HM Treasury

Economic Evidence to the Pay Review Bodies

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Chapter 1
Summary

1.1 At Spending Review 2020, in the face of significant uncertainty due to COVID-19, the government announced a more targeted public sector pay policy for 2021/22. This helped protect jobs at a time of crisis and ensure fairness between the private and public sectors. Those working in the public sector have, on average, better remuneration packages than those in the private sector, with the pandemic also demonstrating the significant value of the greater job security offered by the public sector. The temporary pause in rises for some public sector workers was intended to ensure that the gap between the public and private sector wages did not widen further.

1.2 At Spending Review 2021, the Chancellor announced that the public sector will see pay rises over the next three years as the recovery in the economy and labour market allows a return to a normal pay setting process. The Pay Review Bodies have been, or will be, remitted in full for Pay Round 2022/23. SR21 set out that, to ensure fairness and the sustainability of the public finances, public sector earnings growth over the next three years should retain broad parity with the private sector and continue to be affordable. In the current context, where inflation is expected to temporarily peak at its highest rate in over a decade, it is imperative that Pay Review Bodies also have regard of the government's objective for price stability, defined in the Monetary Policy Committee's remit as a 2 per cent inflation (CPI) target.

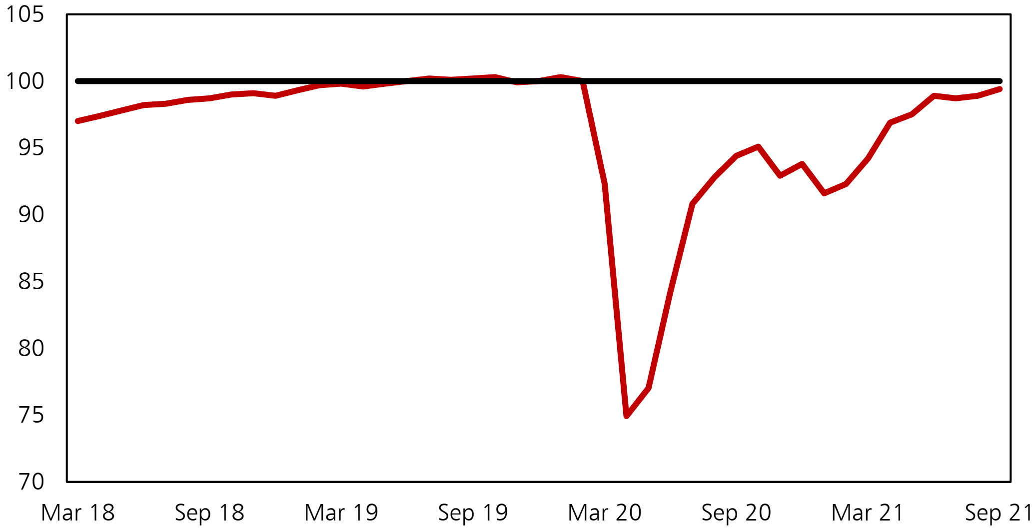
1.3 This document sets out the economic, labour market and fiscal context within which we ask the independent Pay Review Bodies to consider their recommendations for 2022/23 pay awards.

Chapter 2

Economic Context

2.1 The achievements of the government's vaccine programme to date, the support provided to families and businesses, and the Plan for Jobs have led to a stronger than previously anticipated recovery in economic activity and the labour market across the country. The economy is expected to reach its pre-pandemic size around the turn of the year, while both the OECD and IMF are forecasting the UK to have the highest annual growth in the G7 this year. The strength of recovery and effectiveness of government policy mean the OBR is now expecting the pandemic to have had a smaller long-term effect on the economy than they previously anticipated.

Chart 2.A: Real GDP (Index, Feb 20 = 100)

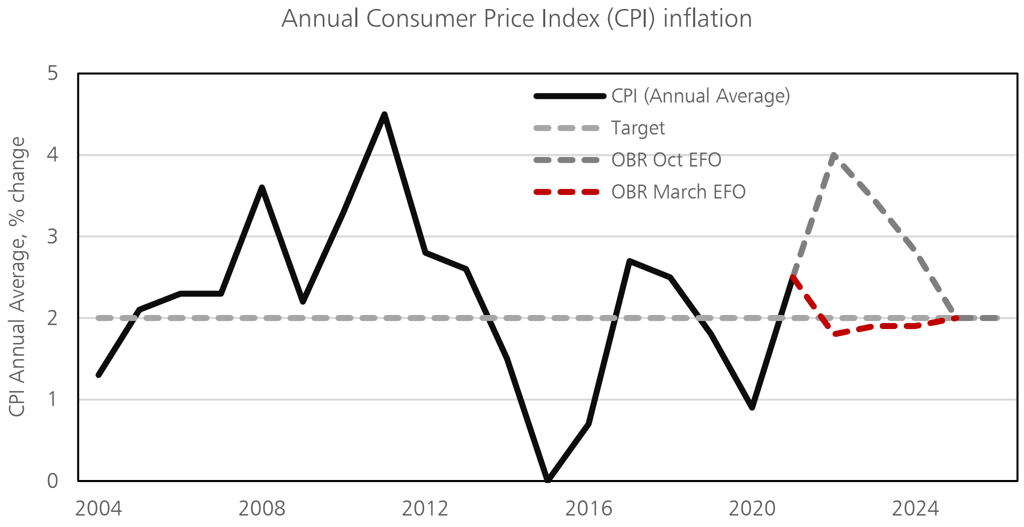


Source: ONS

2.2 As the global economy has reopened, inflation has risen rapidly around the world. Demand for goods has recovered more quickly than can be immediately met by supply, putting pressure on global supply chains and leading to higher prices for energy, raw materials and goods. In the UK, this helps to explain the recent increase in inflation above its 2% target. Further detail on the recent drivers of inflation is discussed in the Autumn Budget and Spending Review 2021.

2.3 The Consumer Prices Index (CPI) increased by 4.2% in the 12 months to September, compared to a low of 0.4% in February 2021. For this reason, the government is taking action to support those most acutely affected by recent increases in the cost of living.

Chart 2.B: Consumer Price Index (CPI) Inflation



Source: ONS, OBR

2.4 As the OBR noted in their October Economic and Fiscal Outlook (EFO), ongoing global supply chain issues, energy price rises, and labour market shortages are likely to continue to push up inflation in the near term, albeit temporarily, and these will continue to affect households and businesses in the public and private sectors across the UK. The OBR expects that inflation will peak at around 4% in 2022, while also noting in their EFO that developments since it closed its forecast would be "consistent with inflation peaking at close to 5 per cent." The Bank of England's more recent November forecast expects a peak of around 5% in April 2022. Both the OBR and the Bank of England expect the increase in cost pressures that have driven higher inflation to be temporary, with the OBR expecting inflation to return quickly to target by the end of 2024, aided by a modest tightening of monetary policy. The Bank of England expect CPI inflation to fall back materially over the second half of 2022 and during 2023.

2.5 This is largely because global markets are expected to adjust as supply responds to higher prices and demand conditions normalise. The government is also working with international partners and businesses to help ease supply issues where possible. The Bank of England note that the direct effect of higher energy prices on CPI inflation is expected to be temporary, while "Goods price inflation is also expected to decline, reflecting an easing of supply bottlenecks, as spending rotates away from goods back towards services during the continuing recovery from the pandemic, and as supply constraints ease."

2.6 The timely return of inflation to the 2% target is also underpinned by the UK's strong and credible macroeconomic framework which seeks to achieve strong, sustainable and balanced growth. Within this framework, the Bank of England's Monetary Policy Committee (MPC) has operational independence to set monetary policy to meet its primary objective of price stability and, subject to that, to support the economic policy of the government, including its objectives for growth and employment.

2.7 Both the OBR and the Bank of England also note risks to their forecasts, including the possibility that price pressures are sustained over a longer period of time. The OBR published two stylised scenarios for higher, more persistent inflation in their October EFO. Under these scenarios, despite the Bank Rate rising much more significantly, the OBR stated it would take longer for monetary policy to return inflation to target. These demonstrate how inflation could become more durable if people come to expect high inflation to continue, for example if workers demand larger wage increases to maintain their purchasing power.

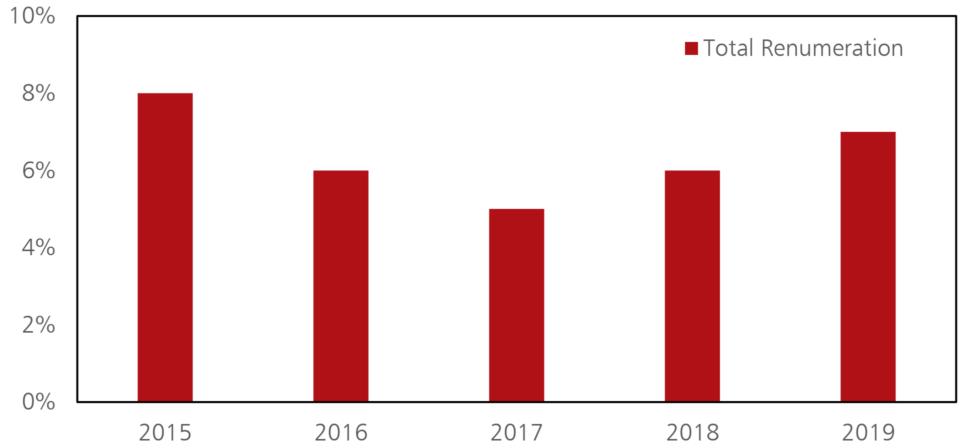
2.8 The Bank highlighted in their November Monetary Policy Report that while inflation expectations are currently well anchored, "A risk to the inflation outlook is that longer-term inflation expectations evolve such that wage and price setting is not consistent with inflation returning to the 2% target in the medium term...". If public sector pay increases were to exacerbate temporary inflationary pressure, for instance through spilling over into higher wage demands across the economy or contributing to higher inflation expectations, then these short-term pressures would become more sustained. In turn, this would exacerbate cost of living pressures, as higher pay awards were offset by higher inflation, and would require significantly tighter monetary policy to address, which would also harm growth.

Chapter 3
Labour Market Context

Public Sector Renumeration

3.1 The whole public sector renumeration package remains competitive, when taking account of pay, pensions and wider benefits including job security. On average, those working in the public sector have a better remuneration package than those in the private sector, including substantially more generous pensions. COVID-19 has also demonstrated the significant value of job security in the public sector. The temporary pay pause in the public sector meant the gap between the public and private sector did not widen further.

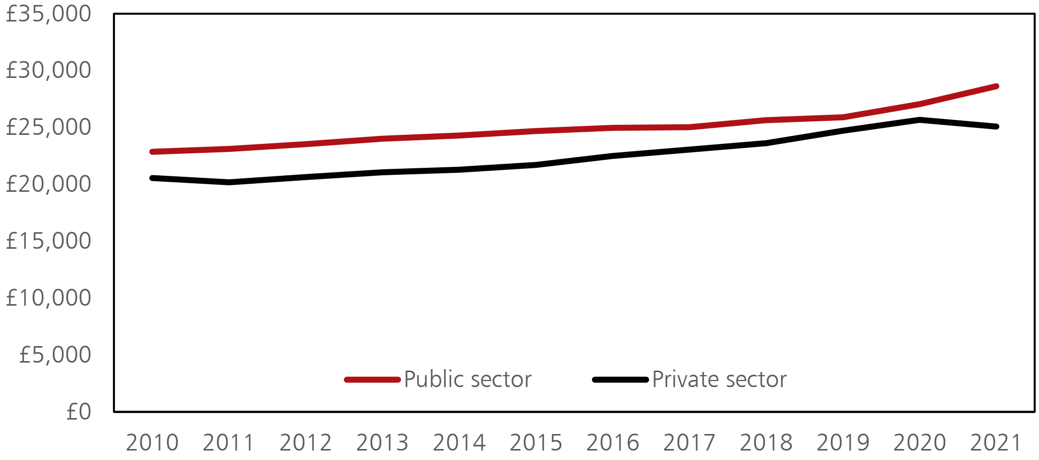
Chart 3.A: Modelled average public sector earnings premiums based on different earnings variables, 2019



Source: ONS, ASHE

3.2 In April 2021, the median salary in the public sector was £3,500 higher than private sector.

Chart 3.B: Annual median pay (gross) – for all employees



Source: ONS

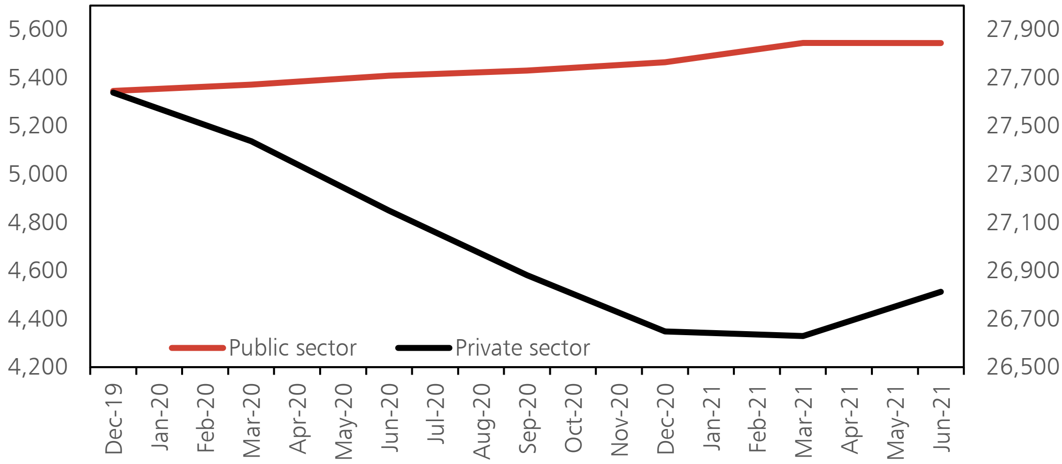
3.3 The public sector remuneration premium is most apparent at lower grades (public sector average hourly wage over 20% higher at lower percentiles[1]). The 6.6% increase in the NLW for 22/23 will also protect those public sector workers at the bottom of the income distribution.

3.4 In 2020/21, public sector recruitment trends were generally positive. Vacancy rates dropped across the board, with most workforces seeing an increase in FTE staff from 2020 to 2021. In 2020/21, leaver rates dropped generally, with many workforces seeing significant reductions in leaver levels. The announcement and introduction of the temporary pause to pay awards in the public sector has, not resulted in recruitment and retention concerns across the majority of workforces. There are some acute issues within specific roles, though many of these cite factors other than pay as the key driver.

3.5 Latest Labour Force Survey data for June 2021 shows private sector employment has not returned to pre-pandemic levels, whilst public sector employment continues to rise.

[1] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/publicandprivatesectorashetable13

Chart 3.C: Private and public sector employment (excluding reclassification effects)



Source: ONS

3.6 More timely data from HMRC Pay As You Earn Real Time Information (RTI) for October 2021 shows employee numbers in private sector facing sectors remained 75,000 below February 2020 levels in latest data for October 2021, whilst employee numbers were 310,000 above February 2020 levels in private sector facing sectors.

3.7 Redundancy levels were at an all-time high during the pandemic, with the vast majority of the increase in redundancies occurring in private sector facing sectors. Employment fell by 2.9% between Q1 2020 and Q1 2021 whilst employment in the public sector rose by 3%. Over the course of the Coronavirus Job Retention Scheme, 11.6m jobs, from 1.3m different employers, were furloughed.

Pay and earnings growth

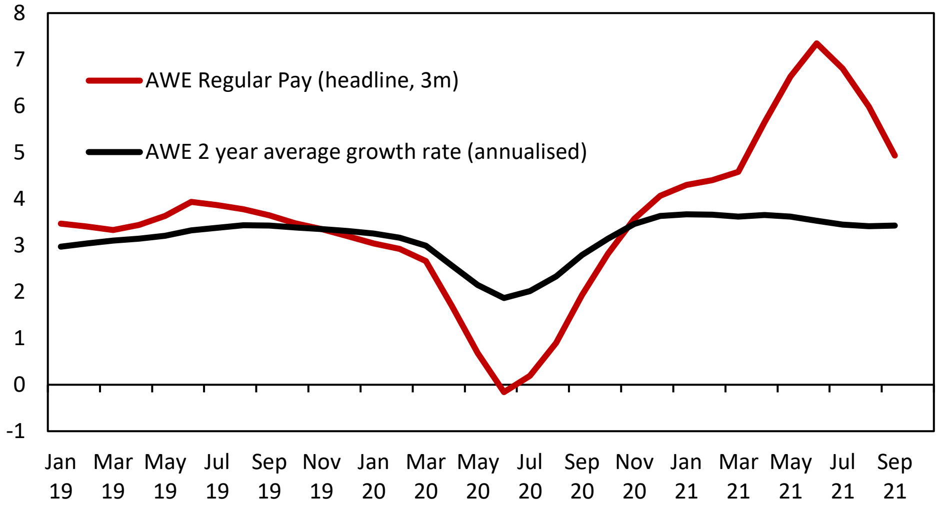
3.8 Average weekly earnings (regular pay) growth was 4.9% for the three months to September 2021. The ONS emphasize that headline earnings data is inflated by a base effect from annual comparisons to a period in 2020 when wages were deflated by furlough. Using the following two methods: two-year annualized growth and projecting forward earnings using pre-pandemic trends in average weekly earnings, growth in average weekly earnings for regular pay could be between 3.4% and 4.9% in latest data for the 3 months to September 2021. This is the approach used by the ONS to inform their underlying average earnings growth measure. Given the uncertainty around this methodology interpretation should be taken with caution.

3.9 Latest forecasts for whole economy pay growth suggest that growth in average earnings will be in line with the pre-pandemic period over the coming years, as the base effects unwind

3.10 The two-year annualized growth measure will be inflated relative to average pay settlements due to pay drift from increases in measured average earnings typically exceeding average settlements, and an effect from changes in the composition of the workforce. These compositional effects can be large, estimated to have inflated average weekly earnings growth by an average of 1 percentage point prior to the pandemic.[2] Prior to the pandemic, settlements typically averaged 0.5-1.5 per cent below headline earnings growth[3].

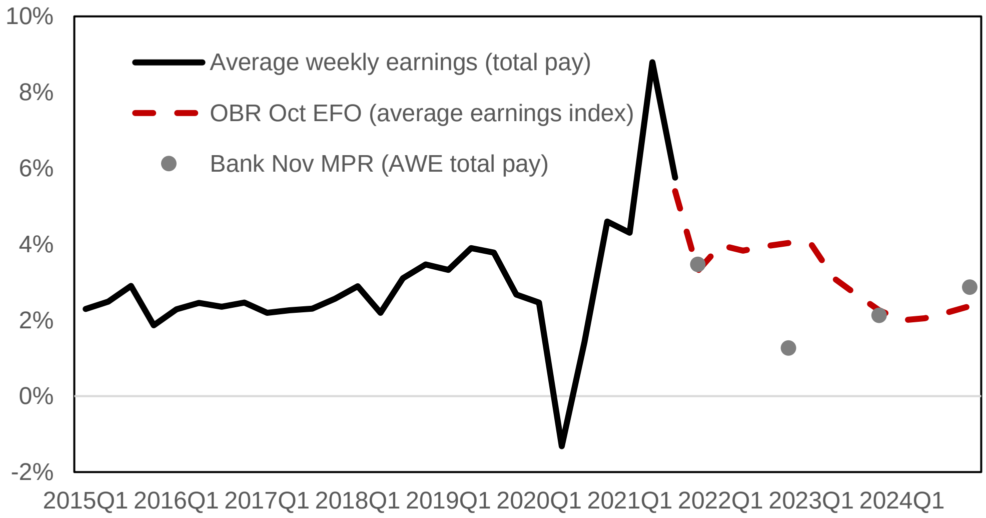
3.11 For these reasons, average pay settlements are the appropriate measure of earnings growth to consider in setting public sector pay settlements. The combined effect of pay drift and compositional effects imply that average weekly earnings will rise faster than average settlements.

Chart 3.D: Average weekly earnings (regular pay), headline and two-year average growth



Source: ONS

Chart 3.E: Nominal pay growth, outturn and forecast (quarter on year)



Source: Bank of England, OBR, ONS

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[2] See discussion of compositional effects in:
efhttps://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/october2021

[3] See discussion of settlements on page 13 of:
https://www.niesr.ac.uk/sites/default/files/publications/UK%20Economic%20Outlook%20%28Autumn%202021%29.pdf

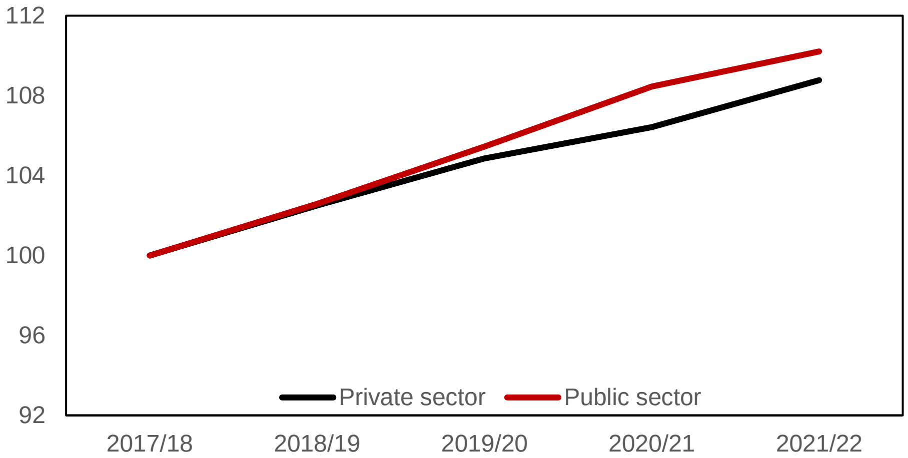
3.12 Median whole economy pay settlements were 2.0% in latest data for the 3 months to October 2021 and 1.7% for the 12 months to October 2021. This is below average settlement levels in 2019, but has recovered from the drop during the pandemic. Business surveys on expected settlements in the year to August 2022 suggests a slight increase in settlements, with private sector employers anticipating awards of 2.5% in the 12 months to the end of August 2022

Chart 3.F: Median pay settlement, 3 month rolling average

Source: XpertHR

3.13 Over the last 5 years public sector wage settlements have been higher than in the private sector. Wage settlement data is the most analogous to how pay awards are set in the public sector. The temporary pause to public sector pay awards in 2021/22 ensured the public sector premium did not widen further.

Chart 3.G: Pay settlement data, split by private and public sector, indexed to 2017/18[4]



Source: XpertHR (private sector)

Employment

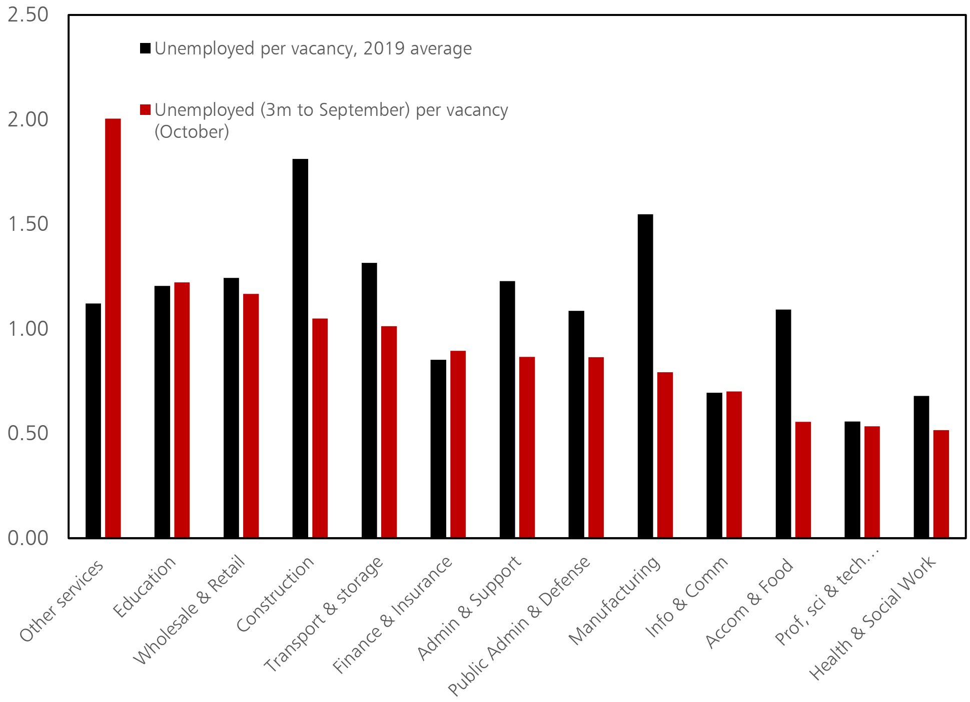
3.14 The labour market has recovered rapidly from the economic impact of COVID-19 over the past year, with the number of employees on payrolls at record levels, having increased for 11 consecutive months. This recovery has led to a significant labour market tightening in recent months, while the ratio of unemployed people per vacancy has fallen to a record low level of 1.3 in Q3. This is driving recruitment challenges in many sectors across both the public and private sectors. This tightening has been sharpest in the manufacturing, construction and accommodation and food sectors.

3.15 This increase in labour market tightness has not driven large increases in economy wide pay growth. There is a weak relationship between levels of pay growth by sector and levels of sectoral tightness, as measured by the ratio of unemployed people per vacancy.

3.16 The expected temporary increase in inflation has also not led to increases in economy wide wage growth. Data on posted salaries from Indeed shows that the average advertised salary increased by just 1.9% across all postings between January and October 2021.

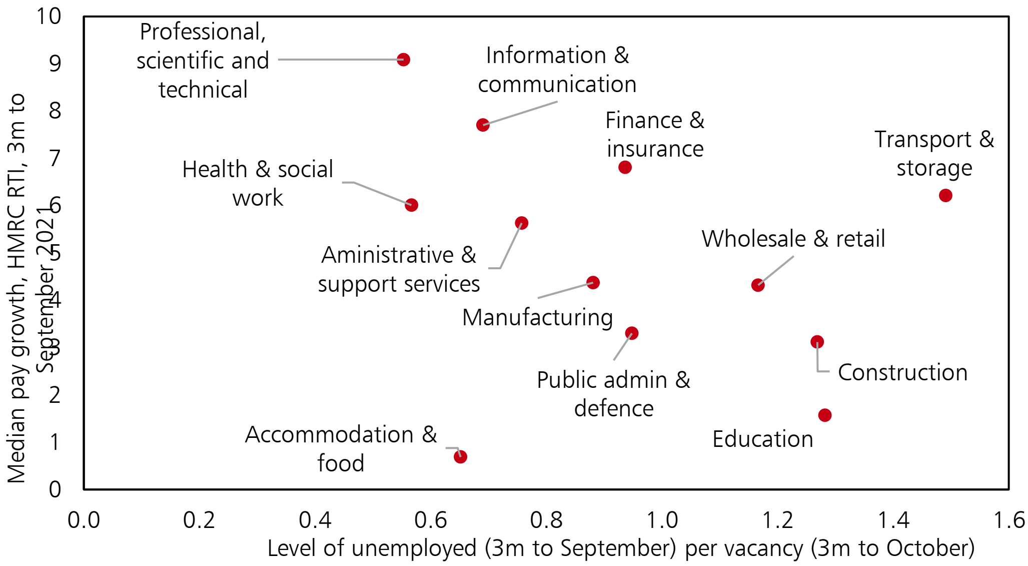
4 Private sector line refers to median pay settlements, private sector figure for 2021/22 latest data to date (6 months to October 2021).Public sector figure represents a weighted average of PRB workforce settlements

Chart 3.H: Unemployed per vacancy ratio, by sector of previous employment



Source: ONS

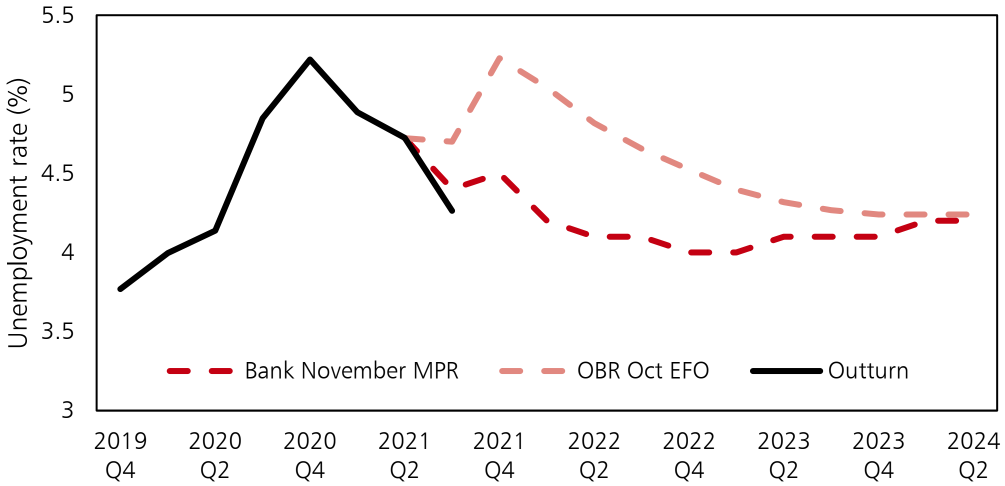
Chart 3.I: Sectoral tightness and median pay growth



Source: HMRC RTI, ONS

3.17 There remains uncertainty over the near-term outlook for the labour market, with latest forecasts implying a modest loosening in 2021 Q4, before falling to around pre-pandemic levels over the following years.

Chart 3.J: Comparison of unemployment rate forecasts



Source: Bank of England, OBR, ONS

Chapter 4
Fiscal Context

4.1 The strong recovery and necessary tax rises have put the public finances on a more sustainable footing, however, borrowing and debt remain at historically high levels. The government's commitment to sustainable public finances over the medium term is underpinned by new fiscal rules. These ensure that the government's spending plans are consistent with reducing debt. The recent OBR forecast confirmed the fiscal mandate is met with debt as a proportion of GDP falling from 2024-25. In addition, the current budget is in surplus in 2024-25, public sector net investment averages 2.7% of GDP over the rolling forecast period, and the welfare cap is met.

4.2 Public sector net debt excluding the Bank of England (PSND ex BoE) is on average 11.0% lower each year than forecast in March 2021, but 12.5% higher than the March 2020 forecast, and there is £17.5 billion (0.6% of GDP) of headroom in the target year of 2024- 25. However, risks still remain. Public sector net debt (PSND) is at the highest level since the 1960s and the public finances are now more sensitive to changes in inflation and interest rates than before the pandemic. A sustained 1 percentage point increase in both inflation and interest rates would increase spending on debt interest by £22.8bn in 2026-27.

4.3 In just over a decade, the UK has faced two major economic shocks. Developing fiscal buffers ensures that governments will be able to effectively support the economy in future crises and provides space to allow the government to address long-term challenges.

4.4 By taking early action to repair the public finances over the past year, the government is able to confirm that every department will see a real-term rise in overall spending as a result of Spending Review 2021 and over the Parliament.

4.5 Alongside departmental budgets, the Spending review also announced the government's plans to increase public service activity in key areas of demand. For example:

- The NHS in England will aim to deliver around 30 percent more elective activity by 2024-25 than it was before the pandemic, after accounting for the impact of an improved care offer through system transformation, and advice and guidance
- Expanding teacher training and development, progressing the government's ambition to train up to 500,000 teachers over the three academic years from 2021/22 to 2023/24

- Completing the government's commitment to recruit 20,000 police officers over the three years to 2023
- Recruiting additional work coaches, on top of the commitment to double work coaches set out in the Plan for Jobs.

4.6 Pay rises above affordability could materially impact HMG's ability to deliver on these and other commitments – there is a direct trade-off between recruiting more staff, investing in public services and giving higher pay rises.

4.7 Recommendations above departments' specified affordability represent a significant fiscal cost. Illustratively, if all public sector pay was increased by 1% in 2022-23, this would cost c. £4.5bn over the SR period[1]. This would also ratchet up the cost of any pay deals in the later years of the SR period, because pay would be increasing from a higher base.

4.8 To fund a significant increase in permanent spending on the NHS and adult social care, the government took the tough but responsible choice to increase taxes. The new 1.25% dedicated Health and Social Care Levy is based on NICs and paid by employers, employees and self-employed people. To maintain departmental spending power, the government has compensated departments and other public sector employers for the increased cost of employer contributions. However, if the employee element was accounted for in public sector pay awards, this would result in a reduction in revenue from the Levy and therefore funding available for the NHS and adult social care.

4.9 Moreover, as we have stated, public sector pay policy should retain broad parity with the private sector. The Levy applies across the whole economy so accounting for the increase in public sector awards would result in differential treatment to those in the private sector.

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[1] Based on pay data from Public Expenditure Statistical Analyses 2021

Chapter 5
Conclusion

5.1 Inflation is expected to peak at around 4% in 2022 - its highest rate in over a decade - as a result of ongoing global supply chain issues and labour market shortages. However, the OBR and the Bank of England both expect this to be temporary, with a return of inflation to the 2% target underpinned by the UK's strong and credible macroeconomic framework. Nonetheless, both forecasters also note risks to their forecasts, including the possibility that price pressures are sustained over a longer period of time. The Bank highlighted in their November Monetary Policy Report that "A risk to the inflation outlook is that longer-term inflation expectations evolve such that wage and price setting is not consistent with inflation returning to 2% in the medium term…".

5.2 Pay settlement is the most comparable to PRB decisions. Generally, recruitment and retention issues in the private sector haven't necessarily translated into economy wide wage rises. Base and compositional effects are making earnings data difficult to interpret, but pay growth is forecast to be modest once base effects unwind. Recruitment and retention data in the public sector presents a generally positive picture. The whole public sector renumeration package remains competitive, when taking account of pay, pensions and wider benefits including job security.

5.3 There will be growth in RDEL over the SR period, but, in the context of a fixed envelope, there is a direct trade-off between giving pay rises above affordability, recruiting more staff and investing in public services.

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