Pay and Location:
What are the Key Issues for Employers?

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1. Introduction

For the public sector, the debate on the relationship between base pay and location has taken on a new urgency of late. In the 2003 budget, Gordon Brown raised the question of pay flexibility as a means of more cost-effective departmental spending and the creation of a more vibrant economy. He suggested that localised pay arrangements might have more merit than national schemes because they could be better aligned to market circumstances. The Treasury has argued that the private sector is more efficient in responding to labour market signals, and, if the public sector can be just as flexible, it could see benefits in service delivery (through a better response to recruitment and retention hotspots) and in value for money.

For the private sector, market alignment has also been an increasing driver in determining pay rates. This may relate to geographical differences as much as to occupational differences.

However, it is all very well asserting that there should be a better link between location and pay, but the reality is that it is not so simple to deliver. This is shown both by the statistics on geographical pay dispersion and by research on employer behaviour. Work done for the London Assembly[1] suggests that there is little wage differentiation between the regions of England outside of the South East. Leaving London aside, this suggests that many large employers have common national pay systems. Moreover, IDS (2003), provides evidence that big companies with dispersed workforces, particularly banks and retailers, tend to use essentially common pay rates across the country.

So, from the employer's perspective, what are the advantages and disadvantages of setting base pay at different levels, depending upon location? How does this compare with paying local allowances as an alternative? Local base pay or local allowance systems face common issues compared to

1 National Economic Research Associates (2002)

using national remuneration structures — but there are differences. We will consider both the general cases for and against localised pay, and specific points of difference between the alternative routes. We will conclude with a checklist of points to consider before proceeding down the local pay route.

2. Benefits of Local Pay Systems

2.1 More precise market alignment

Local pay avoids having to work on the basis of a national pay system that may not perfectly match the various labour markets within which the organisation operates. National pay systems have to average out pay rates across the country out of necessity, irrespective of the recruitment, retention ease or difficulties of particular locations. This may mean that some staff are relatively overpaid for their locality, whereas others are underpaid. The quality of staff may suffer if pay rates are too low. Vacancies may remain unfilled. Agency staff may have to be used at greater cost, and questionable quality. Conversely, if there is over-payment, the hired labour may be over-qualified for the work and the payroll cost higher than it need be.

2.2 Inflexibility of national systems

National pay systems tend to be inflexible. They may be slow to respond to changing labour market conditions. Moreover, it is inefficient to increase pay rates across the country to deal with specific difficulties.

2.3 Preventing grade corruption

In local government in particular, one response to situations where the national pay rate is insufficient, either at individual or collective level, is to upgrade staff. This creates a corruption of the grading system and may leave the organisation open to equal pay claims, *eg* if it results in men and women, whose posts have similar job evaluations, being placed in different grades.

(Huw Jones-Owen, of the Association of London Government, told the London Assembly enquiry into London Weighting that:

> *'tailoring job evaluation schemes to suit an individual authority's needs helped to exacerbate problems, as that could result in pay discrepancies between boroughs and so intensify competition for staff.'* London Assembly [2002]

IDS reports that Pickfords found themselves in the same position, with staff being over-promoted against their job responsibilities in order to respond to perceived recruitment and retention difficulties [IDS, 2003]).

3. Using Location Allowances or Adjusting Base Pay?

There are two policy solutions to reflecting local labour market conditions in your pay system. One is to adjust your base pay; the other is to pay location allowances.

3.1 Base pay adjustment

Having different base pay rates for different locations makes sense if your organisation believes that these differences are long-term and structural rather than short-term and temporary. The fact that many organisations consolidated London allowance into base pay reflected the almost certainly correct view that London's pay lead would last long into the future. Since base pay will automatically be regarded as pensionable, staff will benefit from working in a high cost/tight labour market into their retirement.

But incorporating an allowance into base pay or using base pay variability from the outset is a dangerous policy if the labour market is at all volatile. It is harder to readjust base pay than remove a temporary allowance (though this is difficult enough). Nonetheless, pay differences need to be kept under regular review, otherwise pay leads may persist for much longer than is justified. This clearly is costly, but it also raises equal pay difficulties.

Otherwise there are many common issues between applying a base pay and an allowance solution, especially in determining the size of the additional remuneration required, except that, because of the impact on pensionable earnings, organisations are likely to be more cautious in creating basic pay leads.

3.2 Location allowances

An alternative approach to dealing with the problem of having to operate in numerous and varied labour markets is to set the national rate below the highest paying areas and use allowances to top up. Using supplementary allowances is an adequate response, so long as they can be given and, just as importantly, taken away or adjusted quickly as conditions change. In particular, organisations usually find it easier to give allowances than take them away. It is tempting not to regularly review the policy and to allow it atrophy. As with base pay, allowances often get stuck, neither rising nor falling sufficiently as circumstances change. Again, leaving allowances unjustifiably adds cost, and risks claims of discrimination. Alternatively, though less commonly, allowances are not extended to locations where the labour market has become tighter and the requirement for additional money is clear-cut.

One further danger with allowances is that, over time, organisations produce too many solutions to market difficulties, via a mixture of occupational and locational payments, and to end up with excessive 'ad hockery', to use a phrase coined by IDS. IDS quotes the Nationwide Building Society complaining that payments used to solve this and that problem were, by the end of the 1990s, 'spiralling out of control'. Dealing with differences in geography through variations in base pay removes one class of problem. If there are still difficulties with certain occupational groups, these can be tackled via pay supplements that can, if necessary, be varied according to location.

Another question that has to be faced is whether the allowances should be pensionable and whether they are 'consolidated' (*ie* used in the calculation of overtime and the application of pay awards). If the labour market problem appears to be due to the short-term vagaries of the market (*eg* IT staff in the City at the time of the millennium), then this would argue for non-pensionability and non-consolidation. Should the problem persist or appear as a long-term employment feature, then the allowance might well be included in pension calculations. However, one might then ask the question: why is the allowance not converted into base pay?

4. Difficulties with Local Pay Schemes

4.1 Lack of clarity in the basis of pay determination

Location based pay (via allowances or base pay) frequently suffers from a lack of clarity in the reasoning behind its introduction. Are they offered to deal with recruitment or retention failings? Are they set simply because a local pay survey calculates a shortfall against the market? Or, are they determined on the basis of a cost comparison: how living costs vary between locations.[1] Even if the organisation was clear at the outset of the logic behind the allowance, consistently communicating the approach, and sticking to it, seems to have proved difficult for organisations to do.

4.2 Inability to increase income to cover local pay increases

If your organisation believes it must pay higher wages to attract and retain staff, does it have the means to pay for such increases? In commercial companies there may be the prospect of being able to raise more cash but, even for these companies, income may not be retained at the local level. Financial

[1] From 1974, the National Board for Prices and Incomes justified London Allowance for those working in the public sector on the basis of higher transport costs, housing costs, consumer costs and a general 'wear and tear' and housing standard element. Employers discontinued the calculations on which London Allowance was based in 1982, with the argument that they did not sufficiently reflect market conditions and the different recruitment and retention issues faced.

Some cost compensation approaches try to take account of a wide number of features in an area beyond the usual cost of living factors. These might include the presence of amenities and environmental features. These items are not easy to price, leaving much room for argument. Indeed, the London Assembly concluded that the cost comparison method was too fraught with difficulties to use (London Assembly, 2002).

decentralisation must accompany pay decentralisation if the income/expenditure balance is to be properly managed.

However, many local organisations are unable to significantly change their income, or to passport the extra costs to a head office to pay for higher local salaries. Take schools, as an example, if they wish to make use of the freedom to pay extra pay, this has to come from local, not national, budgets.

4.3 Hindering national mobility

How important is the flexibility of resourcing in your organisation? National pay systems allow the easy transfer of staff between locations, which is why they are often favoured for managerial staff. If a fully mobile individual has a choice of location, will they tend to gravitate to the highest paying area? If so, local pay may produce undesired effects, leaving certain areas bereft of professional staff.

Even for more junior staff, pay based on locations can produce boundaries that might impede (or accelerate) the movement of employees between workplaces.

4.4 Dealing with trade unions

If a trade union is recognised, the next problem to be faced is whether the organisation has the capacity and capability to negotiate locally with it? Moreover, if the organisation is unionised with national collective bargaining, changing to local pay bargaining is likely to be met by fierce trade union opposition. This is true in both the public and private sectors. This opposition may present itself in equal pay claims that might be difficult to defend, unless there is robust market data that provides an 'objective justification' for any difference between locations.

4.5 Leapfrogging

There is evidence[1] that, if you have a decentralised pay bargaining system in a unionised environment, you are likely to see wage inflation. This is because there is a risk that one location will leapfrog another, producing a constant game of

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1 Nickell (1997) argues that the evidence shows that leapfrogging (and consequent wage inflation) is a feature of 'decentralised, uncoordinated, union dominated systems'. Turner (2001) makes the same point: 'the half-way house, *ie* strong trade unions but without responsible co-ordination, is believed to be the worst combination' of pay systems.

catch up. This is particularly true with base pay varying locally, but the same could occur if the use of location allowances was widespread.

There is also the potential for local pay drift in an area if pay determination is not properly managed and controlled. Competition for labour in an area may push up pay levels for all concerned.

5. Common Issues to be Faced

There are a number of issues, not necessarily problems, that have to be tackled whether you deal with variations in labour market conditions through locally determined base pay, or through pay additions — supplements or allowances.

5.1 Data

Firstly, organisations need to be clear that pay should be market determined, *ie* set on the basis of the competition (rather than on cost of living differences). Then you have to decide what information is required. The wider the range of data collected the more robust decisions on local pay are likely to be. Will managers be required to justify pay rises on the basis of salary survey data alone? Most organisations would say not. In which case you could require managers to collect at least some of the following data to support their case for a local increase:

- **Data on recruitment problems** — *eg* from failed recruitment exercises. You will need to decide what constitutes a recruitment 'problem' and see that this definition is applied consistently at local level.
- **Data on retention problem**s — *eg* as shown in labour turnover. You will need to decide what degree of churn is healthy and where it is problematic.
- **Information** on organisational attractiveness — *eg* from job refusal and exit interviews. To demonstrate that pay is the prime cause of recruitment or retention problems.
- **Information relating to specific grades or job functions** — to demonstrate whether the market problems are entirely linked to location, or whether it is to do with shortage in particular occupation.
- **Evidence of labour market tightness** — *eg* unemployment or vacancy rates.

When gathering together the external pay data you must ensure you have like for like comparisons. If you are benchmarking against other organisations, you will need to do a proper job matching or match grade points if you use the same job evaluation system. If you try to compare against pay statistics for a particular area, you will have to make sure you are looking at similar organisations within that area (certainly by size, possibly by sector) with similar workforce characteristics (especially contract type and occupation). Otherwise you are at risk of misunderstanding the market. For example, you may pitch yourself too low if you are large sophisticated company and you are comparing yourself against the local SMEs. Alternatively, you might think that your pay is not high enough because you have looked at organisations with a richer mix of more highly qualified staff, doing more demanding work.

Organisations should realise that there is a cost involved in administering a series of different pay rates or allowances. In reality, collecting and using pay and workforce data appears to be a hit and miss affair in too many organisations. Yet, as this data is needed to justify why one location is paid less than another is, or why remuneration at a particular establishment should be uprated, it needs to be of good quality. Therefore, organisations must invest the resources in doing the job properly.

Moreover, it seems that few private sector companies monitor their pay arrangements from an equal pay angle. It is especially important that if pay is varied by location based on market data, then these results should be regularly reviewed to ensure that they remain robust. Failure to do this would leave the organisation vulnerable if an equal pay challenge were made.

5.2 Boundary issues

Then there are boundary issues. One work area may be granted a pay increase or supplement, but this might be denied in a neighbouring area. Can this distinction be defended? Are the two work areas operating in different labour markets or do the Travel to Work Areas (TTWAs) overlap? This problem has already been seen over recent years as the number of allowances in the South East has grown. Once there was just London Allowance, sometimes divided into inner and outer London. Now allowances have spread into ROSELAND — Rest of the South East. The dramatic increase in London Allowance to £6,000 for the Metropolitan Police had the effect of pushing location allowances further afield. A £2,000 per annum allowance is now being paid to those forces surrounding London and £1,000 per annum to forces, like Sussex, that are adjacent to those getting £2,000.[1]

The Metropolitan Police solution not only had a knock on effect within the police service, it also upped the anti for other public sector workers. This led to strikes in local government and the Post Office. The boundary problems are both geographic and organisational.

This problem is compounded in organisations where internal structures do not always fit their pay constructs. So, for example, staff may be working in the same organisational team straddling the inner/outer London boundary. Should they all be paid the same London allowance or different rates, depending upon their workplace? If you opt for the latter, you create local inflexibility. If you opt for the former, you then may have other interfaces to consider — that between other outer-London offices.

If an organisation resists the pressure to extend allowances or base pay increases to adjacent locations, then there may be movement from lower paying to higher paying establishments. The former may also suffer from recruitment problems.

Clearly, the larger the number of pay areas the more boundaries there are to manage, but the better the alignment between market and pay levels. Thus, a finely graded system has higher management costs but potentially more accuracy, at least until the data no longer remains robust. Broad pay zones are easier to administer, but risk creating cliff effects between zones, as London is often in the same zone as the rest of the South East.

5.3 Defining the different pay areas

Organisations need to decide on what basis they will divide up their workforce into pay areas. The options include:

- travel to work areas (TTWAs)
- business units
- natural geography
- government boundaries.

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1 The problem of geographical logic, or lack of it, was pointed out by a respondent to the London Assembly investigation into local pay. The employee 'expressed bemusement at the fact that workers in Hertfordshire, even though parts of the county are north of Luton, receive London Weighting, while workers in Bedfordshire do not', London Assembly (2002).

TTWAs would reflect the labour market within which the organisation operates. Organisations can test whether their workforce follows the standard TTWAs, as used by the Office of National Statistics, or whether it has different characteristics.

Using business units means that you reduce the internal boundary disputes, described above, but may not reflect the labour market from which you draw staff.

Geography may well affect the TTWAs if, for example, transport links reflect the natural environment, but this may be coming less and less true. Take for example in Edinburgh, where the Firth of Forth used to separate Fife from the city, but increasingly people are commuting from the north because of high housing costs in Edinburgh itself.

Government boundaries are probably rather artificial constructs in this setting. They may, however, have more relevance for the public sector. Wales and Scotland may be distinct from England for wider cultural and administrative reasons.

5.4 Over-sensitivity in remuneration management

Especially if you choose a large number of pay areas, there is a risk that organisations attune their pay rates too closely to the labour market. This might put the organisation in what it sees as a perfect equilibrium, in terms of wage rates versus retention. Yet, a sudden tightening in the labour market might see a sharp rise in resignations and problems in recruitment — either in numbers or in quality. This suggests that organisations might choose to leave themselves a margin above the 'perfect' labour rate. The extra cost of such an approach can be offset against the lower cost of churn.

5.5 Deadweight

Market data may apparently justify higher levels of remuneration at specific locations and this is then paid to all staff at those locations. However, such an approach may not be entirely justified. Are all staff equally behind the market? Is there difficulty in attracting and keeping all types of staff? Or is it that some occupational groups are suffering and others are not? The truth is that the dynamics within the local TTWA may be especially important for the lower paid, but, for other staff they may operate in regional, national or even international labour markets. You may be using local labour market information inappropriately. In other words, organisations may use local pay where occupational pay might be a better solution.[1]

This argument holds if local pay is driven by recruitment and retention considerations. If it is higher costs that justify extra pay, then there are other deadweight considerations to be faced. Take London allowance for example, it is paid to those who struggle with high housing and commuting costs, as well as to those living in the city in social housing.

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[1] *Eg* in the NHS, recruitment and retention problems vary significantly by occupation. As an illustration, vacancy rates are low for hospital doctors and pharmacists in London, but high for nurses. There are recruitment problems for radiographers nationally, irrespective of location, (HM Treasury, 2002).

6. Considering the Options

So, in thinking about your options, what issues should you consider?

- What attracts people to your organisation, and why do they stay? How important is pay to these considerations?
- Do you find difficulty recruiting to particular locations; Or keeping people at particular locations?
- Are your difficulties more to do with occupational groups — some are hard to recruit and retain irrespective of location?
- Are your problems apparently short-term ones (lending weight to allowances as a solution) or long-term and structural (suggesting base pay solutions)?
- How far is a pay adjustment likely to be the solution, and for what groups?
- Do you operate a national resourcing approach or are people hired and paid for locally?
- How discrete are your locations — close together or far apart?
- How would you define the boundaries between your 'local' pay areas?
- What capacities have you and your managers to gather accurate remuneration local statistics, negotiate with a trade union (if one is recognised), set pay rates and monitor them effectively?
- How will you fund local increase — out of local budgets or 'nationally'?
- Which organisations will be used to benchmark pay against? Will they be chosen because they are comparators in terms of size or sector?
- Which jobs are to be used for comparison purposes (only the key ones where you need an external reference), are there good external matches for these jobs?

- Do you operate in a single labour market, or different ones for different occupational groups? This might be a local labour market for some more junior jobs, a national or even an international one for other, more senior staff.
- Is your organisation aiming to be at the median position, the upper quartile or another position? Is this the same for all occupational groups? And what drives your choice of positioning — the optimum cost versus recruitment/ retention effectiveness balance?

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