term unemployment and inactivity, often in areas which suffer from multiple disadvantages. Future trends in the job market risk exacerbating current divisions, with increasing numbers of higher skill jobs in London and the south east, with other parts of the UK facing the challenge of high concentrations of low skilled jobs, large numbers of people with low-level skills and poor school attainment, and social deprivation.<sup>19</sup>

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<sup>16</sup> IDS Pay report 1066 , February 2011

<sup>17</sup> Chris Cook – Financial Times – “Deprived schools lose out in teacher quest”

<sup>18</sup> CBI – “A vision for rebalancing the economy – A new approach to growth”

<sup>19</sup> CBI – “Mapping the route to growth - rebalancing employment”

Only by firing up the private sector in regions which have had large public sector workforces and high unemployment can we resolve this issue.

The latest labour market statistics<sup>20</sup> show very tentative signs of recovery in the UK labour market, with overall unemployment continuing to rise but at a much slower rate than over the past six months. Although unemployment is now increasing in fewer than half of the UK regions Scotland saw a 0.6 percentage point increase in the unemployment rate in the last quarter of 2011. One particular challenge facing Scotland in reducing the unemployment rate is the reduction of public sector employment associated with the need to cut the deficit. Public sector employment represents a very significant force in Scotland which has a significant state sector (with the exception of Aberdeen, where employment is primarily driven by the offshore sector and some parts of central Scotland which are reliant primarily on farming).<sup>21</sup>

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

The goal of hiring in the private sector is hobbled by the public sector pay premium. National pay scales undermine the less affluent regions' major competitive advantage of lower wages.<sup>22</sup> Lower costs – in the form of lower commercial rents, lower house prices and, most importantly, lower wages and more available people to hire – are the only major source of competitive advantage for economically depressed areas. The public sector fails to utilise these benefits itself by relocating nationwide services to those areas which are able to compete on cost. But it also prevents the private sector from fully utilising these comparative advantages by essentially establishing a pay floor at public sector rates for the wages a private sector employer can offer to compete for the best staff in less economically successful areas.

To attract comparable quality staff, the private sector must then pay competitive salaries to those bargained nationally in the public sector. Where public sector salaries are higher than the efficient market-facing pay levels of local labour markets the private sector is crowded out and cannot compete. With, for example, women in Scotland facing a 20 per cent public sector pay premium, private sector employers face this elevated competition and must factor in this significant pay premium to compete for high quality staff. This impact exists across the wage distribution and for both roles where transferable jobs exist across both sectors – for examples lawyers or administrators – but also where pay differentials shape workers incentives, aspirations and longer-term career choices. Areas and communities that are currently dependent on the public sector must make the transition to private sector-led growth and prosperity.

To do this, private sector work must be allowed to make itself an attractive employer through facing fair competition from public sector employers who pay market-facing rates.

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<sup>20</sup> ONS – Labour market statistics: February 2012

<sup>21</sup> CBI – “Mapping the route to growth - rebalancing employment”

<sup>22</sup> Alison Wolf, CentreForum – “More than we bargained for: the social and economic costs of national wage bargaining”



## **Public Sector Remuneration in Scotland: Issues for a Devolved or Independent Government The Private Sector Perspective**

**David Watt**

The driving force for any economy must be the private sector - or in a small number of instances social enterprises – the parts of our civic society which produce the wealth through the production and delivery of goods and services for consumption in the marketplace – local or global.

Any government regardless of structure and form must face up to rebalancing our economy to grow the income side of the economy to allow it to spend even at the same level of public expenditure in the future and to fund its on-going deficit of around £11Bn. Certainly any sustainable country under a more fiscally responsible government could not continue to ignore the earning side of its finances and just keep spending.

This focus on wealth creation is essential not just desirable if the country is to grow and employment increase. In turn this would help sustain certain manageable levels of public spending. Whilst of course the public sector does input to the turnover side of any country's GDP – in Scotland's case in excess of 50% - the need to grow the pot of money to be spent will become crucial to the economic viability of the country.

This position should not be seen as a competition - private v public - but rather a statement of where Scotland needs to be – a viable economy with a successful private sector generating wealth to provide necessary, affordable and efficient public services. Wherever we are employed we as citizens of Scotland want top quality public services properly funded and delivered through the most effective mechanism to get us all value for money and the highest standard.

It just seems sometimes that politicians don't seem to understand how all this is funded. A more successful private sector means that the public sector will have more funding available in to allow for more of the provision we all seek. Sometimes we get the cart before the horse – we commit to spend without working out how we will get the income or how we will cut the cloth to suit.

Successive Scottish Governments have had a record of a shopping list of expenditure with little responsibility for raising the money or for creating a climate which facilitates tax take growth.

### **Employment regulation/legislation**

There is an abundance of regulation in the area of employment, much of it emanating from Europe and added to by Westminster, which brings cost and inconvenience for employers and acts as a disincentive to taking on additional staff especially those in any unusual post or conditions e.g. short term or temporary.

Expanded parental rights, for example, are seen as an additional burden and complication for employers especially for smaller firms and the related costs are a genuine discouragement to employ people of a certain age – especially women.

The IoD has consistently surveyed its members and found that the vast majority of employers are keen to be adaptable and keen to offer their employees the opportunity to work flexibly and great working conditions; once they have found good staff that are very keen to retain them. They do not feel they need forced to do that by legislation.

Recently we have also strongly welcomed the suggestion by the current UK government that it will revise the existing employment tribunal system and make it fairer to the employer. In particular the suggestion that the employee has to deposit a sum (£500) before taking forward the tribunal is welcome in that it should reduce the number of vexatious claims. There have even been cases of people who spend their time applying for posts just to sue the employer when not appointed for alleged discrimination reasons.

The balance of fairness has swung away from the employer and some are literally terrified at the prospect of getting caught up in long term and costly tribunal disputes. This means they just avoid the possibility by simply not taking on more staff – especially in times of economic challenge.

Getting caught up in employment legalities also make it less attractive for companies to implement changes in structure which they need and so further slows business improvement. Many boards consider such negative impacts of change and sometimes on balance may decide it is not worth the hassle.

### **Affordability**

There is a massive issue around the affordability of pay packages in the public sector as the historic image of lower pay but security of employment has been turned on its head. The low paid image is no longer the case – especially in Scotland and that is true across the board.

The Scottish Government's recent pledge to a "living wage" means that the public servants whose wages it controls directly will be paid well above the minimum wage – at a level the private sector could not easily match for equivalent work. The level of £7.20 an hour is more than a pound an hour above the UK national wage and in excess of 18% more – unsustainable for private sector employers who bizarrely are ultimately funding this level which they can't afford to pay. Ironically if the government taxed them less then perhaps they could!

At the top end of the scale we have hosts of people from University Principals to Consultant Surgeons and QUANGO CEO's earning more than the Prime Minister. The level of low pay is well and truly gone in Scotland as well as the rest of the UK. At middle management level too many administrative posts have a benefits package well in excess of equivalent private sector posts.

An interesting current issue is the localised setting of pay which might well have an impact on the levels set and could lead to public sector pay more accurately matching equivalent private sector standards in any given area.

Moving on to the rest of the remuneration – without considering working hours, flexible working or absence levels – we encounter the massive issue of public sector pension levels.

Back in 2007-8 even the UK Government's own figures indicated that the cost of unfunded public sector public pensions was £30,000 per household, and while that will not all become due in one grab it is an unsustainable situation where governments must act to restructure pension deals. There is a constant cry about "people should get back the reward for what they put in" – this is simplistic and public sector workers, like everyone else, must only expect to get back what they and their employers put in is actually worth at the time of retirement

Lord Hutton carried out a very reasonable and measured review of public sector pensions and suggested some sensible reforms to bring the long term commitments of the tax payer under control and put a fairer share of the cost burden on the pension scheme beneficiary. Despite this there has been delay in implementation and strikes against his sage and sustainable suggestions.

It seems that the air of unreality surrounding this issue continues. The IoD did some research a few years ago that suggested that most people in the private sector were actually paying more towards public sector pensions than they were towards their own! Certainly whether this is factually true or not the feeling in the private sector – SME sector - is that this is certainly the case.

For people to hear factual stories of staff receiving a 12% or even a 20% non-contributory pension is almost sickening at a time when smaller company directors struggle to find any money to put into their or staff schemes.

This is undoubtedly one of the biggest issues for a Scottish Government in whatever new constitutional form, where they would have real accountability for income and expenditure, and one that none so far have shown any appetite for dealing with.

### **Business scale**

All the issues raised so far have an impact on businesses large and small but they do hit particularly hard on the heartland of Scottish business – the SME sector.

The largest commercial companies in terms of employment in Scotland are in the retail and financial services and for them – RBS, HBOS, Standard Life, Asda or Tesco – the burdens of employment legislation and local and national taxes while costly are borne across a sizeable business and are not life-threatening though expensive and sometimes discouraging.

However for much of the rest of the private sector across the country the public sector in all its forms can provide a threat as well as an opportunity. The sheer scale of the public sector in many areas of Scotland almost drowns out the private sector and so becomes the lead employer of choice.

To look at places like Fife and Ayrshire as examples, the public sector massively outweighs any private presence and significantly distorts the job market. Fife Council – even slimmed down - will employ 20,000 people which in combination with the health board and the University and College sector dwarfs even Dockyard employment let alone small engineering businesses.

There are a host of figures trotted out as to the makeup of the Scottish economic base but it is widely recognised that over 90% of Scottish Businesses may be ranked as small and employ less than 10 people. They are though enormously important to the economy and the geography of Scotland and have a disproportionate impact on many of the more remote communities in particular.

The next level of businesses employing 10 – 250 people and turning over anything from £3 – £100 million per annum are very important to Scotland as well and predominate in terms of significant employment in many areas of our industrial hot spots like Lanarkshire or West Lothian.

There is no realistic way that businesses in these sectors can compete for employees over remuneration levels or packages, making it supremely difficult for them to attract staff – especially in non-specialist roles.

The public sector may not employ thousands of engineers but it does offer very favourable terms and conditions in administrative, service, care and support roles.

It can and does squeeze out the private sector from some sectors and raises levels of pay for support staff well above the reward levels which SME's can afford.

The public sector needs to realise the impact it has in such areas and, despite political pressures, work harder not to displace the private opportunity. The controversial plan to set and vary public sector wages locally is certainly worth considering and may well have a beneficial impact in areas like the Highland and Islands in particular where labour can be scarce and attracted away by the public sector.

An interesting current suggestion from the UK government (opposed by the Scottish Government) is the localised setting of pay which might well have an impact on the levels set and could lead to public sector pay more accurately matching equivalent private sector standards in any given area.

Some IoD UK Policy Voice data drawn from a survey of 1,117 IoD members conducted in Oct/Nov of 2011 produced some interesting findings – the findings for Scotland are given in brackets. Whilst the usual health warnings apply vis-à-vis sample sizes in the Scottish context, the feedback does suggest some support for local wage setting, although considerably less in Scotland than the rest of the UK.

1. "Currently public sector pay is set by national pay scales. Decentralising public sector pay in health and education would mean, for example, that a head teacher would set salaries for teachers in their school. Would you support or oppose the decentralisation of public sector pay in health and education?"

Oppose - 23% (44%)

Neither support nor oppose - 17% (27%)

Support - 57% (40%)

DK - 3% (2%)

Somewhat contradicting this finding there appears to be more concern in Scotland that public sector pay scales make it difficult for private sector companies to compete in the recruitment market.

2. "It has been argued that national public sector pay scales make it difficult for SME's in some parts of the UK to attract skilled staff because they can't compete with the public sector on wage levels. In your experience, has this been a problem?"

No - 57% (50%)

Yes - 27% (39%)

DK - 16% (11%)

## **Summary**

There is real concern in the private sector over public sector remuneration – not simply about wage levels but also about the benefits; the pension costs and the displacement effect. It is an issue in Scotland right now and one which will affect the speed of the drive towards wealth creation instead of wealth spending. It also has a disproportionate effect on the SME sector which predominates in the Scottish economy.

It is particularly relevant to the constitutional debate because there can be little doubt that whatever the structural format of the government in the future and the outcome of any referendum on independence, Scotland can only grow and thrive if it increases the size of the private sector and alters the balance of its balance sheet away from reliance on the public sector.

The real debate going forward must be about the economy and how it is best re-structured in a new constitutional arrangement, because this will determine the country's future prosperity and sustainability.



## **The Reform of Pay Setting**

**Robert Elliott and Alex Bryson**

### **Introduction**

The context in which public sector pay is set in Scotland and the rest of the UK has changed in recent years. Over the twenty years to 2004 the percentage of public sector employees in the UK who are union members fell from 84% to 57% and collective bargaining as the locus of decision for pay determination declined steadily (Bach et.al.) The preferred mechanism of the governments of the territories in the UK for up-rating the pay of public sector employees is now Pay Review Bodies. The recent focus of discussion within these bodies has been on tying salary progression to performance and introducing local pay.

How should Scotland set the pay of its public servants? What institutions should it establish to do this and at what level should pay be set: nationally, regionally or locally? These issues are interlinked and are discussed in this chapter. The issue of reform transcends the debate about independence for many argue that the reform of pay setting is required even if the existing arrangements remain. In this chapter we shall look at the current arrangements for setting the pay of public servants in Scotland and contrast these with those in other small open economies in Northern Europe. We shall discuss the issue of local versus centralised pay setting and consider which of these might be appropriate for Scotland or whether some intermediate arrangement might be better.

Chapter 1 set the backdrop for this discussion, reporting the changing composition of the public sector workforce, the overall difference between pay in the public and private sectors of the Scottish economy and the cyclical nature of these pay differences. At a time when the Scottish and UK economies have yet to attain the output levels achieved prior to recession and there is extreme downward pressure on public spending, arguments for reform proposed on efficiency grounds can become confused with arguments for reform motivated by a desire to cut public spending. In this chapter we concentrate on the former.

### **Current Pay Setting in Scotland**

The pay of public sector employees working in Scotland is currently set in one of two ways. Either pay results from Scotland-wide negotiations, where these are led by either the Scottish Government or a Negotiating Body, or the Scottish Government adopts the recommendations of UK-wide pay review or negotiating bodies. How each of these applies to the main groups of public sector employees in Scotland is shown in Table 1.

**Table 1**

**Public Sector Pay Setting Arrangements in Scotland**

Pay Determining Bodies	Staff Groups	Geographical Coverage of Pay Rates
<p><b>Scotland-wide negotiations</b> <i>Led by Scottish Government</i></p>	NDPBs, Public Corporations, Departments and Agencies (including Scottish Prison Service), Main Scottish Government (excl. SCS) and NHS senior managers	Scotland
<p><i>Led by negotiating bodies</i> Scottish Negotiating Committee for Teachers (SNCT).</p>	Teachers and associated professionals	Scotland
Scottish Joint Council, Scottish Joint Council for Craft Operatives, Scottish Joint National Council for Chief Officers	Local authority staff (excluding teachers, police and fire)	Scotland
National Joint Council for Local Authority Fire and Rescue Services	Fire Officers	Scotland
<p><b>Scottish Government adopts recommendations of:</b></p>		
Doctors and Dentists Review Body ( DDBR)	Employed Hospital Doctors, General Medical Practitioners ( GMP) and General Dental Practitioners ( GDP)	UK-wide
NHS Pay Review Body (NHSPRB)	Agenda for Change - nurses, allied health professionals, clerical and administrative staff	UK-wide
UK Police Negotiating Board (UKPNB)	Police	UK-wide
<p><b>Reserved to UK Government:</b></p>		
Armed Forces Review Body (AFRB)	Armed Forces (below senior ranks)	UK-wide
Senior Salaries Review Body (SSRB)	Senior Civil Service ( SCS), Judiciary and Senior Officers of Armed forces	UK-wide



There are two important features of the present arrangements. First all of them result in national, Scotland-wide, rates of pay. Save for small additional payments, called ‘Islands Allowances’, made to some who work in remote and island locations they take no account of local and regional variations in labour markets. Local labour market conditions will be important determinants of the labour supply of some groups of public sector workers.

Second for a very substantial part of the Scottish public sector workforce, all working in the Scottish NHS and police service, the rates they are paid are the same as those paid to staff in the same grade in the rest of the UK, save for those working in London or the South-East of England. Under these arrangements the agenda informing either the pay negotiations or the pay review is, in the main part, set in England. The priorities of the other territorial governments need not always be the same as those of the Scottish government. Where distinctive Scottish institutions deliver Scottish public services we might expect these to be complemented by distinctive Scottish pay structures. This is already the case in teaching and local authorities where Scotland has established separate Scottish pay structures and up-rating arrangements. It follows that some of the existing arrangements are unlikely to be sustained under either more devolved fiscal powers or full independence.

### **Wage Setting in Other Small Open Economies**

Contrast the arrangements in Scotland with those that exist in other small open economies in Northern Europe. How other small open economies set the wages of their public servants could provide lessons for Scotland. We shall look at three countries often held up as examples for Scotland to follow in discussions of economic affairs: Sweden, Norway and Ireland.

Broadly speaking models of wage setting may be classified as either centralised or decentralised and while centralised means wage setting is co-ordinated across different, usually occupational, groups decentralised can be further split into co-ordinated or fragmented. Wage setting in the UK private sector would be an example of the latter. Sweden offers a model of decentralised and co-ordinated pay setting, Ireland of highly centralised and therefore necessarily co-ordinated pay setting, while Norway is an intermediate case combining national centralised bargaining and local bargaining.

Sweden’s model of decentralised pay setting is one of individualised pay setting within a general framework which ensures co-ordination and facilitates a degree of equity and control of wage costs. Negotiations take place at two levels; national to determine the framework and individual to set the pay of each employee. In Sweden there has been a gradual but sustained move over the past three decades away from centralised bargaining to what they term ‘individualised and differentiated’ pay. Framework agreements set limits to the total amount by which the wage bill for any part of the public sector can increase and establish some conditions, such as holiday entitlements, that will apply nationally. Within the wage bill ceiling highly decentralised negotiations then determine what individual employees will receive. Negotiations may go down to units of as few as ten people. Any performance elements of salary are awarded on the basis of local management’s decisions using procedures agreed locally. Large numbers of public sector professionals represented by the Swedish Confederation of Professional Associations (SACO) negotiate on an entirely individual basis, while in schools the head typically deals with all teachers (Bender and Elliott, 2003; Wolf, 2010).

Such a system requires strong and confident local employer and union branch structures. These local structures have been a feature of the Swedish public sector for several decades. A distinctive feature of Swedish industrial relations has been the history of cooperation between employers and organised labour. This stretches back over many decades and is most vividly illustrated by the construction, in the sixties and seventies, of a common macroeconomic forecasting model which served as the main model informing Swedish macroeconomic policy for many years. (Bender and Elliott, 2003) A common macro model requires a common view of the economy. The move to decentralised bargaining was facilitated by this common view and made possible by local union officials and employers confident in negotiating locally and who did not resist reform. None of these conditions is met in Scotland and thus an immediate move to individualised bargaining will not work in Scotland.

Norway has a tradition of centralised national pay bargaining but there has been a trend towards decentralisation in recent years with the emergence of enterprise-level bargaining. However, local negotiations take place within a framework set by national-level agreements. The Norwegian system is thus often described as one of "articulated decentralisation" or "organized decentralisation"<sup>1</sup>. Negotiations are first concluded for the competitive, private, sector, and the level of settlement for this sector indicates the overall ceiling for the public sector. Negotiations in the public sector then take place at two levels and comprise three elements: a central negotiation delivering a general, national, pay increase (2% in 2011); a further centrally negotiated adjustment which takes account of specific conditions, such as a generalised shortage, which applies to only some occupational groups and; a third element which is determined in local bargaining. This last is generally quite small, for example 0.9% in 2011. Many of the observations applicable to Sweden also apply here. There has been a strong tradition of national collective bargaining underpinned by strong and confident local employers and union branches with a history of co-operation.

The Irish case is quite different. The "voluntarist" tradition of employment relations that it shared with the UK has been supplanted by a rights-based system built on individual employment law which some argue is supplanting collective bargaining as the chief means of resolving industrial relations issues. But Ireland is a good example of a country that has radically transformed its arrangements for pay bargaining in recent decades. Since 1987, the national level has been the most important arena for setting wages which it does via a highly centralised system of tripartite bargaining<sup>2</sup>.

Consider the similarities and differences between these countries and Scotland. Scandinavian countries are distinguished by their separate languages and systems of education. Cross-border labour flows between Scandinavian countries are small. In contrast Ireland shares a common language with the UK and educational qualifications are generally mutually recognised and skills therefore transferable. There are large labour flows between Ireland and the UK. Language and education are two determinants which facilitate labour mobility.

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<sup>1</sup> See [http://www.eurofound.europa.eu/eiro/country/norway\\_4.htm](http://www.eurofound.europa.eu/eiro/country/norway_4.htm)

<sup>2</sup> See [http://www.eurofound.europa.eu/eiro/country/ireland\\_4.htm](http://www.eurofound.europa.eu/eiro/country/ireland_4.htm)

Scotland, like Ireland, shares large cross border labour flows with the rest of the UK. Indeed those between Scotland and the rest of the UK are much larger than those between Ireland and the UK, even allowing for differences in population size.<sup>3</sup> Any redesign of public sector pay systems in Scotland must take this into account. Where Scotland and the rest of the UK compete in the same labour market the rates paid in these countries cannot diverge very far if they are both to recruit and retain the labour they need.

Yet Ireland also illustrates that even where two countries are competing in the same labour markets very different wage setting systems can co-exist. This is partly a function of Ireland's membership of a different currency area, for exchange rates also play a role in determining labour flows, but this is not the entire explanation. Countries can arrive at different national views about what the appropriate wage structure might be, and where there is national consensus that different arrangements should apply different systems can co-exist.

### **Centralised or Decentralised Pay Setting?**

Ireland has a highly centralised system of wage setting, Sweden a system of decentralised, individual, pay setting. What are the advantages of each? Centralised systems offer the advantage that they enable governments to exert direct control over pay. At times when general restraint on public sector pay is judged to be required they can be most effective. The disadvantage is that they typically impose uniform pay and conditions on several different staff groups and lack sensitivity to conditions in the different labour markets for each of these groups. The advantage of decentralised systems is that they enable pay to be set at levels that reflect conditions in the local labour market though this consideration is less relevant where the labour market for the staff group is national or international.

Individualised systems such as exist in Sweden offer local managers greater autonomy to set pay and for better alignment of pay and performance. But for these advantages to be realised robust performance management and appraisal systems must be in place. This is seldom the case anywhere in the UK public sector and accordingly any move toward individualised bargaining would require new systems to be developed. HR departments and managers would also need to assume new powers and responsibilities where they currently have little or no relevant experience or expertise. For there to be meaningful local or even individualised negotiations there would need to be competent local union or professional body branches and again this is seldom the case.

A disadvantage of an individualised or decentralised system can be the exploitation of bargaining strength when there are large inequalities in bargaining power either on the part of employers or employees. Where power is held by employers they could use this to push rates of pay below competitive levels. Though this should not be sustained where employees are free to exit their jobs and look for other work. Where there are high levels of unemployment and employees have few alternative job opportunities the abuse of market power would be a concern.

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<sup>3</sup> In 2011, total flows between Scotland and the rest of the UK were 82.4 thousand, compared to 28.5 thousand between Ireland and the UK.

Where employees, or their representative professional bodies or trade unions, possess the greater power they may push rates above competitive market clearing levels, resulting in higher levels of public expenditure or job loss. However there is evidence that this disadvantage may disappear where unions bargain over *both* wages and employment for it has been shown that under these conditions the negative effects of exploitation of union bargaining power on employment growth disappear (Bryson, 2004).

Decentralised systems can be high cost systems. The high costs can arise from duplication of time and effort that is associated with multiple centres of pay setting. Decentralised systems can also result in higher wage bills or increased turnover where local managers do not have the skills and experience to set pay at the 'right' level for the local market. These disadvantages can be minimised if local negotiations take place within a framework which clearly identifies the conditions under which higher pay can be awarded in some localities.

### **Local or National Pay Setting?**

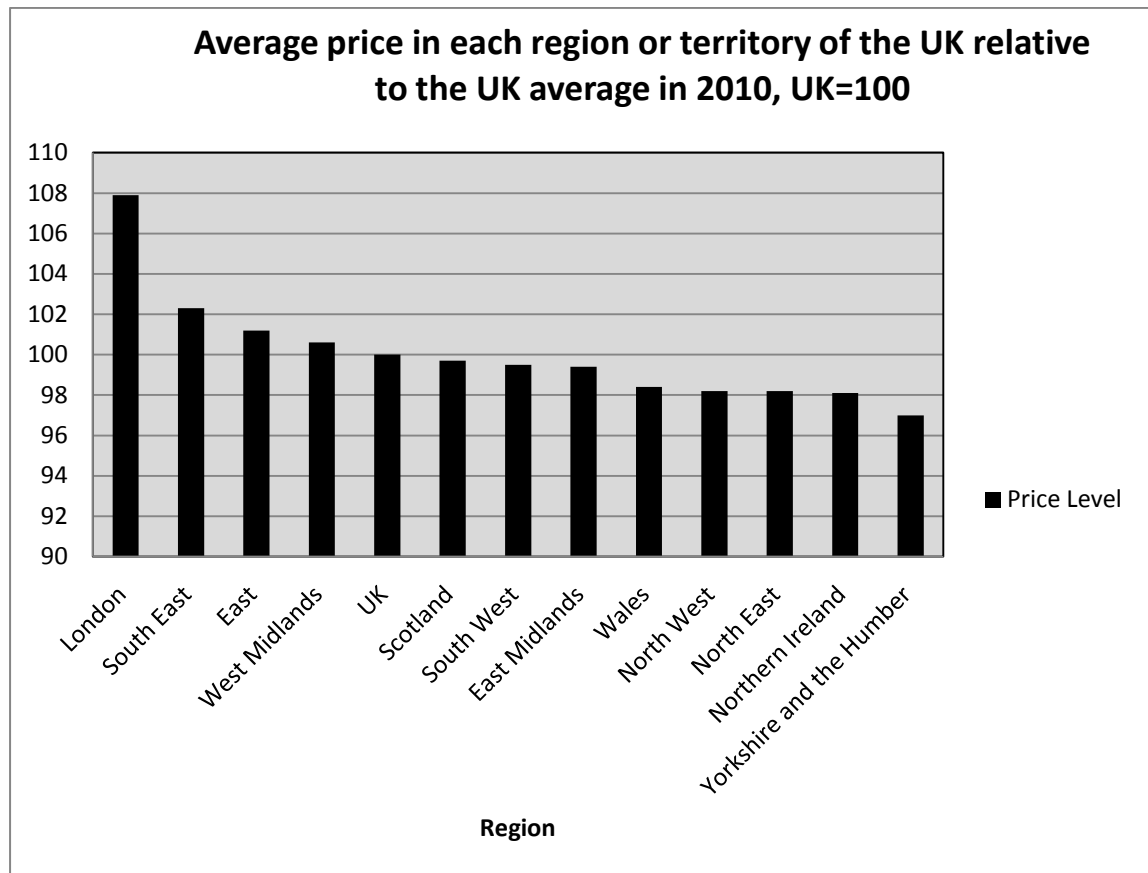
Pay should be set at competitive levels as defined by conditions in the relevant labour market. For some staff groups this will mean pay should be set with reference to local markets while for others pay should be set with reference to national. For a very few at the very top of the public sector pay might need to reference international labour markets. Conditions will vary between these labour markets, and where pay is set with reference to local markets pay will vary between localities.

Research evidence on the boundaries of public sector labour markets is scarce. There is evidence to suggest that teachers and nurses are recruited in local labour markets. Though it is largely for England, recent research has shown that the ability of schools to attract teachers and of hospitals to attract nurses varies with the local competitiveness of teachers and nurses pay (Elliott et. al. 2007 and 2011 and Ma et. al. 2012). By extension we would anticipate that the markets in which public sector employees at similar skill levels are recruited are also local.

There is evidence to suggest that the labour markets in which NHS hospital doctors operate is at least national and likely UK-wide (Elliott et. al. 2007). Hospital doctors frequently move hospital and in doing so move quite substantial distances. Again by extension it can be deduced that the labour markets in which other senior professionals in the public sector operate are at least national.

If pay is set locally it will almost certainly vary between localities in Scotland. Though the only published data is for regions and territories in the UK it shows that the cost of living varies by as much as 11% between the regions of the UK. The variation in the cost of living across the regions of the UK is shown in Figure 1 below. Received wisdom is that the cost of living also varies across Scotland though by how much is not known. However, house price variations, which are often substantial, are a major element. In 2011, the range of house prices lay between Edinburgh City, 44% above the Scottish average, and East Dunbartonshire, 33% below.

**Figure 1: Regional and territorial price levels relative to national price levels, 2010<sup>10</sup>**



Source: *UK Relative Regional Consumer Price levels for Goods and Services for 2010, Office for National Statistics (2011)*

Employees are concerned about real pay and we should therefore expect that, in the absence of wage regulation through either collective bargaining or the deliberations of pay review bodies, nominal rates of pay would exhibit the same pattern of regional variation as do prices. Where pay is set in competitive labour markets we expect pay to compensate for local price differences and to equalise real incomes. If there was less than full compensation mobile employees would move out of the high cost areas to the low cost ones and new entrants to the labour market would resist working in high cost areas. There is a further reason why pay would be expected to differ between localities and this is because localities differ in attractiveness. For example it has for long been very difficult to attract general and specialist medical staff to the Scottish Islands; pay would appear not to compensate fully for the perceived unattractiveness (to these professions) of working in these remote communities.

In 1776 Adam Smith developed the theory of net advantages which he proposed to explain how, as a result of competition in labour markets, wages would be expected to adjust to compensate for differences in the cost-of-living and attractiveness of working in different areas. He wrote:

*“The whole of the advantages and disadvantages of different employments of labour --- must in the same neighbourhood, be either perfectly equal or continually tending to equality. If in the same neighbourhood there was any employment either evidently more or less advantageous than the rest so many people would crowd into it in the one case, and so many desert it in the other, that its advantages would soon return to the level of other employments”.* Smith, 1776  
Book 1 Chapter 10

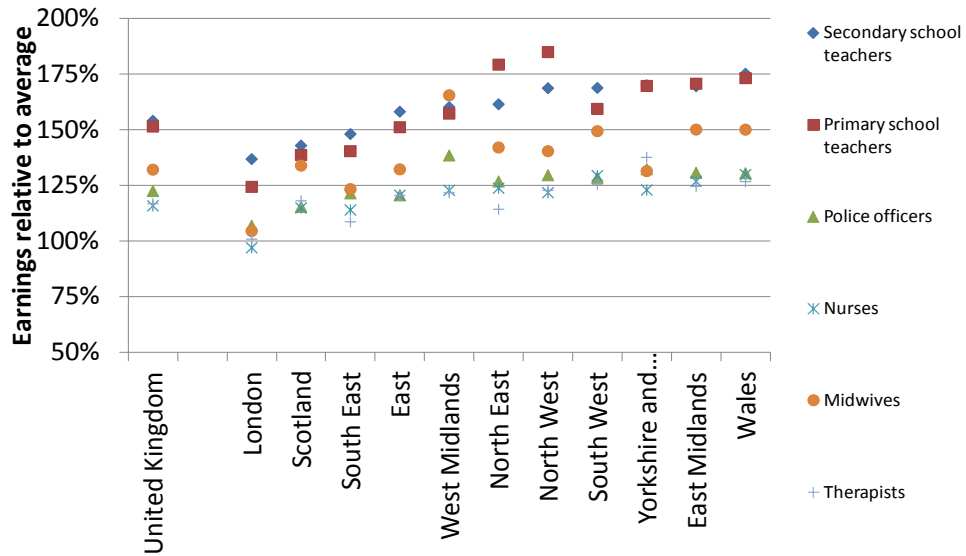
Large employers in the private sector of the UK economy, who have workplaces in different parts of the UK, usually have regional pay structures. Typically these are framework agreements which make specific provision for setting different rates of pay in different areas. These frameworks describe ‘pay zones’ and attach different pay bands to each zone. Some of these zones cover London and the South East but the remaining bands cover other localities. They are sometimes called ‘regional salary bands’ but the geographical areas they detail do not correspond to regions and therefore this description is misleading. They specify rules and procedures for adjusting pay to the local market conditions and the rules are usually designed to remove discretion from local managers inexperienced in pay setting: rules identify the conditions under which higher pay is offered. Typically the rules require managers to produce evidence of the rates paid by local competitors, of the local cost of living, and perhaps of local unemployment or turnover rates as evidence of market tightness (Incomes Data Services, 2002). Private sector employers employ also other ways to adjust pay to local market conditions. They place new employees on higher scale points and advance existing employees more quickly up pay scale in areas where labour would otherwise be difficult to attract. They might also offer additional overtime payments or accelerated promotion in hard to recruit areas. These adjustments don’t show up in basic salary scales and can only really be distinguished in data on average earnings.

The evidence shows that average earnings in the private sector of the UK economy vary quite substantially between localities (Elliott et. al., Ma et. al. and Propper and Van Reenen op.cit.). One explanation for these differences is that employers set wages and they pay only what is necessary to attract and retain labour. Over the last twenty five years the impact of trade unions on pay setting in the UK has diminished. In 2009 one in six private sector employees were covered by a collective agreement and only 15% were members of a trade union (Bryson and Forth, 2011). In 2011 14.6% of private sector employees were union members in Scotland (see the Chapter by Bell and Elliott). This development may give employers greater leeway to set local rates as they choose.

In contrast in the UK public sector where wages are regulated through collective bargaining and Review Bodies there is, save for London and the South East of England, very little difference between the pay of public servants in any staff group working in different areas of the UK. This means that there are local variations in the gap between public and private sector pay.

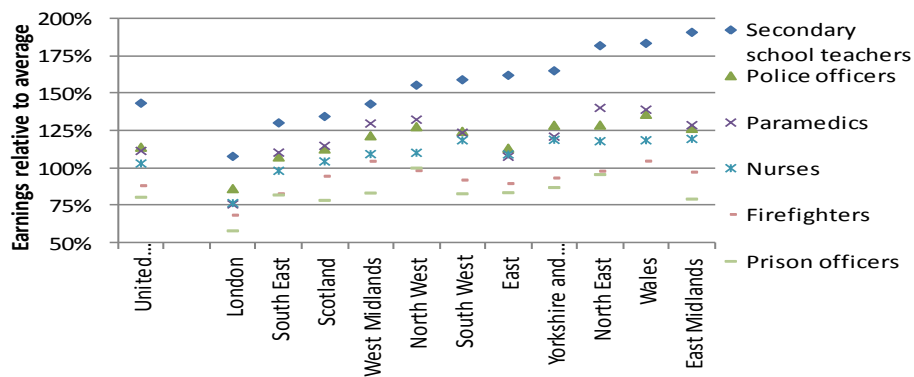
Evidence that the gap varies between the regions and territories of Great Britain has recently been produced by the IFS. After they have controlled for the differences between the skills and experience of the workforce in the public and private sectors they report the patterns shown below in Figures 2 and 3.

**Figure 2 Relative pay across regions, selected occupations for women**



Notes and sources: see Figure 5.11 of *The IFS Green Budget: February 2012*.

**Figure 3: Relative pay across regions, selected occupations for men**



Notes and sources: see Figure 5.10 of *The IFS Green Budget: February 2012*.

The IFS analysis shows that the difference between public and private sector pay, often called the public sector pay premium, differs between the regions of the UK - with some of the highest premiums in Wales and the North East of England. A premium between the pay of public sector employees and that of private sector employees with similar levels of training may be warranted, where for example the public sector jobs are more stressful or dangerous, but what is not evident is why the premium should vary as shown in Figures 2 and 3. The premium is shown to be generally greater for women, the pattern differs by occupation and the variation appears greatest for teachers. Much has been made of these differences and it should be noted that the like-for-like comparisons that underpin the analysis take no account of important differences in several other factors that will influence pay in the two sectors. They take no account of variations in the industrial and occupational composition of the workforces in different areas. If this were done it is likely that the regional pattern of wage differences between the public and private sectors would change.

However though the pattern might change it will not disappear. Evidence that there are differences and they matter has been produced in research that links local differences in the measured public premium to local differences in the supply of labour to public employers and local differences in the ability of public sector employers to attract and retain labour. Elliott et. al. 2007 have shown that local differences in the measured premium affect local nursing vacancy rates in England. Propper and Van Reenen (2010) have shown that local differences in the measured premium directly affect service quality in the NHS in England and Ma and Elliott (2012) have shown that local differences in the premium affect the ability of secondary schools in England to attract and retain teachers and that this affects pupil performance.

The most robust evidence available is for England. Unfortunately the data is rarely detailed enough or the samples sufficiently large to allow the same analysis for Scotland. However there are reasons to suspect that this might also be true for Scotland.

### **Pay in the Private Sector in Scotland**

There is evidence that pay in the private sector of the Scottish economy varies between different areas of Scotland. In evidence to the NHS Scotland Resource Allocation Committee in 2006 (Sutton et. al.) it was shown that once controls have been introduced to ensure like-for-like comparisons, rates of pay in the private sector in Scotland differed by quite a wide margin between the areas of Scotland. When these are set against Scotland-wide rates of pay for most public sector jobs it is evident that the attractiveness of public sector jobs differs between areas of Scotland.

Like-for-like comparisons between different localities are produced by calculating Standardised Spatial Wage Differentials (SSWDs). SSWDs are calculated by taking observations on individual employees' pay then adjusting them, using multivariate methods, to account for differences in the personal characteristics of employees, such as their age and gender, and the characteristics of the jobs they do, such as the occupation and industry in which they work. The SSWDs that result distinguish those differences in pay that are attributable to the locality in which the employee works. When this was done for Scotland for the period 1999 – 2005 it revealed much less variation between areas of Scotland than between the areas of England, but there was still significant variation. Table 2 reports these SSWDs and their evolution over the period 1999 to 2005 for Scottish Local Authority Districts (LADs).



Five sets of wage differentials were calculated in order to observe whether or not the wage differences across LADs had widened or narrowed. The summary statistics of the SSWDs by LADs for each of the periods and the values of all the SSWDs are reported in Table 2.

The standard deviation shows the variation in pay between the different areas. This has changed little: it was 5.03 percent in 1999 –2001, and 4.67 in 2003 – 2005. Another measure of dispersion is the difference between the highest and the lowest SSWDs. The dispersion around the (standardised) mean, as reflected in the difference between the Max-Min, has reduced from 25.28% in 1999 – 2001 to 19.4% in 2003 – 2005 reflecting a reduction in dispersion in the lower part of the distribution. But the maximum is a steady 8% more than the Scottish average and the minimum rises from 18% to 11.5% below the Scottish average.

**Table 2: Summary Statistics of Private Sector SSWDs by Local Authority Districts**

	1999-2001	2000-2002	2001-2003	2002-2004	2003-2005
Mean	100	100	100	100	100
Standard Deviation	5.03	5.22	5.04	4.70	4.67
Min	81.98	86.01	86.49	87.48	88.51
Max	107.26	107.72	107.79	107.45	107.92
Max – Min	25.28	21.71	21.30	19.97	19.42
Number of Obs.	23,590	23,735	23,748	23,774	24,195

Means standardised to 100

This same report also identified those Local Authorities that had SSWDs that were significantly different from the Scottish average. Three of the four city LADs, covering the major conurbations in Scotland, those in Grampian<sup>4</sup>, Lothian and Greater Glasgow had SSWDs that were significantly above the Scottish average. Many of the LADs in the central belt area also had SSWDs that were significantly above the national average, as did the Shetland Islands. The SSWDs that were significantly below the Scottish average were those for many rural local authorities, particularly the Scottish Borders, the Western Isles, Argyll & Bute, East Ayrshire and the Orkney Islands.

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<sup>4</sup> The oil industry plays an important role in setting the wage level in the Grampian area. Once controls have been introduced to capture this effects of the oil industry the wage difference between Aberdeen City and the average for Scotland falls from 118.4 (no controls) to 107.9 (all controls).

Remoteness is recognised to be associated with higher prices for foodstuffs and fuel, which are important elements of the cost of living, but there are other elements most notably housing which are lower. The differences in SSWDs may reflect a lower overall cost of living in most rural and remote areas or the perceived higher amenity of living and working in these areas. Whatever the explanation, these SSWDs reflect differences in what the private sector pays in the different areas of Scotland and it follows that when these differences are set alongside the national wage schedules that operate in the public sector in Scotland there are likely to be substantial variations between areas in Scotland in the public sector premium. Chapter 1 has explored some of the consequences of spatial differences in the premium.

## **Discussion**

As the differences between the institutions that deliver public services in Scotland and the rest of the UK grow, so does the case for reform of public sector pay structures in Scotland. We already have separate pay structures for our teachers and local government. Pay structures need to align with the systems that deliver public services and motivate the achievement of specific institutional goals. If Scotland's delivery systems and goals are different then so should be pay structures. Discussion about pay reform will grow whatever the constitutional arrangements.

The cost-of-living seems likely to differ between localities in Scotland and there are also likely to be variations in the attractiveness of working in different areas of Scotland; uniform nominal rates of pay across Scotland for public sector jobs would appear inappropriate. Uniform nominal rates might give the appearance that they are fair because they pay public sector workers with the same skills and qualifications in one area the same as public sector workers in another area. However this is an illusion, if the cost of living differs between areas then **real** rates of pay will differ and this is unfair. The argument against local pay needs to be made on grounds of practicality or for other reasons, not on grounds of fairness.

Indeed the public sector already has regional pay. In England public sector employees in London and the South East are already generally paid more. The current discussion in England involves increasing the London and South East premiums and extending differentiation to other areas, to 'hot spots' in which there are recruiting difficulties. Differentiation introduces 'cliff edges', large discontinuities at the borders between areas which attract a premium and those which do not. These discontinuities can increase problems of retention in those areas contiguous to localities paying a premium.

In Scotland the discussion is about whether regional or local differentiation of pay should be introduced. The scale of any local differentiation would almost certainly differ between occupations. It might be necessary to pay nurses more to attract them to work in high cost areas but not doctors. If the high cost areas are also the areas in which doctors can best advance their careers through more rapid promotion or through greater opportunities for private practice then they do not require the same premium as nurses to attract them to work in these areas. The case for each occupation needs to be evidenced by robust research. At present the data required to evidence robustly the extent of both public and private local pay differences in Scotland is not available in the detail required.

These practical issues do not mean there should not be local pay variation. One model for Scotland might be the introduction of framework agreements, such as exist in the private sector of the UK economy. However in the Scottish public sector where employees are represented by unions and professional associations, unilateral employer led determination of the appropriate pay band is unlikely to win agreement.

Framework agreements of a different type, such as exist in Sweden offer the attractions of co-ordination and cost containment, associated with national agreements, combined with the sensitivity to local market conditions associated with decentralised systems. Both the Swedish and Norwegian models combine elements of central pay setting with local pay bargaining. But the highly individualised pay setting of the Swedish model is inappropriate; neither employers nor employee representatives yet have the local networks required to make this work. Equally handing responsibility for pay setting over to public employers to unilaterally set local rates of pay will encounter employee resistance and prove disruptive in the short term.

The key data in this discussion are local vacancy and turnover rates in public sector jobs. Where these show local variations in the ability of the public sector to attract and retain staff they offer prima facia evidence that public sector rates of pay vary in competitiveness between localities. Of course data for the current period will not reveal such patterns: in a period of severe public expenditure cuts, public sector job losses and extensive unemployment there is little if any voluntary turnover or hiring and a queue for any job. Though current vacancy and turnover data will provide little guide as to what is appropriate over the medium term, pre-recession data can.

If new institutions are created to set public sector pay they must be effective in both the short and medium term, because they are unlikely to be changed again quickly. They must enable pay to be set at competitive levels and responsive to the different conditions in the labour markets in which the public sector recruits. The survey of wage setting in other small open economies in Northern Europe reported the Norwegian model which combined an element of central pay setting with some element of local bargaining within a framework which offered overall central control of wage bill growth. This could be the way for Scotland to proceed.

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## Public Sector Pensions in Scotland

### David Bell

#### Introduction

Public sector pensions have a number of important roles in the Scottish economy. First, they are an important source of income for a significant fraction of Scottish pensioners; second they are an important cost both to public sector employers and employees; third, they are a potential source of pressure on the budgets of both the Scottish and UK governments; fourth, they confer benefits on public sector retirees that are only available, or available on a much lower value basis, to a declining share of private sector retirees. This chapter reviews public sector pensions in Scotland, shedding some light on these issues. In particular, it focuses on the following issues:

- current public sector pensions and contributions
- the future affordability of public sector pensions
- public sector pensions in an independent Scotland
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#### Current Pensions and Contributions

The broad statistics on public sector pensions suggest that they are playing an increasingly important macroeconomic role in the economy. In the UK as a whole, expenditure on public sector pensions was £32 billion in 2008/09. It increased by a third in ten years. The costs of public sector pensions are now equivalent to around two-thirds of the cost of the entire state pension. They are also equivalent to around 2% of GDP – more than double their cost 40 years ago.

There is also a microeconomic aspect to public sector pensions. They affect the decisions workers make about jobs and their future. So the question of whether public sector pensions are larger than those enjoyed in the rest of the community has wide interest. But it is quite a difficult question to answer because although pensioner incomes are well-known, few surveys ask pensioners whether they previously worked in the private sector, the public sector, or indeed worked at all. However, it is possible to piece together some comparative statistics. These are shown in Table 1 below:

**Table 2: Weekly Earnings from Occupational or Private Pensions, Scotland 2009-10**

	Total	Men	Women
Civil Service	£81.2	n/a	n/a
Local Government	£91.4	£130.2	£62.6
National Health Service	£135.7	£256.8	£98.0
Teachers	£196.5	£246.9	£171.9
Fire-fighters	£255.6	£281.4	£111.9
Police	£301.4	£341.0	£173.1
Scotland Occupational or Private Pension	£168.2	£198.2	£121.8
RUK Occupational or Private Pension	£172.4	£209.2	£116.3

*Sources: Family Resources Survey and Audit Scotland*

A recent report by Audit Scotland<sup>1</sup> estimates the annual value of pensions in Scotland received by members of the six largest public sector pension schemes. These are listed in Table 2. On average, weekly pensions range from £81.20 for ex-civil service employees to £301.40 for ex-police officers. The low-level of civil service and local government pensions partly reflects the preponderance of low-paying jobs in these parts of the public sector, shorter average hours and more opportunities to transfer to other sectors of the economy, which shortens average lengths of service and therefore pension entitlement. Table 2 also shows that pensions for men are significantly higher than those for women. Again, this reflects higher career earnings among men, which is then reflected in the value of their pensions. For women, career interruptions reduce length of service, which under present pension rules has an adverse effect on their value.

Table 2 includes estimates of the weekly value of occupational and private pensions for Scotland and the Rest of the UK<sup>2</sup>. These are derived from the 2009-10 Family Resources Survey (FRS). These estimates therefore include pensions from both the public and private sectors: the data do not identify the source of the pension. They show that weekly pensions in Scotland are slightly less than the UK average of £172.40. This is not surprising, given that through time weekly earnings in the UK have typically exceeded those in Scotland, albeit by a small margin. Interestingly, the gap is driven by lower male pensions: occupational and private pensions for women in Scotland are more than £5 per week greater than those in RUK. Perhaps this reflects greater lengths of service among female workers in Scotland, where perhaps there have been fewer alternative sources of employment.

The overall estimates show that the average pensions derived from the civil service, local government and the NHS are somewhat lower than the Scottish average, whereas teachers, fire-fighters and particularly police officers receive pensions that are well above the average for all occupational groups in Scotland. The FRS data also show that only around 48% of Scots aged over 65 have any form of pension other than the state pension. We do not know whether these individuals previously worked, and if so, for what type of organisation, though it is very unlikely that those employed by the public sector, except in the very temporary capacity, will not have earned some eligibility to a pension.

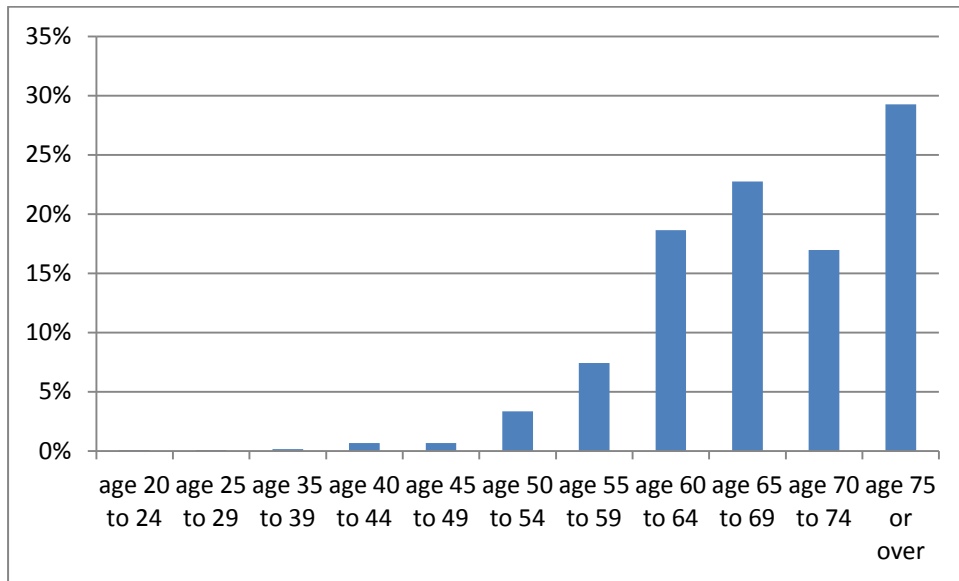
Although the data in Table 1 do not suggest a great disparity in the average value of public sector pensions and the overall average value of occupational and private pensions in Scotland, these figures reflect historic patterns of pension design and contribution. This is clear from Figure 1, which shows the age distribution of those used to calculate the value of the average weekly pension in Scotland in Table 1. Almost 30% of this group are aged 75+ and are likely to have left the labour force at least 10 years ago, when the outlook for pensions was much different from the present.

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<sup>1</sup> Audit Scotland (2011) "The Cost of Public Sector Pensions. In Scotland "

<sup>2</sup> The estimates do not take account of lump sum awards, which may form an important part of some pension settlements.

**Figure 15: Age Distribution of Occupational and Private Pension Recipients Scotland 2009-10**

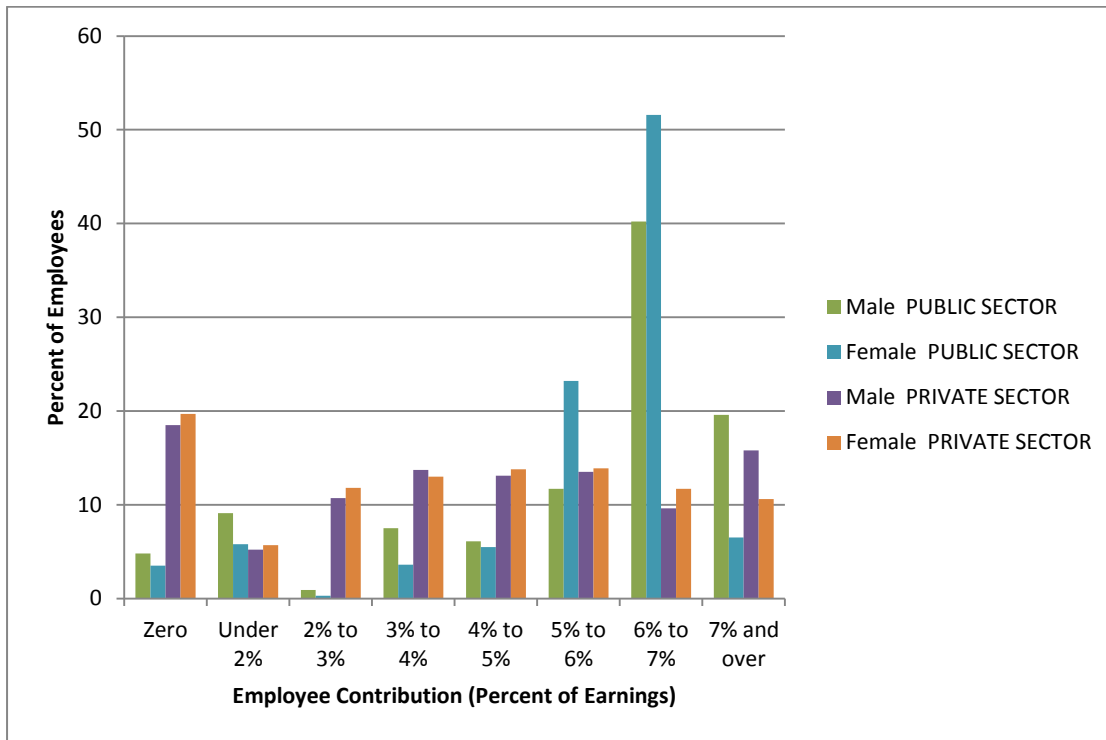


*Source: Family Resources Survey*

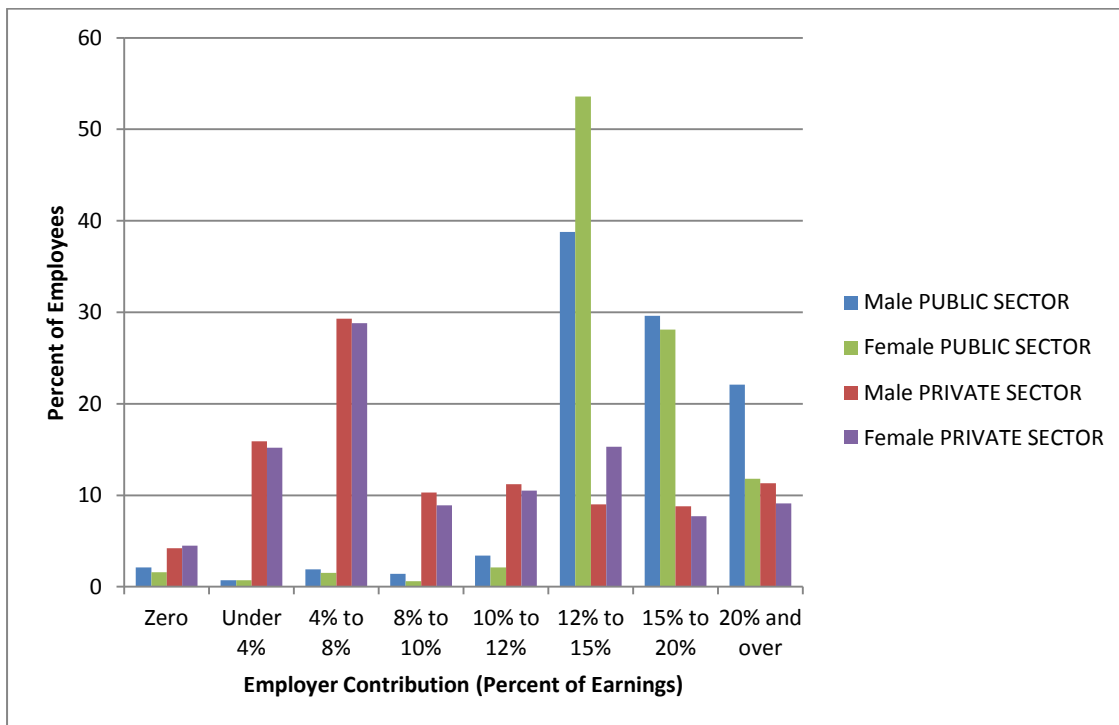
If the data shown in Figure 15 and Table 2 capture the position of those receiving a pension, what of those that are currently contributing to a pension? Are the circumstances of those in the private and public sector likely to diverge in the future?

There are no Scottish data on the pension contributions of employers and employees, but given the similarity between Scotland and UK as a whole in the structure of earnings, there are no strong reasons to expect pension contribution patterns in Scotland to divert significantly from the UK as a whole. Figure 16 and Figure 17 show the most recent estimates of employer and employee contributions from the Annual Survey of Hours and Earnings (ASHE) for the UK as a whole.

**Figure 16: Employee Pension Contributions as a Percentage of Income, Private and Public Sector, UK 2011**



**Figure 17: Employer Pension Contributions as a Percentage of Income, Private and Public Sector, UK 2011**



Source: Annual Survey of Hours and Earnings 2011 (Provisional)



There are a number of important lessons from these data. First, employee contributions are typically higher in the public sector than in the private sector. More than 50% of females and around 40% of male workers in the public sector make contributions of between 6 and 7% of earnings. In contrast, more than 20% of employees in the private sector make no pension contribution at all.

Employer contributions follow a similar pattern. Almost all employers in the public sector make a contribution that is worth at least 12% of earnings. In the private sector, almost 30% of employers contribute between 4% and 8% of earnings. Whereas 92.4% of all public sector employers provide at least 12% contributions towards employee pensions, only 30% of employers in the private sector exceed 12%. Employers in the public sector are far more generous than those in the private sector in supporting employee pensions.

These contributions by employers and employees towards pensions are all expressed as percentages of earnings. Recall from Chapter 1 that in 2011 Scottish public sector employees' weekly earnings were 10.8% higher than those in the private sector. Suppose that pension contribution rates in both sectors were equal. Even if this were the case, the actual value of pension contributions in the public sector would be larger than those in the private sector simply because weekly earnings are higher in the public sector. This difference alone would guarantee higher public sector pensions. But in addition, as we have seen from Figure 16 and Figure 17, contributions from both employers and employees in the public sector comprise a significantly higher share of earnings than the equivalent contributions in the private sector. Therefore, both because earnings are higher and percentage contribution rates are also higher, the average weekly amount of cash per employed scheme member being provided to pension funds is much greater for public sector workers than for their private sector equivalents.

There are some gender differences in contributions: these are concentrated in the public rather than the private sector. Male public sector workers are much more likely than females to contribute more than 7% of their earnings towards their pension. Similarly, employers provide over 22% of male employees with pension contributions above 20%. Only 11.8% of female public sector workers receive such a high employer contribution. At the top end of pension provision, males contribute more, and receive more from their employers, than do females.

However, the key message emerging from the ASHE data is the much larger contributions towards public sector pensions. If contributions were invested with equal efficiency, this would imply that the public sector could afford to pay much larger pensions to its scheme members. Employees judge the attractiveness of a job offer not just on the wage but on all its relative advantages and disadvantages. These include the expected future value of the pension. For those taking a longer-term view of their income prospects, the disparity in contributions can only increase the relative attractiveness of the public sector. Thus, while other chapters in this volume have focussed on wages, the argument presented here suggests that in the future, public sector workers are likely to enjoy a substantial *non-wage* premium over workers in the private sector. Recent IFS estimates suggest that the pension advantage enjoyed by public sector workers is equivalent to 12 per cent of earnings<sup>3</sup>.

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<sup>3</sup> Institute of Fiscal Studies (2010) "Public Sector Pay and Pensions" Accessed at: [www.ifs.org.uk/budgets/gb2010/antoine\\_bozio.pdf](http://www.ifs.org.uk/budgets/gb2010/antoine_bozio.pdf)

For Scotland, there is some direct information on contributions in the larger public sector pension schemes, which suggests that the contribution pattern shown in Tables 2 and 3 for the UK as a whole are consistent with those in Scotland. Thus, data from the SPPA indicates that most of the large pension funds in Scotland, such as local government, NHS and teachers, required employee contributions of around 6% in 2010. Employer contribution rates were larger and more varied. In 2010, employer contributions to the local government scheme were 19.3%; to the NHS scheme 13.5%; and to the teachers' scheme 14.9%. The much smaller police and fire-fighters' schemes had contribution rates above 20%, reflecting their higher costs.

Another major difference that has recently emerged between private and public sector pensions is in the distribution of risk between pension recipient and the pension fund. All of the major public sector pension schemes in the UK are described as "defined benefit" (DB). This means that the value of an individual's pensions is determined by rules that reflect characteristics of his or her employment, such as maximum career earnings, length of service etc. In contrast most private sector pensions would now be described as "defined contribution": the value of the employee's and employer's contribution is set by the rules of the scheme, but the pension received depends on the investment return from these contributions. With "defined contribution" (DC) schemes, the employee takes the market risk. With the "defined benefit" scheme, the pension fund takes the risk. This is a further benefit to public sector workers: most individuals would be prepared to give up a proportion of their pension benefits to avoid risk.

Large companies are no longer prepared to shoulder this risk. Shell was the last FTSE 100 company to maintain a DB scheme for all employees. It closed this scheme to new employees at the start of 2012. While virtually all of Scotland's public bodies continue to offer defined benefit pensions, there are no FTSE 100 companies offering similar benefits to new employees.

The recession has contributed to the difficulty of maintaining DB pension schemes. But another, possibly more important pressure has been the way in which pension assets and liabilities are now treated on balance sheets. Finance officers have been obliged to replace Standard Statement of Accounting Practice 24 with the Financial Reporting Standard 17 when constructing their accounts. Compared with SSAP 24, the FRS17 rules governing the accounting treatment of pension funds are much more proscriptive. Companies and public sector bodies are forced to value pension assets at market value rather than an actuarially determined view of their long-run value. This introduces substantial volatility into balance sheets, driven by short-term changes in asset returns. Liabilities must be valued using the current rate of return on AA rated corporate bonds of a term equivalent to the time over which the liabilities will arise. This rules out any alternative, more optimistic, view of long-run rates of return on investment.

There is widespread criticism of this approach. For example Clacher and Mozier (2011)<sup>4</sup> argue that “Current pension accounting fails to take adequate account of the long-term nature of the assets held to meet the pension obligation and the systematic way in which pension liabilities evolve through time. Current accounting standards apply a mixed-model approach and so pension assets and pension liabilities are not accounted for in a consistent way.”<sup>5</sup> Nevertheless, such criticism has not stopped commentators taking a very negative view of currently reported deficits<sup>6</sup>.

Nevertheless, one of the effects of this change in accounting practice has been that companies, wishing to reduce the year-to-year volatility in their balance sheets caused by having to revalue pension assets and liabilities at market prices each year, have sought to reduce the further risk associated with uncertainty over their future liability to scheme members. Hence, by only offering defined contribution pension schemes, they are now requiring scheme members to take the risk associated with the returns on the funds invested on their behalf.

Public sector accounting rules are the same as those in the private sector. Market valuation under FRS 17 have been one of the major causes of increased contributions by public sector employers in recent years, which have substantial opportunity costs, since employer contributions are drawn from Scotland’s DEL budget. While there is clear logic in addressing potential deficits in pension funds at the earliest opportunity, there are again arguments around whether FRS 17 has led to the introduction of unnecessary volatility in the valuation of these funds.

The statistics for the withdrawal of the private sector from DB pensions are fairly stark. In 2010, 79.0% of public sector employees in the UK belonged to a DB scheme, while only 11.0% of private sector employees were in a DB scheme. The decline in private sector membership of DB schemes has been dramatic: in 1997, 34% of private sector workers belonged to a DB scheme, more than 3 times the current level. There are also large sectoral differences in membership rates of *any* workplace-based pension scheme. In 2010, 83.9% of public sector workers, but only 34.4% of private sector workers were members of a workplace scheme. The remainder are either investing in a private pension, or have no pension provision at all.

The large numbers of individuals with inadequate pension provision is both a concern for the individuals themselves, and also for government. If individuals retire with no pension provision, they will have to rely on state-support. This will both raise public expenditure and, based on current state pensions, increase the number of pensioners living in, or close to, poverty. Therefore, it is not surprising that both the current and previous UK governments have taken substantial interest in pensions policy, trying to design mechanisms that would increase take-up, particularly in the private sector.

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<sup>4</sup> Clacher, I. and Moizer, P., (2011), Accounting for Pensions: A Report for the National Association of Pension Funds, September, Leeds University Business School

<sup>5</sup> They also argue that FRS 17 has also led to more conservative investment strategies by pension funds, which is not necessarily in the long-term interest of the economy.

<sup>6</sup> See, for example, the Taxpayers Alliance (2012)  
<http://www.taxpayersalliance.com/home/2012/04/research-54-billion-black-hole-council-pension-schemes-revealed.html>

Further initiatives have been aimed at the public sector, mainly aimed at reducing taxpayer support for public sector pensions, while increasing individual contributions and retirement ages.

To address concerns about falling take-up, the UK government is introducing major changes to the UK pension system during 2012. The National Employment Savings Trust (NEST) is a new DC pension scheme that will be introduced for employees with modest earnings in the United Kingdom from 2012. It is designed as an “opt-out” system. Employees will be automatically enrolled and will have to consciously decide to leave the scheme.

The NEST should increase the number of workers saving for a pension. It will also increase the value of their pensions, since employers will be required to make a minimum matching contribution of 3 per cent. Between 5 and 11 million people should receive contributions from their employers that are worth around £9 billion each year. Employees will be required to contribute at least 5 per cent of their earnings between £5720 and £33540. It will be a very large scheme and can therefore reduce overhead charges, which will enhance final pension benefits. Tax relief at the basic rate will be available on all contributions. Clearly, these costs may affect wage outcomes at the lower end of the wage distribution, where pension coverage is thin. And the contributions are relatively small compared with those in most public sector pension schemes, which inevitably implies that the final pensions will be correspondingly lower. Nevertheless, this initiative will address some of the difficulties raised by employer withdrawal from pension provision. However, NEST is a DC scheme, which will only serve to highlight the public sector’s near monopoly of DB pensions.

The tricky issue of how to design an effective and fair pension system will not disappear if Scotland becomes independent. And even if private sector pensions can be somewhat improved, public sector pensions will still have to be funded. In the next section, we focus on the affordability of public sector pensions.

### **The Affordability of Public Sector Pensions**

Pensions are a form of deferred consumption. By investing in a pension, individuals are able to consume more after retirement by saving (consuming less) while they are employed. From the perspective of employers, pension contributions are a form of deferred payment to workers. They are among the largest *non-wage* costs of employment in the UK.

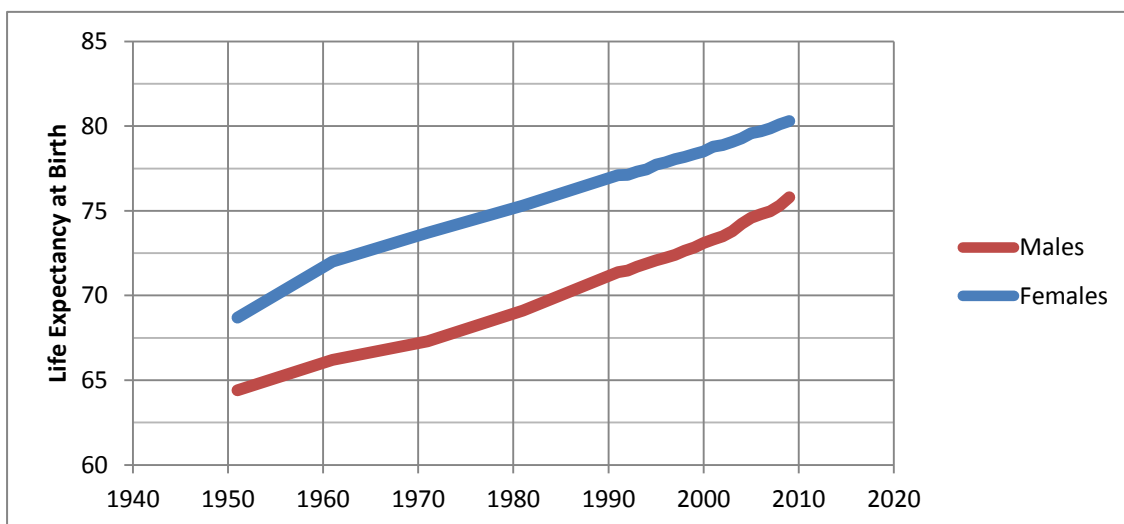
The value of a pension is conditional on future events. They are contracts that guarantee an income to an individual (and perhaps their surviving spouse or partner) for the remainder of their lives. These contracts are administered by pension funds, which collect and invest contributions from members and their employers, and redistribute these funds to members after retirement. There is uncertainty over how long individuals and their spouses will survive after retirement. There is uncertainty over the investment returns that pension funds can make from members’ contributions. Such uncertainty implies that pensions involve risk. For public sector pensions, a key policy issue is who bears this risk.

Pensions are also a form of income transfer between generations. This transfer can work in one of two ways. Pension schemes are either “funded” or “unfunded”. Funded schemes use employer and employee contributions to invest in assets which create a fund from which pensions are subsequently drawn down. The Local Government Pension Scheme is the main funded scheme in the Scottish public sector.

With unfunded, or "pay-as-you-go" schemes, employer and employee contributions pay for the pensions of existing retirees. Today's pension contributions are mainly allocated to existing pensioners. In Scotland, the NHS, teachers, civil servants, police and fire-fighters' pensions are all unfunded. With unfunded schemes, the transfer of resources from the current workforce to their retired predecessors is clear. The current generations of workers are directly contributing to the pensions of the previous generation of workers. With funded schemes, income transfer between generations is more subtle. The fund built up by the last generation of workers is used to buy claims on the future income of the firms and governments in which the fund has invested.

Pension funds make estimates of the amount of cash they require to pay existing pensioners. These can only be estimates due to uncertainty over age of retirement, life expectancy, the rate at which pension rights are being accrued etc. For many public sector schemes, rules regarding contribution rates are set by HM Treasury based on its forecast of the scheme's future liabilities. If there is a shortfall in funding, the historic experience is that the taxpayer makes up the deficit.

**Figure 18: Life Expectancy in Scotland 1951-2009**



*Source: General Register Office Scotland*

One of these is increasing life expectancy. shows life expectancy in Scotland for males and females from 1951 to 2009. Over this period, life expectancy of Scottish males increased from 64.4 to 75.8, while the life expectancy of females increased from 68.7 to 80.3. In 1980, male life expectancy was 69.1 years, while that of females was 75.3 years. Males retiring at 65 in 1980 could only expect to live for a further 4.1 years and females for 15.3 years if they retired aged 60. In 2009, Scottish males can expect to live for 10.8 years if they retire aged 65, while women retiring aged 60 can expect a further 20.3 years of life. In practice, not all individuals retire at the age that they become eligible for a state pension. For women, this age is increasing towards equality with men at age 65. However, the increase in effective pension age has not kept pace with life expectancy. This is one of the major problems facing pension providers. The length of working life has not increased but life expectancy post retirement has grown significantly. If the value of lifetime contributions towards pensions do not increase then increased life expectancy must imply reduced annual pension value.

To offset the potential costs of increased longevity to taxpayers during a period of fiscal austerity, the UK government has proposed an average 3.2 percentage point rise in employee pension contributions, increasing contribution rates from 6.4% to around 9.6%. Those earning under £15,000 are exempt. Those earning £15,000-21,000 will have their increase capped at 1.5 percentage points so those earning in excess of this will pay significantly more. Though the increase is being staged between 2011-12 and 2014-15, it has created substantial discontent among public sector workers and has already led to some industrial action.

The Scottish Government has claimed that the increased contributions are unjust, but argues that it has no option but to implement them, since HM Treasury has threatened to reduce its budget if Scotland does not adhere to the policy. At the time of writing, the Scottish Government has not set out an alternative vision for the funding of public sector pensions. Clearly, in an independent Scotland, setting out such a strategy would not be avoidable.

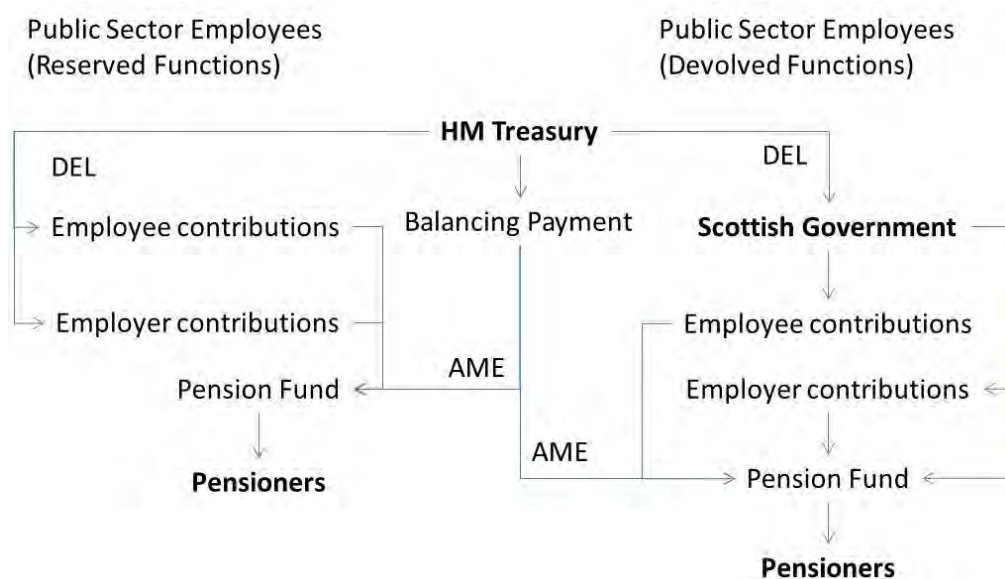
Another factor affecting the cost of pensions is the reduction in returns on investment, brought about by the recession and the consequent lack of growth prospects for the economy. Declining returns on government bonds, commercial property, residential property and on industrial investment mean that it is becoming more expensive to purchase a constant year-on-year income for the rest of life (also known as an annuity). At present, due to low interest rates, a lifetime annuity for a male aged 65 of £117 per week costs £100,000. This implies that, in the present financial climate, even very modest pensions require very substantial savings, from employee contributions, employer contributions and/or any other source.

The four main public sector schemes administered at UK level are the Armed Forces, the civil service, the NHS and teachers. Between 1999-2000 and 2008-09, the real cost of these schemes to the UK taxpayer increased by 33% from £11.2 billion to £14.9 billion (2008-09 prices). In effect, private sector employees, whose pension quality is in decline, have had to pay more tax to fund public sector pensions. This has been widely seen as unfair. The policy of reducing the public sector deficit has given further impetus to the pressure to reduce taxpayer support for public sector pensions. There is now in place a policy to substantially increase employee contributions. These have been highly unpopular with public sector employees.

The way in which public sector pensions in Scotland are funded is shown in Figure 5, which is subdivided between public sector workers currently or previously employed on "reserved functions" - governmental functions retained by the UK government - such as the armed services or DWP and those working for the Scottish Government or the public sector agencies that it supports.

From the money it has collected in taxes or borrowed, HM Treasury makes regular payments to the Scottish Government. These are determined by the Barnett formula and are usually planned over a three-year period as part of the Spending Review process. This type of spending is described as Scotland's Departmental Expenditure Limit (DEL). DEL is also allocated to UK government departments responsible for "reserved" functions. For example, social security is a reserved function and the Department for Work and Pensions (DWP) have several thousand employees in Scotland. It is from the DWP's DEL allocation that the pension contributions for these workers are funded.

**Figure 19: Funding of Pay-As –You-Go Public Sector Pensions in Scotland**



Aside from DEL-derived employee and employer contributions, other financial flows, known as balancing payments, are made by HM Treasury to ensure that pension schemes meet their current obligations. These arise because the liabilities of any scheme cannot be predicted with certainty, even on a short-term basis. Spending on public sector pensions, including balancing payments, is part of Annually Managed Expenditure (AME). This is the part of government spending that cannot be easily forecast on a year-to-year basis. The UK taxpayer contribution to meet the shortfall in the four major schemes of £14.9 billion in 2008-09 was channelled through AME.

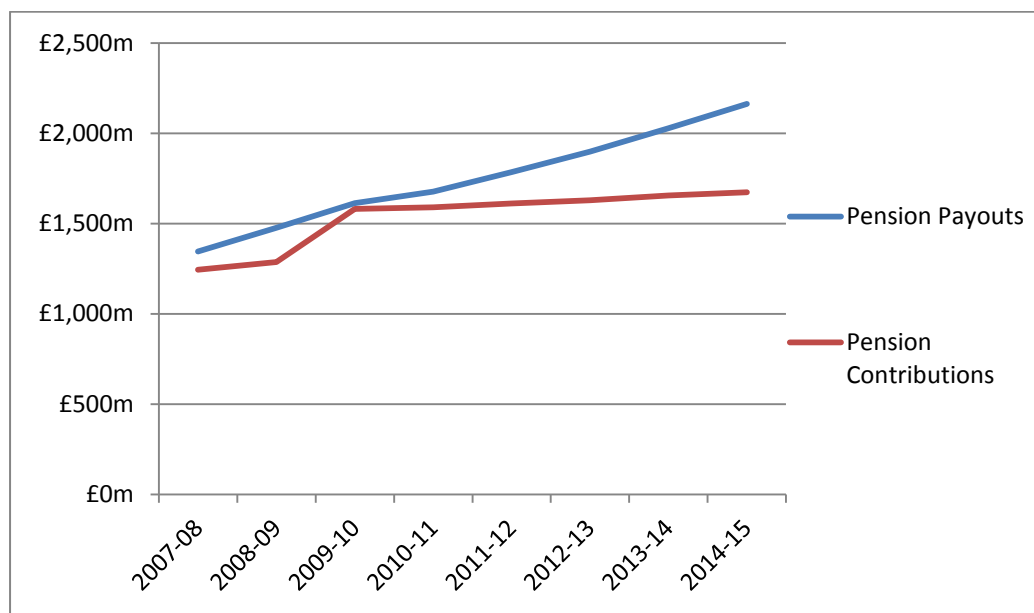
As part of its budget, Scotland receives an AME allocation, but this is not a direct claim on other parts of the Scottish budget, such as health and transport spending. Pension payments to the teachers and NHS schemes are part of this AME allocation, which is paid directly by the Treasury.

In contrast, Scottish police and fire-fighters' pensions are paid from Scottish Government DEL. Increased spending on police and fire-fighters pensions means less spending on other Scottish government priorities such as health and education. The Scottish Government itself makes balancing payments for these pensions.

In the 2011 Spending Review, AME payments to the Scottish Public Pensions Agency (SPPA)<sup>7</sup> were expected to be around £3.2 billion in 2011-12, rising to £3.6 billion by 2014-15.

<sup>7</sup> The SPPA is responsible for both teachers and the NHS pension schemes. Rather confusingly, it also regulates the police and fire-fighters schemes in Scotland.

**Figure 20: Projected contributions and payments in the NHS, teachers and civil service pension schemes 2007-08 to 2014-15.**



Source: Audit Scotland

Recent projections by Audit Scotland show a widening gap between pension contributions and payouts in three of the main “pay-as-you-go” public sector schemes in Scotland. These are set to rise to £490m by 2014-15 (see

**Figure 20).**

The main funded public sector pension scheme in Scotland is the Local Government Pension scheme, which had 141,400 LGPS pensioners in 2009-10. Payments to this group increased by 26 per cent in real terms over the last five years, from £667 million to £840 million annually. This is not a sustainable rate of growth. Some of this has been funded by increases in employer contribution rates. Such increases have direct opportunity costs within local councils’ budgets.

**Public Sector Pensions in an independent Scotland**

An independent Scotland would be liable for a share of UK debts. Pensions’ liabilities do not appear within the standard National Accounts definition of public sector debt. However, they are included within the “Whole of Government” method which takes a more comprehensive view of the public sector’s exposure to debt. A recent calculation by Sutton (2012)<sup>8</sup> concluded that the Scottish Government’s liability for public sector pensions could be around £112bn based on this data and using Scotland’s share of UK public sector workers to pro rata the UK public sector pension liability total. Sutton indicates that this is an overestimate due to the differing salary structures of the Scottish

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<sup>8</sup> Sutton, L. (2012) “Issues Facing an Independent Scotland – Scotland’s Share of UK Public Debt”, David Hume Research Paper 2012/1



and English/Welsh public sectors. Here is a more sophisticated way of arriving at broadly the same conclusion. For most public sector scheme members, pension value depends principally on length of service and on maximum salary achieved.

For Scotland as a whole, the aggregate value of pensions depends on the number of public sector employees. Thus, one could estimate the Scottish share of public sector liabilities using average values for each of these quantities as follows:

$$Scottish\ Share = \frac{Pay(Scotland)}{Pay(UK)} \times \frac{Length\ of\ Service(Scotland)}{Length\ of\ Service(UK)} \times \frac{Size\ of\ Public\ Sector(Scotland)}{Size\ of\ Public\ Sector(UK)}$$

Given that pension entitlements are built up over time, this calculation is carried out for each of the last ten years and then averaged<sup>9</sup>. This gives an estimate of Scotland's share of UK public sector pension liabilities of almost precisely 9 per cent, which would equate to £102bn, slightly lower than the Sutton estimate. Nevertheless, this would impose a substantial fiscal burden on an independent Scottish government.

There is an important caveat to such estimates of Scotland's net public sector debt result arising from the use of FRS 17 in the assessment of pension fund liabilities. The total net liability of UK public sector pension funds was £1,132.3bn at 31 March 2010. This liability had increased by £330.3 billion during the previous financial year, largely due to a decrease in the rate at which future payments were discounted. Under FRS 17, market rates of return must be used in the valuation of public sector pension liabilities. Thus, because the *current real* rate of return on UK AA corporate bonds fell from 3.2 per cent to 1.8 per cent over the year, pension liabilities were substantially increased, causing an apparently large increase in *future* public sector pension liabilities. And, since *real* rates of return are used in these measurements, a drop in inflation could result in an opposite swing in aggregate public sector pension liabilities next year. Nevertheless, though this argument perhaps casts some doubt on the precise size of Scotland's net pension fund liabilities, there is little doubt that the size of the deficit is substantial and would pose a significant threat to Scotland's public finances, given that the latest GERS estimates suggest that Scotland total tax revenue (including North Sea Oil) was £53bn in 2009-10.

A further challenge for an independent Scottish government would be whether it intended to continue with the changes in the structure of public sector pensions that have recently been initiated at a UK level. These are intended to spread the burden of the public sector pension deficit more equitably across generations. The measures include:

- Increasing employee contributions
- Increasing the normal pension age at which employees can take unreduced pensions from 60 to 65 years in most cases.
- Introduction of a new cost sharing and capping mechanism to transfer risk from employers to employees, particularly those associated with increased longevity.
- Using the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI) for increasing pensions in payment each year
- Continuing the pay freeze for the public sector workforce, which should reduce the long-term costs of public service pensions but will increase balancing

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<sup>9</sup> Data are drawn from the Labour Force Survey

payments from the Treasury in the short term since employee contributions will also be frozen.

If they have the same effects in Scotland as they are predicted to have in the UK as a whole, these changes would reduce costs to taxpayers in 2059-60 by around 14 per cent compared to what they would have been without the changes. Even so, these changes do not offset the risk associated with GDP growth being permanently lower than forecast. While slow growth may lead to further weakness in public sector pay growth, it is almost inevitable that public sector pension costs would rise as a share of GDP if the Scottish economy could not at least match historic growth rates of GDP in the UK.

Another budgetary issue that would have to be resolved in an independent Scotland is the liability for the pensions of public sector civil servants working in Scotland on reserved issues. These include the armed forces, and UK civil servants, including those employed by the Department for Work and Pensions. Although employed by public sector organisations outwith Scotland, they have provided services to the Scottish population. The vast majority of these will be members of pay-as-you-go DB schemes. Their past pension contributions will have helped fund the pensions of retirees across the whole of the UK. Similarly, the pension contributions of those in the same organisations working outside Scotland will have helped fund pensions in Scotland. Should Scotland become independent, it will have to take over the provision of services for these reserved issues. In the first instance, these are likely to mirror their pre-independence structures, including staffing. The logical approach would be to assign the pension contributions in Scotland to Scottish retirees, thus establishing specifically Scottish versions of the current pay-as-you-go schemes. Whether these would have a different balance of assets and liabilities from their UK equivalents is not clear and would likely take considerable time to establish. Until their financial position was established, the most plausible strategy would be to continue with existing rates of contribution from employers and employees.

## **Conclusion**

Whatever the constitutional settlement, public sector pensions are likely to be a difficult area for policymakers for the foreseeable future. The decline in the quality of private sector pensions will only emphasise the relative value of their pension entitlements to public sector workers. The difficulty is how these entitlements are to be funded into the future, particularly as longevity increases. Given the present weak economic outlook, it is inevitable that scheme members will have to accept more risk than is presently the case. A Scottish Government, faced with a very substantial potential liability from public sector pensions, would have to be prepared to make some tough decisions around the equitable sharing of public sector pension costs between scheme members, public sector employers and the taxpayer.

## **And Finally ....an Overview of the Issues**

**Jeremy Peat**

In this chapter we are certainly not attempting to simply summarise the mass of interesting material which has been brought together in earlier essays. Nor are we bringing in significant new material to add to the evidence. Rather our intention is to identify the key issues from the earlier papers, in particular those where policy issues are involved, or might be involved as and when Scotland moves to further devolution or independence. To some extent we are hoping to provide an annotated agenda of issues of relevance to the constitutional debate from this – somewhat neglected – aspect of our economic world.

### **An Overview**

Whilst avoiding attempts at full summarisation, there are a number of key points made in the Bell/Elliott paper that merit our attention as we set out on the task described above. This array of key points starts in their second paragraph where Bell and Elliott make a crucial point with regard to the importance of labour market policy in Scotland in the context of enhanced devolution. They note that whether Scotland were to be a member of the eurozone or a sterling currency union with the rest of the UK there would be no Scottish control over monetary policy and ‘it is realistic to assume that monetary union would also entail co-ordination, if not integration, of fiscal policy’. Consequently ‘the burden of any adjustment that would be required to restore competitiveness in the traded sector would fall on nominal wages’.

They note that ‘under either ‘devolution max’ or full independence, labour market policy would become more important than it is today’. Scotland would no longer be able to be ‘largely content to allow labour market policy to be directed from Westminster.’ This would apply to both private and public sectors, but our essays have been primarily focussed on the latter. Let us simply put down a marker that a more devolved or independent Scotland would need to think carefully about private sector labour market policies as well as those relating solely to the public sector.

The public sector is a major employer in Scotland. Bell and Elliott spell out the diversity of the sector and also note that in 2011 Scotland was the ‘region’ of the UK with the fourth highest share of employment in the public sector, following Northern Ireland, Wales and the North East of England. It is perhaps less widely appreciated that – leaving aside the employees of RBS and Lloyds/HBOS - this share peaked in 2006 and has been declining sharply since 2009, more sharply than in the rest of the UK. There are no forecasts for the level of public sector employment in Scotland but, given the financial circumstances and prospects, a continuing marked decline must be expected, as in the UK overall.

The very fact that the public sector is of importance but declining makes this a key policy topic. This is emphasised once more by the extent of deviation in the share of the public sector in employment across Scotland – a far greater extent of variation than between different parts of the UK - from 19% of total employment in Aberdeenshire to as high as 47% in Orkney. Bell and Elliott note that this may in part reflect differences in the strength of the private sector by region of Scotland, but they also note that the share of public sector employment will be related to differences in the ‘need’ for and cost of provision of public services.

One ‘unintended consequence’ is that some parts of Scotland are highly dependent upon public sector employment; and hence public sector wages form ‘an important component of demand in those areas’. Clearly continuing decline in the level of public sector employment, or indeed any relative decline in public sector remuneration, would have a marked adverse effect on the overall level of demand in those areas where the public sector constitutes a particularly high share of total employment.

One policy response to this diversity of the share of public sector employment across Scotland could be a move to some form of regional pay, with pay cuts or relatively lower pay increases in areas where the employment share is highest. Already we have seen real falls in pay – private and public sector – across the UK. This happened first in the private sector – as recession struck – but (despite a ‘pay freeze’) only with a lag of some two years in the public sector.

As Bell and Elliott note, the Scottish Government already has influence over ‘the pay of the vast majority of employees in the public sector in Scotland’. However, ‘successive Scottish Governments have chosen not to exercise this control by influencing pay rates for the majority of public sector employees’; accepting instead terms and conditions as per those of the rest of the UK.

This approach would have to be reconsidered if devolution progresses. For example Scotland might well wish to no longer rely upon the ‘pay review’ bodies which determine pay policy on a UK-wide basis for the likes of the NHS, police and the fire service. [See also here the paper by others including Hatchett and Elliott/Bryson.] Please also note the further point in this context made by Bell and Elliott, namely that these pay review bodies – as so often is the case for ‘UK’ institutions – allow the ‘priorities and perspectives of England .... to dominate [their] deliberations ..... and therefore the pay rates that they set.’ Similar Scotland-only bodies might have different perspectives and reach different conclusions. Certainly – a point not explicitly made in these papers – they could be established with remits reflecting the situation in Scotland and the policies of the Scottish Government.

Simply to emphasise once more that these issues matter, let us repeat one other point made by other authors, the cost of the NHS pay bill is more than double the current ‘Scottish’ revenue from corporation tax. However, corporation tax has received infinitely more attention in the constitutional debate to date.

Bell and Elliott cite from the Institute for Fiscal Studies (IFS) a general principle for public sector pay namely that ‘What matters is the extent to which the overall remuneration package offered by public sector employers is well designed to attract, motivate and retain sufficient numbers of workers of the desired quality in a way that provides good value to the taxpayer. In general this is likely to mean that public sector workers should have an overall package – in terms of financial and non-financial benefits – that is similar to that available for similar roles in the private sector.’

They then go on to examine relative public/private sector pay in the UK and specifically in Scotland – providing a careful and illuminating analysis. Their conclusions include the following: -

Unadjusted raw pay data show that weekly paid public sector employees in Scotland in April 2011 were paid 10.8% higher at the mean and 21.3% at the median than those in the private sector. The equivalent figures for hourly paid workers were 21.8% and 42.2% respectively.

A differential in this direction was to be expected given that public sector employees tend to be more highly skilled (more graduates), older and more experienced.

The gender gap is less wide in the public than the private sector.

After controlling for age and education, the premium for hourly paid men in Scotland declines to 5.6%. This is much lower than in Wales and most regions of England.

Bell and Elliott conclude on this point that ‘There appears to be no substantive argument that men in the public sector in Scotland are substantially overpaid when compared to the private sector’.

A very different picture emerges for women, with an adjusted gap of nearly 20%, the highest in any component of the UK. [These last two points are to be borne in mind when reading Watt, Lonsdale and Boyd.]

Also the public sector wage structure in Scotland is more compressed than either that in the Scottish private sector or in the UK as a whole. The Scottish public sector tends to pay relatively better at the bottom of the pay distribution and less than the private sector at the top. As per Bell and Elliott ‘Overall differences in the public sector premium are the consequences of overpayment at the bottom of the earnings distribution and underpayment at the top.’ Or ‘there is much greater pay inequality in the private sector’.

This may or may not be related to the fact that overall union membership is higher in Scotland than England; and that union membership in Scotland is 58.9% in the public sector and 14.6% in the private sector. In addition public opinion tends to work against high pay for those at higher levels within the public sector – particularly post banking sector debacle.

Finally IFS work has demonstrated at the UK level that any public sector premium tends to be more likely during recession. IFS expect the present premium to fall back post ‘crisis’.

There are other topics which emerge in the Bell/Elliott chapter – e.g. the whole issue of public sector pensions which rightly receives a chapter on its own from David Bell – and the role of public sector pay in any post-Christie Commission reform of local authorities. Overall from the macro policy issue with which we commenced, through the geographical distribution issues to the private/public sector balance and the issue of ‘compression’ the range and importance of topics is clear. We would re-emphasise the following: -

Public sector pay is potentially an issue of economic policy, and of increased importance in the context of further financial devolution or independence.

Shying away from accepting this point would mean placing greater emphasis on other aspects of policy and potentially seeking other means of maintaining/enhancing competitiveness across the economy.

Following constitutional change the Scottish Government would take responsibility for decisions related to very difficult and potentially divisive issues for which at present the UK Government has been permitted to retain responsibility.

There is also likely to be a need for further attention to an industrial relations policy in Scotland.

Policy in this area will have to take full account of the geographical issues discussed above.

Moving away from a UK-based public sector pay policy will raise the risk of talent drain – if pay tends to (relatively) decline at the top in Scotland.

### **Institutional Arrangements and the Market**

As Hatchett makes clear, some pay bargaining arrangements are already separate for Scotland. This applies to school teachers, local government workers, the Scottish prison service and civil servants working in wholly Scottish departments – such as the Scottish Courts Service and the Scottish Executive.

In some instances there appears to have been parallel working between the Scottish body and that responsible for the remainder of the UK.

Elsewhere the emphasis is on what Hatchett describes as ‘national, but flexible, arrangements’. Amongst the pay review bodies (PRB) where a Scottish solution would need to be sought as devolution progressed are the following: -

The NHS PRB covering 1.5 million staff.

The Doctors and Dentists PRB.

The Armed forces PRB – dependent of course on decisions taken post-independence on defence matters.

The Senior Salaries Review Body for senior civil servants.

The Police Negotiating Board – which it has been proposed be transformed into a PRB.

Higher education where a UK national framework has been agreed with a national pay ‘spine’ but substantial freedoms by institution within that context. It is always possible that a post-financial devolution Scottish Government might wish to re-visit these freedoms.

As Elliott and Bryson point out in some instances (e.g. Doctors and dentists, NHS and police) the Scottish Government has to accept the recommendations of the UK-wide PRB; while in others (e.g. the armed forces and senior civil servants) the formal decision is taken by the UK Government. Under Devo Max or independence it is difficult to assume other than that the decision would always be for the Scottish Government.

These bodies tend to operate under the watchful eye of HM Treasury, which has set tough constraints. (Sometimes – e.g. for local government and universities – these constraints have to come via funding decisions rather than ‘instructions’.) In effect there is an incomes policy for the public sector. A future Scottish Government would have to determine its own incomes policy – as discussed above this leads towards tough and potentially divisive decisions which can be avoided when responsibility remains vested with the Westminster Government.

A recurring theme in these papers has been the issue of regional pay variations. The PRBs are due to report back to the Chancellor by this coming July as to whether ‘public sector pay can be made more responsible to local labour markets’. Also civil service departments have been asked to look into ‘more local, market-facing pay’ for civil servants below the most senior levels.

Hatchett explains how this has also been something of a recurring theme for Governments.

It will doubtless have to be considered by a Scottish Government, either in the context of proposals emanating from the UK Government which would apply in Scotland unless otherwise determined, or following further fiscal devolution or a move to independence.

As is evident from this volume, employers and trade Unions in Scotland would have strong and conflicting views. Hatchett briefly describes how multi-site private sector companies operate and suggests that ‘outside the South East [of England] there is much more similarity than difference in pay levels and labour markets. Most companies find skill levels much more important than geography. He also points to ‘unintended consequences that policy makers might regret’. Certainly the issue of local pay variations will be a less than straightforward one for the future agenda of a Scottish Government with enhanced fiscal freedoms.

The essay by Elliott and Bryson should provide a sound starting point for those setting out to think further about the appropriate approach to setting pay in the context of an increasingly devolved Scotland. Their starting point is that pay should be set ‘at competitive levels as defined by conditions in the local labour market.’ This can and will in theory vary in scale. For example: -

Teachers and nurses and public sector employees ‘at similar skill levels’ are recruited in local labour markets, while

NHS hospital doctors operate in a market that is ‘at least national and likely UK-wide’ and

‘for a very few at the very top of the public sector pay might need to reference international labour markets’.

The key policy question for them is then ‘How should Scotland design the institutions that set the pay of public servants in order to ensure that they are responsive to the different labour markets in which public servants are hired?’

After an illuminating excursion to consider public sector pay-setting arrangements in some other small European economies (Sweden, Norway and Ireland) Elliott and Bryson return to their consideration of the case for regional pay variations. They refer to cost of living differences – which they show can be of real substance – and also the ‘attractiveness’ of different locations; and then produce evidence from IFS to show that within the public sector there are pay variations for different occupational groups across the UK. Relative pay appears to tend to be highest in Wales and the North East of England; and the high premium of public sector pay over private sector pay in Wales (referred to earlier) appears to be linked to the ability of public sector employees to attract and retain labour. In other words there is already some variation in public sector pay across the UK, taking account of the need to attract staff to carry out public services.

Elliott and Bryson also suggest, perhaps in mild contradiction to the theme from Hatchett, that there are variations in private sector pay across areas of Scotland, much less than between English regions but still significant.

One implication is that if areas of Scotland vary in attractiveness – for cost of living or other reasons – and there is no public sector regional pay variation, then it will be more difficult to attract staff to the public sector in some areas and the provision of public services might suffer. The Elliott/Bryson policy suggestion is to follow the example of some other nations and set up ‘framework arrangements which [combine] overall central control of wage bill growth with some element of local bargaining.’

### **Views of practitioners and Particular Interests**

The background essay by Bell and Elliott and then the insights provided to theory and process by first Hatchett and then Elliott and Bryson have helped to set the scene and identify most of the key issues.

It is now time to move on to the more particular views expressed in essays by those with experience and interest from the perspective of employers – public sector and private – and the Trade Unions. Each of these contributions must provide further assistance to any future Scottish Government considering policy on public sector pay et al.

First comes from the paper by Frizzell and Howat – two men with many decades of experience across different segments of the public sector.

They first note that a ‘Scottish civil service’ would emerge, including the existing Scottish Executive and other devolved departments plus civil servants from the currently reserved functions which would be devolved under Devo Max or independence. The latter could number more than the former, so civil service pay policy for Scotland would relate to some 35,000 – 40,000 folk, even excluding Ministry of Defence and Foreign Office functions. Yet again we note the scale and that the Scottish Government would presumably take responsibility for all pay policy for this group, including senior civil servants.

One example cited of the Scottish Government exercising increased control is regarding Non-Departmental Public Bodies (NPDBs) where ‘To all intents and purposes Board and management discretion over pay has been withdrawn’. Actions here, including the bearing down on CEO salaries, may be evidence of direction for future policy over other areas of public service employment. There are parallels here to actions regarding HE, where more Government involvement in provision and governance is certainly on the cards.

Overall it appears conceivable that a Scottish Government might find more that is attractive in the recent report by Will Hutton than was the case for the UK Coalition. Certainly Mr Hutton has given evidence to the Finance Committee of the Scottish Parliament and was listened to and cross-questioned with some intensity.

These authors also note that the Cabinet Secretary for Health and Wellbeing has considered whether to ‘repatriate’ some elements of the contract for Scottish GPs. However, they also remind us that the Cabinet Secretary for Finance and Sustainable Growth earlier this year set out his objections to regional pay variations in Scotland. They suggest that one option for the NHS in Scotland would be to eschew any Pay Board and leave matters to the Scottish Health Boards collectively – within a remit set by the Scottish Government. Elliott and Bryson might well applaud, while Frizzell and Howat see this as ‘having the advantage for employers and Government of removing the potential problem of independent bodies recommending pay increases higher than the Government wished, or was able, to fund’. But they also note the recruitment risks if pay in Scotland falls below that in the rest of the UK – we should note that the Elliott and Bryson evidence suggests that this would only apply to some occupations which operate in a geographically wider labour market.

The section on local government highlights the problems continuing since the 32 unitary authorities were established in 1996, with issues related to wide variations in structures inherited, the implementation of the Single Status Agreement and external pressures, i.e. ‘years of austerity’. They note that at the same time there are pressures for reform and enhanced efficiency. The whole issue of delivery of public services, and how any moves to further devolution or independence can be utilised to increase pressures for reform in line with enhanced efficiency of delivery of priority services, is one that we hope to revisit later this year.



Nevertheless on the local government front the pressure for change is already clear, and issues related to remuneration will be at the forefront of the continuing debate.

Like others Frizzell and Howat see a case for ‘devolution’ of pay setting for (e.g.) police and fire/rescue in the instance of independence, but are less clear in the case of Devo Max when UK-wide bodies might not be ‘problematic in principle’. The question of where Scotland might go on public sector pay setting under the Devo Max option clearly needs more investigation; so too will issues around pay for senior managers – bonuses or ‘earn-back’ as per Hutton or neither? The McCrone recommendations for teachers were criticized by some for the absence of clear performance indicators to justify higher pay. Such indicators may be needed across a broad base in future – but will policy makers welcome such an added complication?

If coverage of the essays by Boyd, Watt and Lonsdale is relatively curtailed here, that should not be taken as any indication of their perceived importance. Each is eminently accessible and each covers a number of the points already covered – albeit from very different perspectives.

Boyd challenges head on several of the ‘increasingly orthodox views on public sector remuneration’ – noting that these tend to be ‘asserted’ rather than ‘justified by recourse to evidence’!

He further suggests that ‘The deterioration in the public finances since 2008, and the high proportion of spending accounted for by wages, has also provided cover for those who wish to undermine both spending and public sector remuneration for ideological reasons’.

Moving on from there he tackles the public/private pay comparisons that Bell and Elliott have already covered in detail, re-confirms their view that the evidence points to Scotland being ‘a very lightly regulated labour market’ and then considers the question of regional pay, echoing much from Hatchett. He also considers the social and economic benefits from collective bargaining, referring – as do Elliott and Bryson – to Scandinavian experience. There is clearly scope to think deep and hard about a possible optimal approach to collective and decentralised approach to bargaining in the Scottish public sector.

Boyd sees regional pay as a likely topic for debate, but comes down firmly for national pay structures – simpler and more consistent inter alia. Further he sees the case for performance related pay in the public sector as ‘embarrassingly’ weak. In this context his discussion of productivity is fascinating. One of us recalls nearly three decades back being asked while at HM Treasury to (a paraphrase) show the public sector was more productive than the private; that the civil services was more productive than its public sector peers; and that the Treasury stood head and shoulders above all others. Attempting that exercise demonstrated that such comparisons cannot be sound, given sectoral differences and data difficulties.

Overall there is plenty of food for thought here, which taken together with other essays should be sufficient to persuade any Scottish Government to avoid any ‘rush to judgement’ on the complex and sensitive set of topics that fall under the heading of public sector remuneration.

The next two papers cover the private sector employers’ perspective, with Lonsdale focussing on medium and large employers and Watt on the interests of smaller companies. Lonsdale emphasises the public/private sector pay differentials and argues that local labour markets do work, and the public sector must take advantage of them.

He notes that unemployment rose less than might have been expected in the recent recession, because ‘businesses and employees cooperated to find ways to reduce costs and retain jobs and skills – with pay restraint’. This was associated with ‘substantial changes in the relationship between employers and employees’.

Meantime, he argues, in the public sector ‘national wage bargaining prevents the kind of responsiveness and flexible use of resources that worked for the private sector’. Again there is reference to the Swedish example of decentralisation. This decentralised approach, with local pay flexibility, would in his view lead to more efficient allocation of public services, improvement in public service quality and ‘the level playing field’ needed to help the private sector back to growth.

Watt shares many of these views and also places emphasis on the need to prioritise wealth creation to achieve growth and rising employment. He is not confident that labour market regulation is light in Scotland. He sees an ‘abundance [of regulation]...much of it emanating from Europe and added to by Westminster’.

In addition he doubts the affordability of pay packages in the public sector and notes ‘hosts of people from University principals to Consultant Surgeons and QUANG CEO’s earning more than the Prime Minister’.

Another key issue for Watt is public sector pensions – to which I shall shortly turn. He sees an ‘air of unreality’ here and supports the reforms proposed by Lord Hutton.

### **Pensions**

Our final topic is pensions, covered in the contribution from Bell. This topic is so complex and so important in terms of finance and implications for recipients that it almost merits a set of papers on its own. The difficulties for pension providers have been accentuated of late by a combination of factors – a perfect storm of lower asset values as the value of equities and other assets tumbled, rapidly rising liabilities as life expectancy rose sharply for males and females, and ultra-low bond yields meaning that the present value of liabilities shot up as discount rates fell to record lows. Taken together with the continuing major constraints on the public finances this was not an easy time to reflect upon public sector pensions’ policies.

But that is exactly what a Scottish Government would have to do in the wake of financial devolution or independence. Decisions on all aspects of all public sector pensions would be for that Government rather than being a part of UK Government decision-making.

Bell provides a very much needed examination of the state of public sector pensions in Scotland, looking at comparisons between the public and private sectors and also comparisons within the public sector, the latter showing up marked variations. As he notes, however, a key finding is the much larger contribution – by employee and employer – towards pensions in the public sector.

One particular question will be whether defined benefit (DB) arrangements can survive in the public sector – now that they are extinct among FTSE 100 companies. However, successive UK Governments have pressed for more employees across the private sector to participate in some form of pension scheme. The policy view is that participation should increase in the private sector – and no doubt be maintained in the public sector – but that the cost of provision to the Government must fall back markedly.

Thus far the Scottish Government has been able to argue in practice against higher contributions, whilst nevertheless implementing them out of financial necessity.

Post Devo max or independence the decisions would be – once more – for the Scottish Government.

As Bell concludes ‘A Scottish Government faced with very substantial potential liabilities from public sector pensions would have to be prepared to make some tough decisions around the equitable sharing of public sector pension costs between scheme members, public sector employers and the tax payer’.

### **In Sum**

There in microcosm is the key point from all these papers. Following either Devo Max or independence there would be difficult and potentially divisive decisions to be taken across a range of remuneration-related issues – against the staggeringly difficult backcloth of the prospective state of the public finances. The decisions taken will matter for individuals, for employers in both public and private sectors, indeed for all citizens and also for the prospects for the Scottish macro economy. From the point made about macro-economic policy at the very outset of this chapter, through all the issues about pay bargaining, regional pay and the like to public sector pensions’ policy there will be no hiding place.

We hope that these essays start the process of careful consideration based on informed, rigorous and objective analysis. We stand ready to debate further – the more open that debate the better for all concerned.

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