Comparing pay settlements and earnings growth

The median pay settlement recorded by IDS has typically been lower than the annual growth rate in the Average Weekly Earnings (AWE) series produced by the ONS but this trend has recently reversed, with the IDS settlement currently *above* average earnings growth. In this article we look at the differences between the two measures, and explore some of the possible reasons for this reversal of a longstanding trend.

Readers sometimes ask us to explain why the level of our median pay settlement differs from the Office for National Statistics' (ONS) official earnings growth figures as recorded in the AWE. In fact, we would not normally expect to see the figures matching exactly, as the two series use different data to measure different trends.

In a 'normal' economy and labour market we would expect to see average earnings increasing at a faster rate than basic pay, because of the inclusion of other factors not directly linked to the annual pay award. This was the case for the five years prior to the 2008 economic crash. Currently, however, the reverse is the case, with growth in average earnings lagging behind basic pay increases. Understanding the reasons for this discrepancy can help to add depth to the overall picture on changes in income and earnings across the economy.

IDS median pay settlement

Pay settlements in IDSPay.co.uk record the increases to basic pay at workplaces in the UK. These increases are almost always awarded on an annual basis, with RPI inflation normally used as a key benchmark in pay negotiations. This relationship is usually retrospective, with pay settlement levels following the RPI up and down rather than anticipating shifts in inflation. As a result, pay settlements generally lag behind inflation.

Where a percentage increase is awarded to all employees at an organisation equally, we record this figure in IDSPay.co.uk, and where the percentage rise varies (for example differing according to individual performance) the figure recorded is the average increase, or the increase received by most employees.

Annual AWE growth and median pay settlements

IDS median pay settlement	Annual growth in AWE
2.5%*	1.8%**

*Figures based on whole economy pay settlements, February to April 2011.
**Figures based on whole economy earnings February to April 2011 compared to February to April 2010.

The settlements recorded by IDS do not include any increases to an employee's income outside the auspices of the annual pay review. Examples of payments outside the parameters of the IDS median settlement include bonuses or lump sums; pay increases through promotion; and increases through workforce restructuring, changes to working time or market adjustments outside the framework of the annual review. Progression is included if it is rolled into the annual pay award under a merit-based system, but excluded if progression structures are budgeted separately from the annual pay review. The IDS median settlement does not measure year-on-year changes in levels of overtime, shift pay or other variable elements of income.

The headline IDS figure is the median settlement – the point at which half of recorded pay settlements are above this level and the other half below. This median figure provides a 'typical' increase – it shows what an employee group in the middle of the distribution

Elements included in pay and earnings statistics

Pay settlements in IDSPay.co.uk	Average Weekly Earnings (AWE)
Included:	**Included:**
Consolidated increases in basic pay	Basic pay
Performance-related pay increases	Overtime pay
Excluded:	Bonuses
Bonuses and lump sums	Merit pay
Incremental progression	Progression increases
'Off-cycle' adjustments (outside the annual pay review)	Pay rises due to promotions
Pay restructuring outside the annual review	Market adjustments
Changes in workforce composition	Effects of pay restructuring
Changes to working time	Changes in workforce composition
	Changes to working time

receives as an annual increase to basic pay. The median is less easily distorted than the average by outlying figures – pay settlements either much lower or much higher than the 'typical' figure. The IDS median settlement, then, represents the annual adjustment in basic pay rates at a typical workplace.

The headline IDS settlement is not weighted – it treats each pay deal as equal. IDS occasionally produces weighed average figures (by size of employee group), to show the effect of pay awards for large groups of employees. While this is part of the overall statistical picture on pay settlement trends, it is not such a useful guide for people making decisions on pay. Instead, the IDS median settlement focuses on workplace outcomes – it shows the typical outcome of the annual pay rounds at workplaces in the economy, rather than the typical pay increase received by an employee within the economy.

Average Weekly Earnings (AWE)

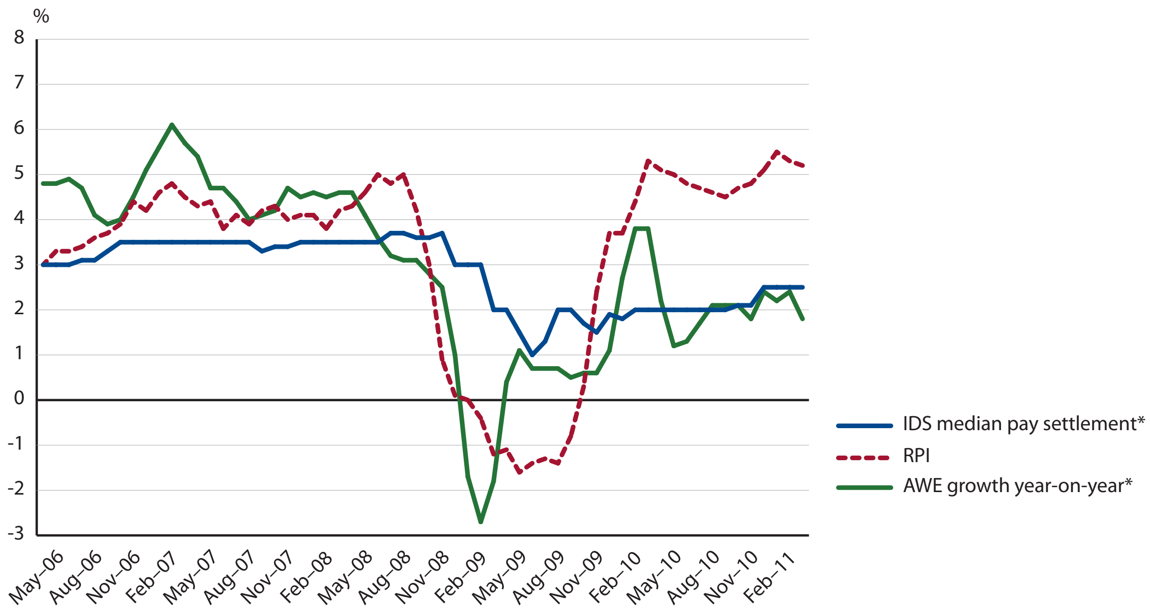
The AWE series produced by the ONS covers a wider range of payments from employers to staff, making it a comprehensive measure of overall earnings levels, but one which can be difficult to interpret. The data is collected by the ONS via the Monthly Wages and Salary Survey – a monthly survey of businesses collecting information on total pay, bonuses, arrears and the number of weekly and monthly paid employees. This information is calculated to produce an average earnings level per employee, weighted for the number of employees in different organisations and sectors within the economy.

The AWE figures include all payments from employers, including basic pay, shift and overtime payments and increases as a result of progression and promotions, as well as increases and adjustments made as a result of restructuring outside the framework of the annual pay review. The 'total pay' series of the AWE, used as the headline figure, also includes bonuses, which can have a major impact on overall earnings levels, particularly in the first quarter of the year.

The AWE figures are expressed in cash, depicting the average amount of income earned per employee within the workforce. Comparing these cash figures year-on-year gives an annual earnings growth rate as a percentage – the headline ONS earnings growth figure. Like the IDS median pay settlement figure, this is typically expressed as a rolling-three month average, meaning that in the latest data the average income figures for February, March and April 2011 were compared to the same three months in 2010, showing annual average earnings growth of 1.8 per cent for the whole economy. It is this average earnings growth level that is sometimes compared to the median pay settlement as measured by IDS.

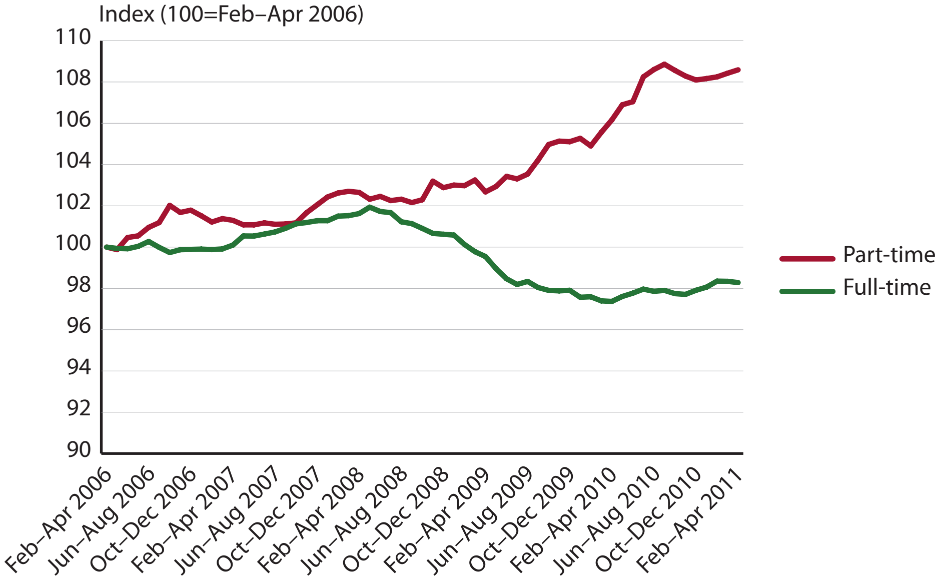
Since the AWE provides average earnings levels per employee, the figures will reflect shifts in the workforce composition – whereby the same individuals will not necessarily be working in the same roles year-on-year. For example, if sufficient numbers of employees across the economy move from well-paid full-time jobs to lower-paid part-time jobs the net effect would be a fall in AWE, regardless of annual pay settlement levels. Or if the economy creates a large number of jobs in high-paying industries while low-paying sectors reduce headcount, the net effect will be a larger increase in overall average earnings than most individuals would

IDS median pay settlements compared to annual growth rates in the AWE and RPI



*rolling three-month averages

Change in employment levels over five years (index: Feb–Apr 2006 = 100)



receive for continuing in the same role over the course of the year. This is a compositional effect.

AWE and settlement levels

Since the AWE and the median IDS pay settlement measure different aspects of pay and income growth, it is no surprise that they produce different figures. But what drives the differences between them, and what can it tell us about pay setting and earnings movements?

Typically, earnings growth outstrips median pay settlement levels for long periods. The impact of promotion and progression can have an upward effect on earnings outside cost-of-living increases to basic pay, and the importance of bonuses has increased comparative to basic pay. There have typically been more boom than bust years since records became available, and in a thriving economy we might expect to see a greater number of market adjustment and off-cycle increases, as well as quicker pay progression and a shift from low-paying or part-time jobs to higher-paying, full-time work. We could also expect more overtime payments and shift premiums to be available to employees.

This trend for overall earnings growth to outstrip the rate of increases to basic pay over time is sometimes known as 'pay drift'. This term can be misleading, however, as it implies a tendency for pay to run out of control. In fact, this 'drift' can also be a result of deliberate increases to earnings, such as market adjustments or extra payments to address recruitment and retention issues. In such cases, IDS has argued in the past that it could be better understood as 'pay drive'.

'Negative drift'

Recently, the trend for higher earnings growth than pay settlements has been reversed, and average earnings growth is actually lower than the median increase to basic pay. According to the most recent figures, annual average earnings for the three months to April 2011 were only 1.8 per cent higher than the previous year, compared to a median pay settlement of 2.5 per cent in the three months to April.

The chart on p.15 shows the last five years of pay settlements and average earnings growth, as well as the RPI inflation rate. It shows that after a period of what we might call normal pay drift, earnings growth fell below basic pay increases from August 2008, and despite several blips, it has broadly remained lower since then. This trend for lower average earnings growth than increases to basic pay is sometimes called 'negative drift'. So why might we currently be experiencing this negative drift now?

Part-time work

The recession caused an increase in part-time working, which tends to depress average earnings levels. Employees working fewer hours generally earn less, regardless of their annual pay increase. The chart above covers the last five years, showing how the recession caused part-time employment to grow even as full-time employment fell. It should be noted that the chart is indexed, with the three months to April 2006 set as a base. This means that it shows the change in part- and full-time employment relative to their own levels, not to one another. In actual fact, since the three months to May 2008, as the economic crash began to affect employment levels, the economy has some 791,000 fewer full-time employees, and 459,000 more part-time workers.

The point at which part-time work began to grow and full-time work to contract was just a few months before earnings growth dropped below pay increases. This is unlikely to be a coincidence. A trend towards a part-time workforce will limit earnings growth, but

Full-time and part-time employment		
Time period	Full-time employment	Part-time employment
Mar-May 2008	22,077,000	7,494,000
Feb-Apr 2011	21,286,000	7,953,000

have no direct effect on pay settlement levels overall. This helps to explain why earnings growth has been lower than the IDS median pay increase level since the onset of the financial crisis.

Compositional effect

The increase in part-time working affects the composition of the workforce, but it is not the only factor in workforce changes. A trend towards employees taking lower-paid jobs would also put negative pressure on earnings growth, as would an increase in short-time working such as in 2009. The ONS records the overall effect of compositional changes in the workforce in a supplementary table to the main release. According to these figures, the 'employment contribution' to average earnings was strongly negative during the whole of 2009 and the first half of 2010, forcing earnings growth down by over 2 percentage points during February and March 2010. Since July 2010, however, the employment contribution to earnings growth has been positive, albeit at very low levels – meaning that employees are moving back towards higher-paying work or longer hours, driving earnings slightly upwards. This may help to explain why average earnings growth has climbed back closer to the IDS median pay settlement level since this period.

Retail pay settlements and the NMW

The lowest-paying sector within the AWE series comprises wholesaling, retailing, hotels and restaurants. Earnings for this group might be expected to be heavily influenced by rises in the level of the National Minimum Wage (NMW) due to the large proportion of the sector earning at or close to minimum wage level. However, we have seen flat earnings growth of less than 2 per cent year-on-year in this sector for some time, despite a 2.5 per cent increase in the minimum wage in 2010 and pay awards in line with this.

A plausible explanation for the low earnings growth in this sector, despite the increases to basic pay and the NMW level, could be that the rise in part-time employment had a disproportionate effect on the retailing, hospitality and wholesaling industries. Part-time work is particularly common in the retail industry, and logically we could expect much of the rise in part-time work to come in this sector, reducing the overall average level of hours worked and therefore average earnings growth. Moreover, high turnover levels could mean less pay progression, restricting earnings growth. This would have had the effect of obscuring the impact of the rise in the NMW in the earnings growth figure.

Bonuses

The rise in the importance of non-consolidated bonuses has been a significant driver in pay drift, particularly as a relatively small number of top earners in the financial services sector have a disproportionate effect on average earnings levels nationwide. Earnings from bonuses as recorded by the AWE rose steadily during the years leading up to the financial crisis, reaching a peak in 2008 shortly before the crash. The subsequent collapse in bonus payments in the first quarter of 2009 caused a huge dip in average earnings levels to -2.7 per cent in March 2009, at a time when the median IDS pay settlement remained at 3 per cent.

Since then, bonuses have recovered somewhat, with a stronger bonus season in 2010 briefly driving earnings growth back above the IDS median settlement level in the first quarter of 2010. Bonuses in 2011 have broadly been paid at a similar level to 2010, meaning that there has been little year-on-year bonus effect, which has helped to keep average earnings growth at a lower level than basic pay increases.

Public sector pay freeze

A recent article by Derek Bird for the ONS examined the possibility of average earnings growth in the public sector falling to zero as a result of the Government's public sector pay freeze. The article, entitled 'Zero pay growth in public sector average weekly earnings; is it likely?' concluded that this was improbable, as a result of the nature of the sector and possible changes in the workforce profile. For example, the £250 minimum increase for the lowest-paid will cover around a third of public sector employees where applied, meaning a minimum 1.2 per cent increase in earnings for this group.

Incremental progression is likely to remain a feature of public sector pay for the majority of employees, which will also provide upward pressure on public sector earnings without a general increase to basic pay. According to Derek Bird, recruitment freezes may also lead to part-time employees working longer hours, while redundancies will in all likelihood affect 'casual' and fixed-term contract staff first – employee groups with typically lower average earnings levels. This compositional effect would actually cause the average earnings of the workforce to rise, even if the pay freeze means that remaining employees see no increase in their own income.