



HM Treasury

Economic Evidence to the Pay Review Bodies 2020/21

Contents

Summary	3
Economic and Fiscal Context	5
Public and Private Sector Pay	11
Public Sector Employment	16
Conclusion	18

Note: statistics up to date as of 14th December 2020

Section 1 - Summary

- 1.1 At this year's Spending Review, the Chancellor announced that pay rises in the public sector will be restrained and targeted in 2021-22. This reflects the significant disruption Covid-19 is causing across the wider economy, including its impact on private sector employment, disruption to wages and uncertainty in the outlook as we move into 2021. As the Chancellor set out at the Spending Review launch, in the interest of fairness we must exercise restraint in future public sector pay awards, ensuring that in the medium-term public sector pay growth retains parity with the private sector.
- 1.2 Given the unique impact of Covid-19 on our health service, and despite this challenging economic context, government will continue pay uplifts for workers across the NHS. In addition, the Chancellor announced that the lowest paid across the public sector would be protected, with those earning less than a £24,000 basic wage on a full-time equivalent basis receiving a minimum £250 uplift.
- 1.3 In that context we are remitting the NHS Pay Review Body, and Doctor and Dentists Pay Review Body (where applicable) in full, and are asking the remaining Pay Review Bodies (PRBs) to consider how to implement the £250 uplift in a way that minimises disruption to pay spines. Full detail on the floor is set out in remit letters. Departments will also ask PRBs to make recommendations on workforce specific issues and reform strategies, where applicable.
- 1.4 This document sets out the economic and fiscal background to this policy decision. Key points are:
- Covid-19 has had a significant impact on the wider economy. In the OBR's central forecast, output is projected to fall by 11.3% this year, which would be the largest annual fall since the Great Frost of 1709. Under the OBR's central forecast unemployment is forecast to rise to 7.5% in Q2 2021¹.
 - Inflation falls to 0.6% in 2020/21, before rising to 1.4% in 2021/22, returning to target in 2025/26².
 - Public Sector Net Borrowing (PSNB) in 2020/21 is £393.5bn, seven times higher than the £54.8bn the OBR expected in March. At 19.0 per cent of GDP, this is the highest

¹ Economic and fiscal outlook, OBR, November 2020

² Ibid

peacetime level on record. Public Sector Net Debt (PSND) is over 100 per cent of GDP in every year of the forecast³.

- In the six months to September, private sector wages fell by 0.8% compared to the same period the previous year, as compared to a 3.9% increase in the public sector (excluding financial services)⁴. The use of a six-month period was specifically in response to the effect of Covid-19 on the labour market. Current wage data are relatively volatile as they have been impacted by the Coronavirus Job Retention Scheme: however, private sector settlements have been subdued, and remain flat at the lower quartile⁵.
- The OBR whole economy earnings forecast is 1.2 percentage points lower in 2021/22 compared to the March forecast⁶.
- Public sector settlements were relatively generous in 2020/21, set against modest inflation of 0.6% and significant disruption to the private sector labour market and wages⁷. For many public sector workers 2020/21 was the third year in a row of above inflation pay rises. Public sector total remuneration, adjusted for characteristics, was already 7% above that seen in the private sector in 2019, according to ONS analysis⁸. The settlements seen in 2020/21 are expected to increase this figure significantly.

1.5 Against this challenging economic backdrop, a pause in public sector pay uplifts excluding the NHS and those earning less than £24,000 will allow government to protect public sector jobs and invest in public services to respond to Covid-19. This policy also ensures that any further expansion of the gap between public and private sector pay is minimised, ahead of revisiting pay policy once the economic recovery is established and the outlook more certain.

Section 2 - Economic and Fiscal Context

³ Economic and fiscal outlook, OBR, November 2020

⁴ ONS, Average Weekly Earnings

⁵ XperTHR, settlements data

⁶ Economic and fiscal outlook, OBR, November 2020

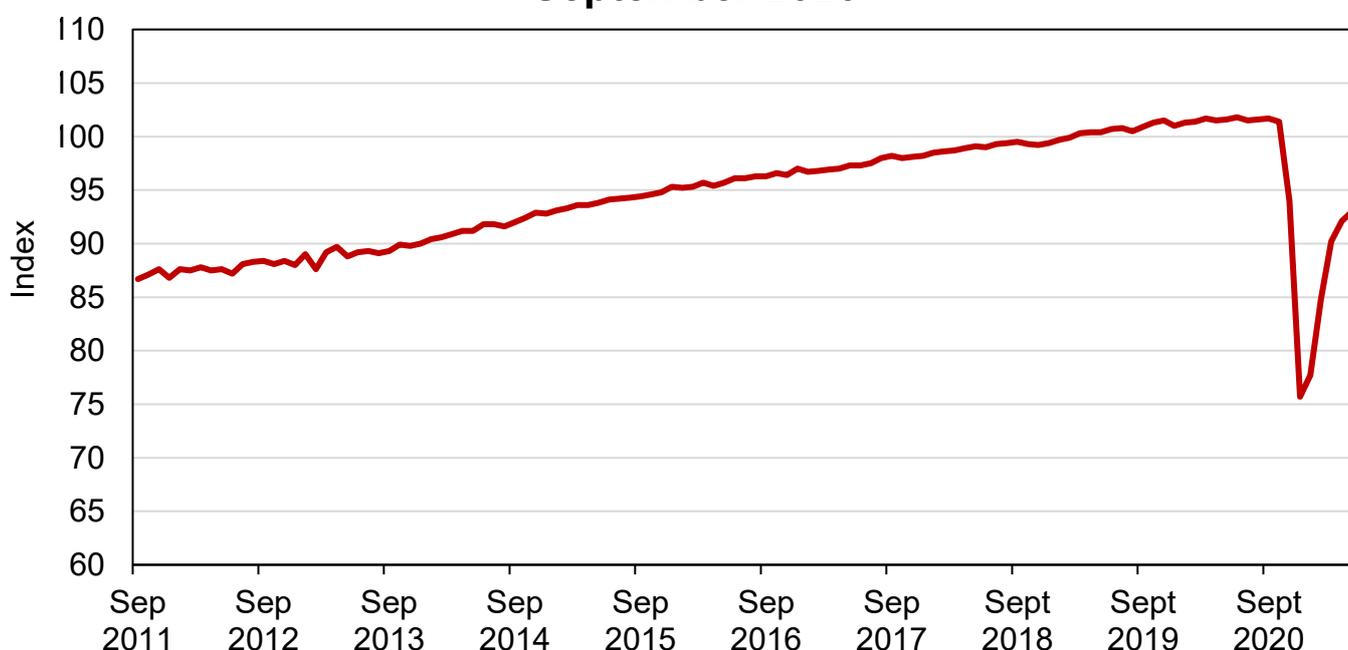
⁷ Gov.uk, Pay rises for doctors, police and more in the public sector

⁸ ONS, Public and Private Sector Earnings: 2019

Economic Context:

- 2.1 The Covid-19 pandemic has brought significant disruption to the UK economy. The Government has taken necessary action to slow the spread of the virus, placing considerable restrictions on people and businesses, and providing support to jobs and income. The Office for National Statistics (ONS) estimates that output fell by 25% between February and April as the economy entered the largest recession on record⁹.
- 2.2 Chart 2.1 shows that as restrictions began to ease over the summer the economy began to recover. GDP in October is 23.4% higher than its April low. However, this still leaves the economy 7.9% below the February level¹⁰.

Chart 2.1: UK Monthly GDP Index, January 2011 to September 2020



- 2.3 According to the latest OBR forecast, output is set to fall by 11.3% this year. This would be the largest annual fall since the Great Frost of 1709. The OBR's central forecast suggests output by March 2021 will be 10% below its pre-virus peak. The long-term outlook assumes permanent economic scarring caused by the pandemic with output at the five-year forecast horizon lying 3% below its pre-pandemic trajectory¹¹. The path of output is highly conditional on the path of Covid-19. The OBR's central forecast assumes a higher infection rate necessitates keeping a set of public health restrictions over winter, but an effective vaccine becomes widely available in the latter half of 2021 permitting a gradual return to normal life. However, the outlook for

⁹ ONS GDP April 2020

¹⁰ Ibid

¹¹ Economic and fiscal outlook, OBR, November 2020

growth is highly uncertain and will depend upon Covid-19's trajectory moving into the new year.

- 2.4 As highlighted by the OBR and the Bank of England, without the measures the government has taken, the outlook would be much worse. The OBR's fiscal multipliers show at the start of 2021 GDP would have been almost 3% lower in absence of the Governments latest measures¹².

Productivity and Inflation

- 2.5 Productivity growth, as measured by output per hour, was flat in 2019, 0.8 percentage points lower¹³ than the OBR's Spring Statement forecast. More recently, productivity fell by 2.0% in Q2 compared to the previous quarter according to the ONS before recovering to above pre-Covid levels in Q3¹⁴.
- 2.6 Lower productivity accounts for 2 percentage points of the pandemic related hit to real GDP by the end of 2025. However, in the short-term productivity loss is predicted to ease as businesses become less restricted in the way they organise production. Nevertheless, the cumulative effects of depressed investment and capital scrapping on the capital stock, overlaid by the effect of higher business debt and an increase in business failures on innovation and total factor productivity are predicted to cause scarring in both central and downside OBR scenarios¹⁵.
- 2.7 Before the pandemic inflationary pressure looked to be broadly consistent with the 2% target over the medium term. Lower oil prices and government policy, like the Eat Out to Help Out scheme, have applied a downward pressure on inflation. CPI fell to 0.2% in August¹⁶ and is expected to be 0.6% for the 2020/21 financial year, before rising to 1.4% in 2021/22, returning to target in 2025/26¹⁷.
- 2.8 Chart 2.2 shows the difference in the OBR's expectations for inflation from March's economic and fiscal outlook to November's publication. It shows that CPI will take an extra three years to reach the 2% target and will be 0.8 percentage points lower in 2020/21 than was expected in March¹⁸.

¹² Ibid

¹³ ONS, UK economy: output per hour worked % change per annum

¹⁴ ONS UK flash estimate: July to September 2020

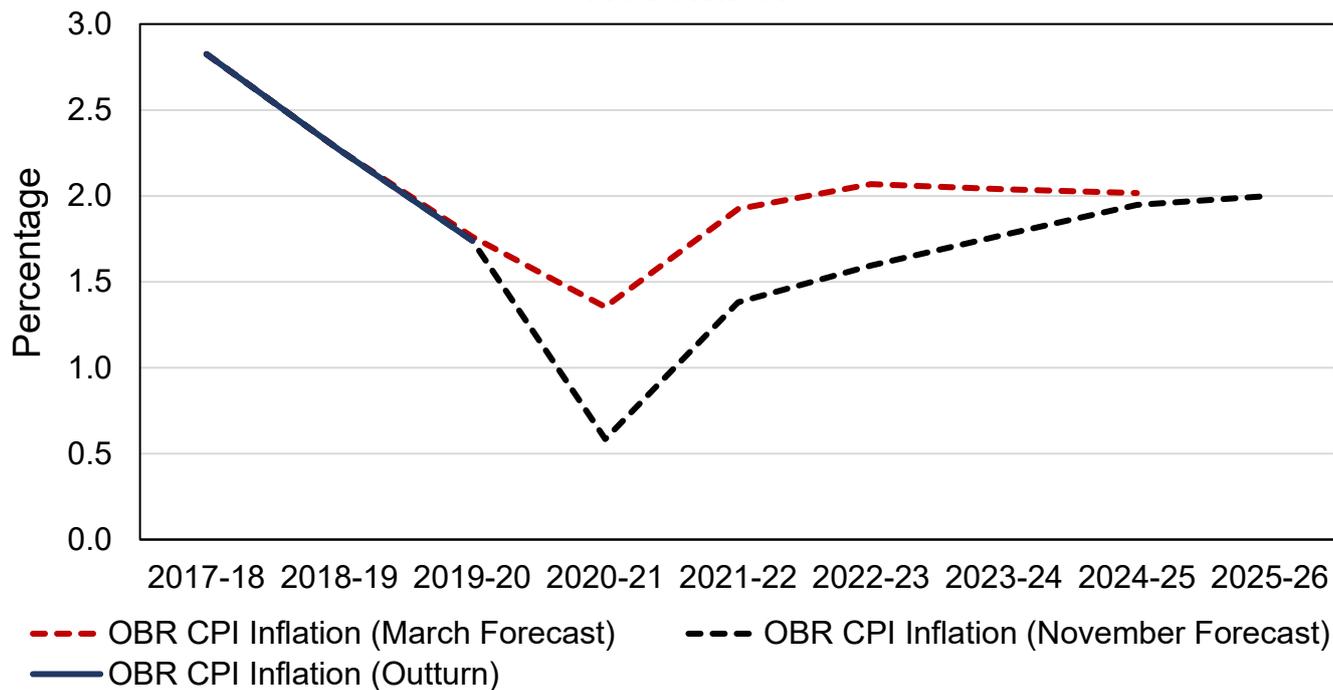
¹⁵ Economic and fiscal outlook, OBR, November 2020

¹⁶ Consumer price inflation, UK: October 2020

¹⁷ Economic and fiscal outlook, OBR, November 2020

¹⁸ Economic and fiscal outlook, OBR, November 2020

Chart 2.2: OBR CPI inflation Forecast March vs November



Public finance outlook

- 2.9 In response to the COVID-19 pandemic the government has provided one of the largest and most comprehensive packages of measures in the world, with targeted support for public services, workers and businesses. Since March, the government has announced a total of over £280 billion of support measures¹⁹. The economic impacts of Covid-19 and the unprecedented support packages announced by Government have meant a significant but necessary increase in borrowing and debt. The OBR’s central forecast for Public Sector Net Borrowing (PSNB) in 2020/21 is £393.5bn, which is seven times higher than the £54.8bn the OBR expected in March. At 19.0 per cent of GDP, this is the highest peacetime level on record.
- 2.10 PSNB falls sharply in 2021/22 to a still historically high £164.2bn (7.4 per cent of GDP) as activity recovers and much of the temporary fiscal support expires. Borrowing continues to decline more gradually thereafter to reach £101.8bn (3.9 per cent of GDP) in 2025/26²⁰.
- 2.11 Public Sector Net Debt (PSND) is over 100 per cent of GDP in every year of the forecast, and peaks 109.4 per cent in 2023/24²¹. Relative to the OBR’s March forecast, debt is higher across all years by around 30 per cent of GDP²².

¹⁹ Gov.uk, Spending Review 2020

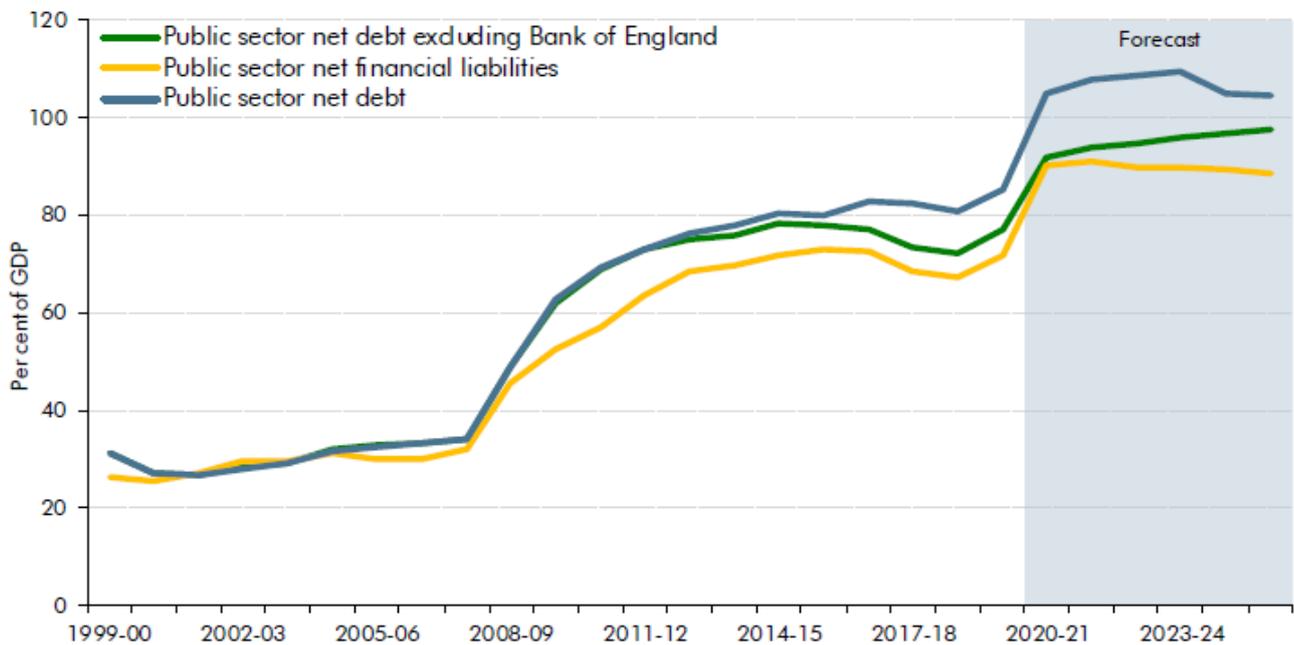
²⁰ Economic and fiscal outlook, OBR, November 2020

²¹ Ibid

²² Ibid

- 2.12 Underlying debt – excluding the effects of Bank of England measures – increases in every year of the forecast, peaking at 97.5 per cent of GDP in 2025/26²³.
- 2.13 Over time, and once the economic recovery is secured, the government is fully committed to taking the necessary steps to ensure borrowing and debt are on a sustainable path. The government will set out further details on its medium-term fiscal strategy, alongside a framework to support its delivery, once the current level of uncertainty recedes. In the meantime, the government will make responsible spending decisions that do not make that process harder than it needs to be.

Chart 2.3: Public Sector Net Debt, outturn and forecast



Source: ONS, OBR

Labour Market

- 2.14 The government has taken significant action this year to protect jobs. However, the unprecedented nature of the Covid-19 crisis means that unemployment has risen: in the three months to September, the unemployment rate rose 0.9 percentage points on the year to 4.8 per cent, as reflected in Chart 2.4²⁴. The OBR’s central forecast points to unemployment rising to 7.5% in the spring, with unemployment rising to 2.6 million²⁵. This labour market slack is expected to weigh down on wages in 2021/22.

²³ Ibid

²⁴ ONS, Unemployment rate (aged 16 and over, seasonally adjusted)

²⁵ Economic and fiscal outlook, OBR, November 2020

Chart 2.4: Unemployment Rate, Quarterly, Seasonally Adjusted (%)



- 2.15 Current relatively modest rises in unemployment as shown in the Labour Force Survey (LFS) contrast with substantial rises in both the claimant count and Universal Credit claims. In October there were 2.7 million²⁶ more households claiming Universal Credit than in March.
- 2.16 LFS data shows employment falling by 500,000²⁷ between first and third quarters of 2020, taking the employment rate down by 1.1²⁸ percentage points. Real time information (RTI) data from the PAYE tax system showed a 782,000 (2.7 percent)²⁹ fall in employees between March and September. The first six months of 2020 saw some of the largest falls in employment in the last two decades.
- 2.17 Redundancies rose to 314,000 in the three months to September³⁰ – the highest level on record. Meanwhile, vacancies this year fell further and more rapidly than during the 2008-2009 recession and the 3 months to October were still 35 per cent down on the year³¹.

²⁶ Gov.uk, Universal Credit statistics: 29 April 2013 to October 2020

²⁷ ONS, labour market overview, UK: November 2020

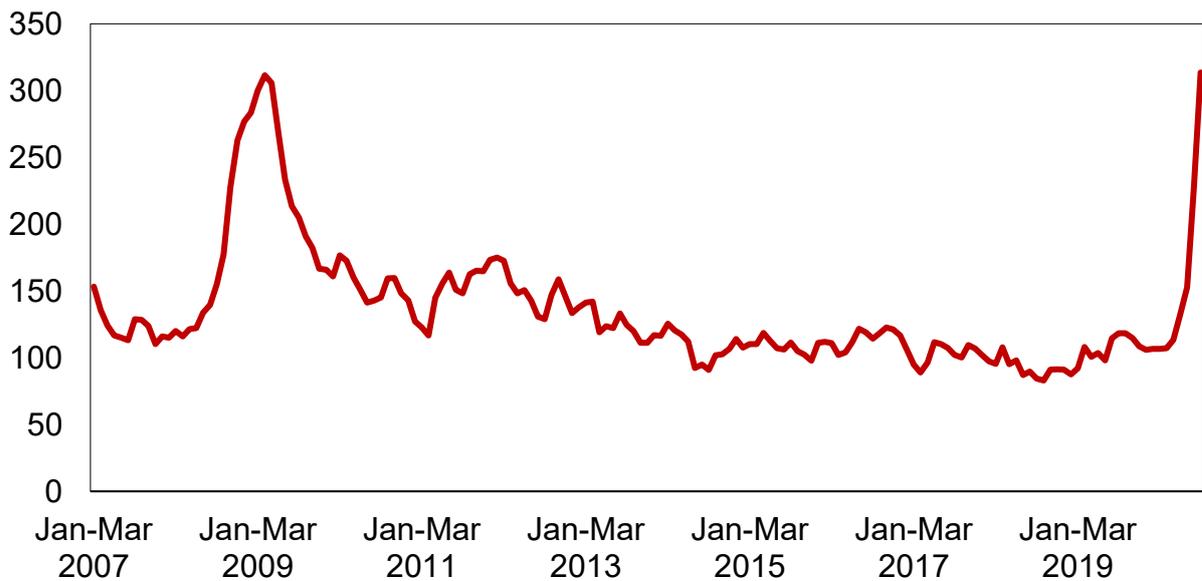
²⁸ ONS, labour market overview

²⁹ ONS, earnings and employment from pay as you earn real time information, UK: November 2020

³⁰ ONS, labour market overview, UK: November 2020

³¹ Ibid

Chart 2.5: Redundancies (thousands)



- 2.18 In the OBR 's central forecast the recovery in employment and fall in unemployment rate broadly follows the recovery in GDP. The unemployment rate falls to 4.4% at the forecast horizon in 2025, 0.4 percentage points higher than the pre-Covid³². However, the outlook for the labour market is contingent on what happens when the support schemes wind down.
- 2.19 The OBR suggests that without the extension to CJRS the peak of unemployment would occur two quarters earlier and at a higher level. The extension is projected to reduce the level of unemployment in the second quarter of 2021 by around 300,000³³.

³² Economic and fiscal outlook, OBR, November 2020

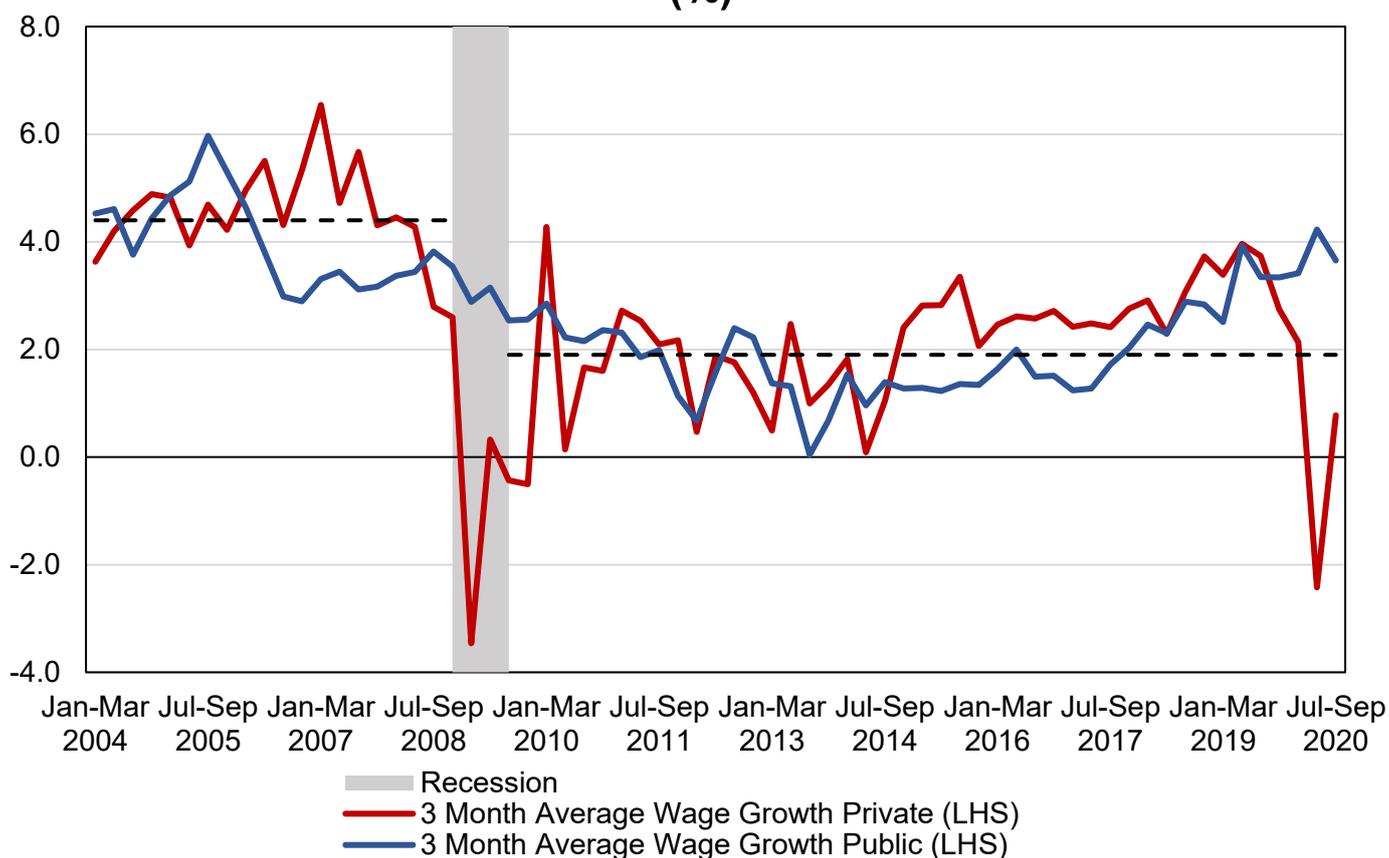
³³ Ibid

Section 3 – Public and Private Sector Pay

3.1 As set out above, the Government has taken significant action this year to protect jobs in the unprecedented economic context of Covid-19. Nonetheless, unemployment and redundancies across the private sector are still rising. Public sector remuneration remains generous relative to the private sector, and Covid-19 is likely to broaden this disparity, especially taking into account Government’s acceptance in full of most of the PRB recommendations for 2020/21³⁴. The government has determined that a temporary pause in public sector pay growth, excluding the NHS and awards for the lowest paid, is needed until the full impact of Covid-19 on the wider economy is clearer.

3.2 Long term average wage growth for both the public and private sector has been the same since the 2008 recession, at 2% for both sectors (July 2009 – September 2020)³⁵.

Chart 3.1: 3 Month Average Wage Growth, By Sector (%)



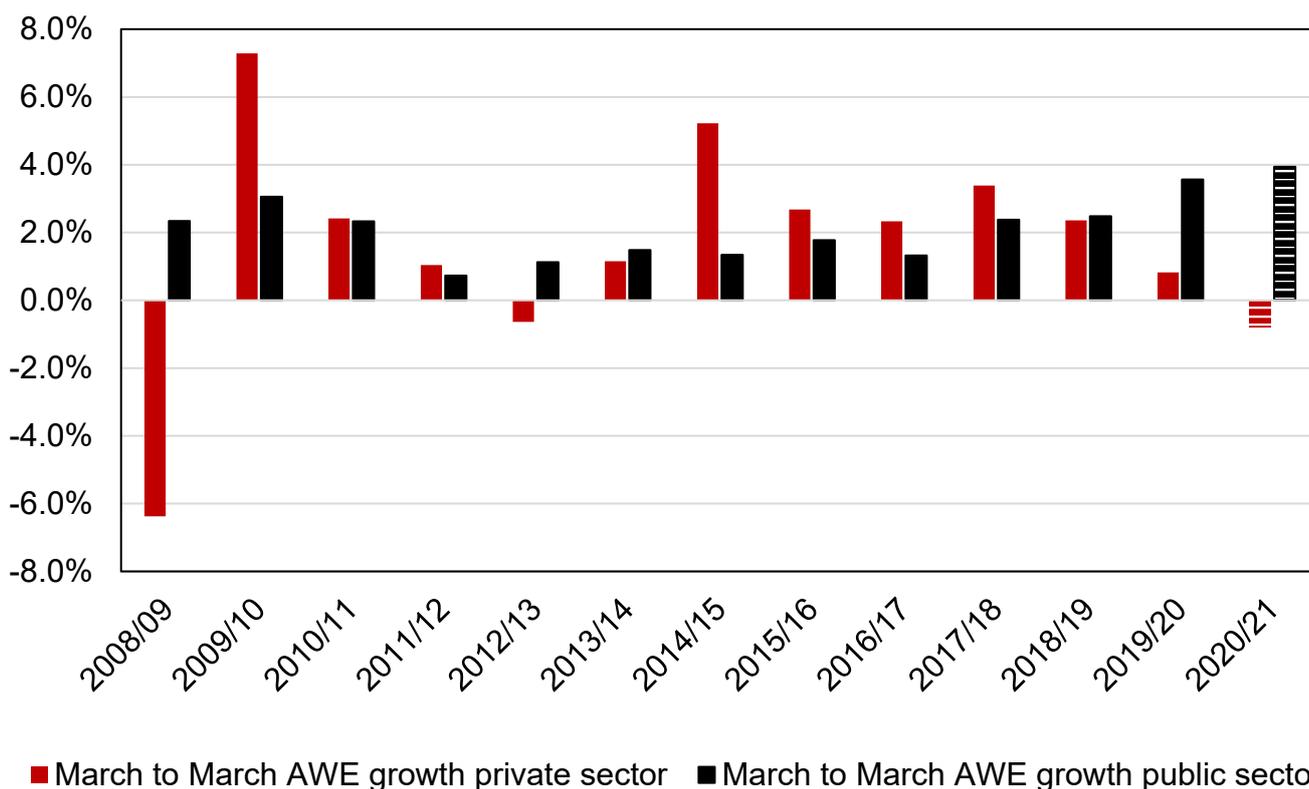
3.3 This pattern has changed dramatically in recent months. Chart 3.2 shows the year on year growth rate of Average Weekly Earnings to March in public and private sectors. Figures in 2020/21 show the growth rate in the six months to September compared to the same period in the previous year. It shows the significant divergence between public and private sector wage growth in

³⁴ Noting that Government has not yet responded to PSPRB recommendation 3.

³⁵ ONS Average Weekly Earnings

recent months. In the six months to September, private sector wages fell by 0.8% compared to the same period the previous year, as compared to a 3.9% increase in the public sector (excluding financial services). Current wage data are relatively volatile as they have been impacted by the Coronavirus Job Retention Scheme (which has supported the wages of employees producing little or no output, albeit at a reduced rate where employers have not topped up wages – note also that this scheme has very limited public sector application), changes to the composition of the labour market and the impact of reduced labour demand.

Chart 3.2: Average Weekly Earnings Growth, (%)



3.4 Settlement data can give a better indication of underlying wage pressure: private sector median settlements fell to 0% in the three months to the end of July, August and September, before rising again to 2% in the three months to October. Private sector settlements remain flat for those in the lower quartile (XpertHR data)³⁶.

3.5 Despite the substantial fall in GDP set out above the OBR expect wages to continue to grow across 2020/21 (0.9%) and 2021/22 (2.2%), albeit at a significantly reduced rate relative to the March forecast. The OBR expect some bounce back in wages in 2021/22 as the economy recovers, although both of these factors are highly uncertain and subject to wider developments. The OBR’s November forecast for whole economy earnings growth in 2021/22 is 1.2 percentage

³⁶ XpertHR, settlements data

points lower than their March forecast³⁷. as a result of continuing labour market slack, productivity scarring, lower inflation expectations and the need for firms to repair balance sheets. It is worth noting that the total earnings forecast incorporates current public sector pay growth for 2020/21, meaning that the equivalent private sector figure is likely to be lower than the 0.9% expected for the whole economy.

Chart 3.3: March vs November OBR average earnings growth forecasts

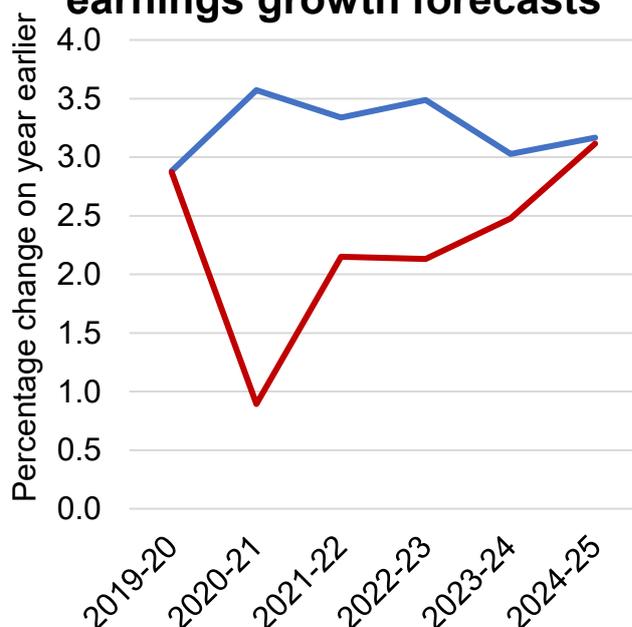
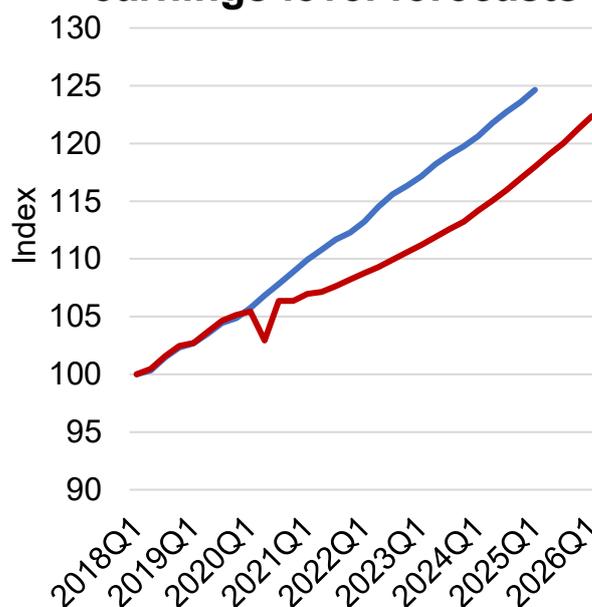


Chart 3.4: March vs November OBR average earnings level forecasts



3.6 Note that these forecasts are predicated on the OBR central scenario, which assumes that a Covid-19 vaccine becomes widely available in the latter half of 2021, and 'Tier 3' type restrictions remain in place, with regional and temporal variation, until the spring. A more positive outlook may mean the wage forecast is revised upward. This uncertainty is a key variable in our approach to public sector pay, which is why the policy will be revisited once the outlook is clearer for 2022/23.

3.7 However, regardless of these scenarios pay awards agreed since 2018/19 mean that we have entered the 2021/22 pay round from a position of relative strength. For the majority of public sector workers, this is the third consecutive year of pay awards in excess of inflation, as set out in Table 3.1 below:

Workforce	Pay award % uplift 2020/21	Pay award % uplift 2019/20	Pay award % uplift 2018/19
Civil Service	1.5-2.5	1-2	1-1.5
Armed forces	2	2.9	2+0.9 non-con

³⁷ Economic and fiscal outlook, OBR, November 2020

Police	2.5	2.5	2
Teachers	3.1 (average)	2.75	2.4 (average)
Prison Officers	2.5	2.74	2.75
Agenda for change: nurses paramedics, hospital support etc.	Agenda for change deal - starting pay for a newly qualified nurse has increased by over 12% since 2017/18		
Consultants	2.8	2.5	1.5% from Oct
Junior Doctors	2	2.5	2% from Oct
GPs	2.8	2.5	2%
Specialist doctors	2.8	2.5	3% from Oct
Inflation (financial year, %, OBR November 2020)	0.6	1.7	2.3
Inflation (financial year, %, OBR March 2020)	1.4	1.8	2.3
Inflation (financial year, %, OBR March 2019)	1.9	2.0	2.3

- 3.8 As set out in the table, the inflation forecast has fallen by 0.8 and 1.3 percentage points since the March 2020 and 2019 forecasts respectively, meaning that awards for 2020/21 were substantially more generous in real terms than expected.
- 3.9 In addition to pay, it is important to consider all parts of remuneration when assessing the position of employees in the public sector relative to private sector. 'Future service'³⁸ employer pension contributions in the public sector are typically around 20%. This is far in excess of generosity even for large private sector employers³⁹, and private sector averages would be far lower again once auto enrolment is taken into account.
- 3.10 The main public service pension schemes, with the exception of the local government scheme, are statutory unfunded defined benefit pension schemes, which means that the benefits a scheme member can accrue are set out in legislation and not subject to investment return. In addition, public service pensions in payment, preserved pensions, and preserved lump sums are increased annually to take account of increases in the cost of living so that pensions retain their purchasing power. This is different to a defined contribution pension scheme where the scheme members bear the risk and the level of benefit is not guaranteed and subject to investment return.

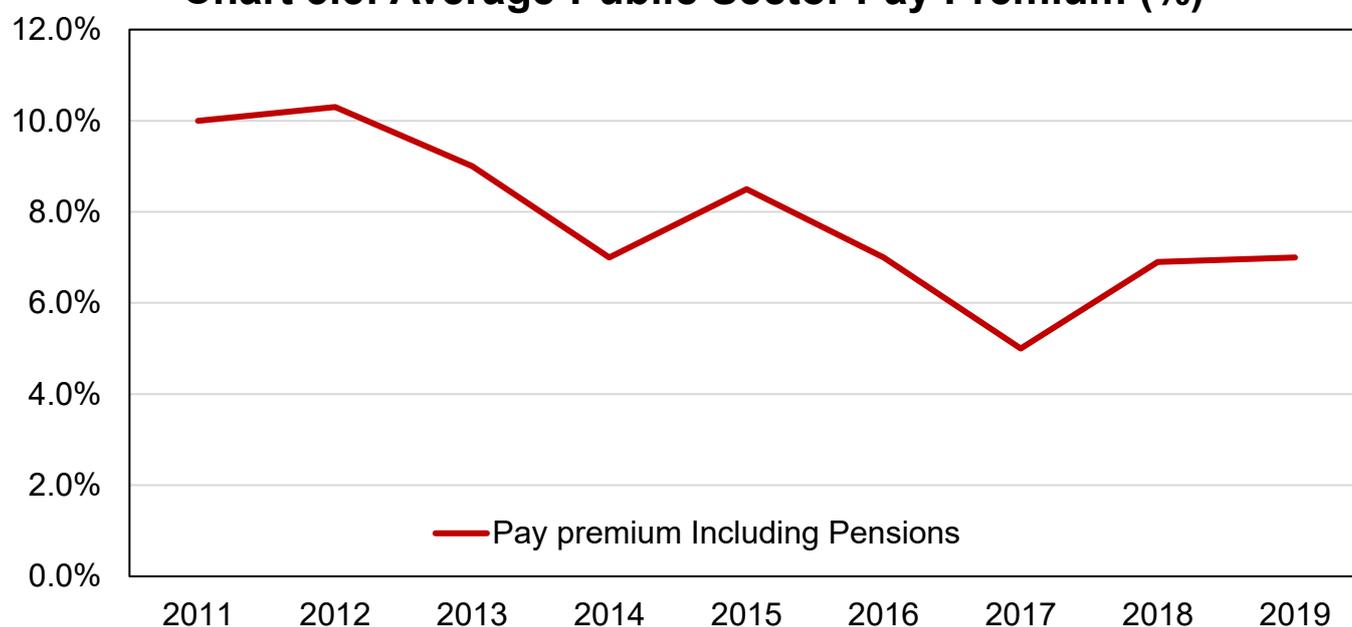
³⁸ Not including employer pension contributions meeting previous public sector pension deficits. This is a more accurate comparison with private sector defined contribution schemes. Total public sector employer contributions would be higher.

³⁹ Willis Towers Watson report that in 2020 FTSE100 companies were on average paying 8.3% of pay towards DC schemes that applied a 'non-matching' contribution rate structure, and 11.4% where a 'matching' contribution rate structure was employed. www.willistowerswatson.com/en-GB/Insights/2020/07/ftse-350-defined-contribution-pension-survey-2020 - page 6

3.11 Chart 3.5 below illustrates the ONS' analysis of the evolution of the public sector pay premium between 2011 and 2019⁴⁰. The analysis considers the full remuneration package of employees (including pensions, bonuses and overtime) and controls for individual and job characteristics that affect an individual's pay. The results show that whilst the remuneration premium has fallen over this period, in general there still exists as significant premium in favour of the public sector.

3.12 This ONS analysis shows that in 2019, public sector workers were paid 7% more than workers in the private sector on average⁴¹. In the current economic climate, we expect at least in the short-run this pay premium figure to be exacerbated without the implementation of pay restraint, given the negative impacts of Covid-19 on private sector earnings and the relatively generous 2020/21 public sector pay awards.

Chart 3.5: Average Public Sector Pay Premium (%)



3.13 Due to a statistical reclassification the ONS pay premium analysis only covers the period following 2011. Chart 3.6 shows the difference between mean gross annual earnings for full-time employees in the public and private sectors⁴². Note that this is not a modelled, but a raw difference in pay between sectors.

3.14 The chart shows that around the 2008 financial crisis the difference in pay between the two sectors increased in comparison to previous years. Given the substantial effects of Covid-19 on the economy and labour market we expect the gap between sectors to widen further. Pausing headline pay awards next year for some workforces will prevent further expansion of the gap between public and private sector reward and help maintain parity in earnings growth between

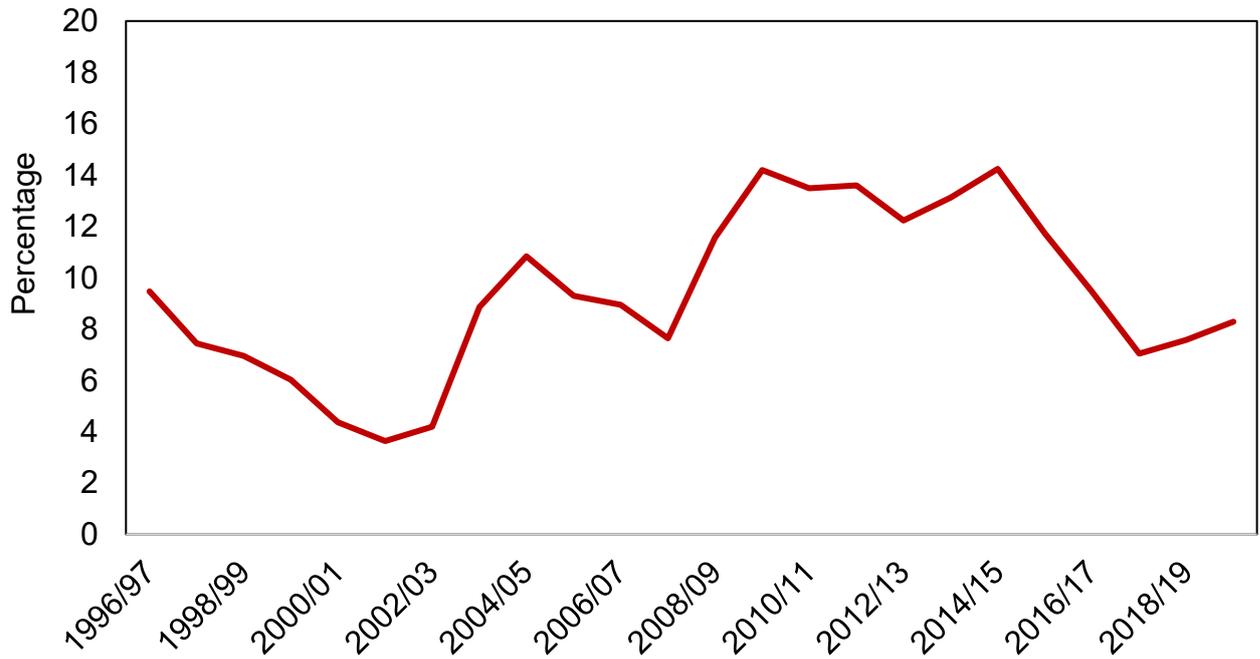
⁴⁰ ONS, Public and Private Sector Earnings: 2019

⁴¹ Ibid

⁴² ONS ASHE data, gross, mean full-time employees

sectors.

Chart 3.6: Percentage differential between public and private sector pay

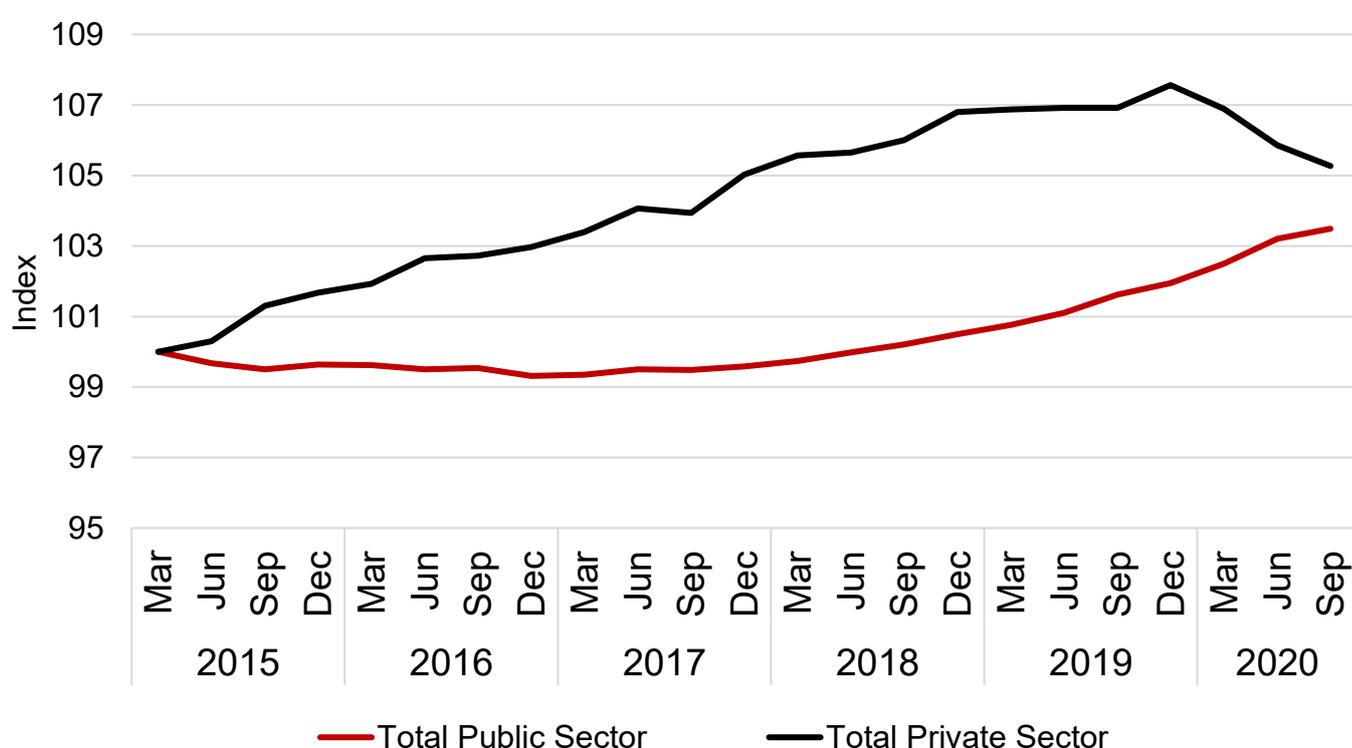


3.15 Note that while this challenging economic context applies equally to all parts of the public sector, the government has chosen to exempt the NHS given the unique and continuing impact of Covid-19 on the health service.

Section 4 – Public Sector Employment

- 4.1 The economy and the private sector labour market has seen huge disruption from Covid-19. However, the public sector has been largely shielded from these effects. Public sector employment is rising, wages are continuing to grow, and the public sector is shielded from redundancies by current public service demand and government policy.
- 4.2 Private sector employment fell by 0.2% between Q1 2020 and Q2 2020. In contrast, employment in the public sector rose by 0.7%⁴³. This was mainly because of increasing employment in the NHS in response to Covid-19.

Chart 4.1: Employment Public and Private Sector (Index)

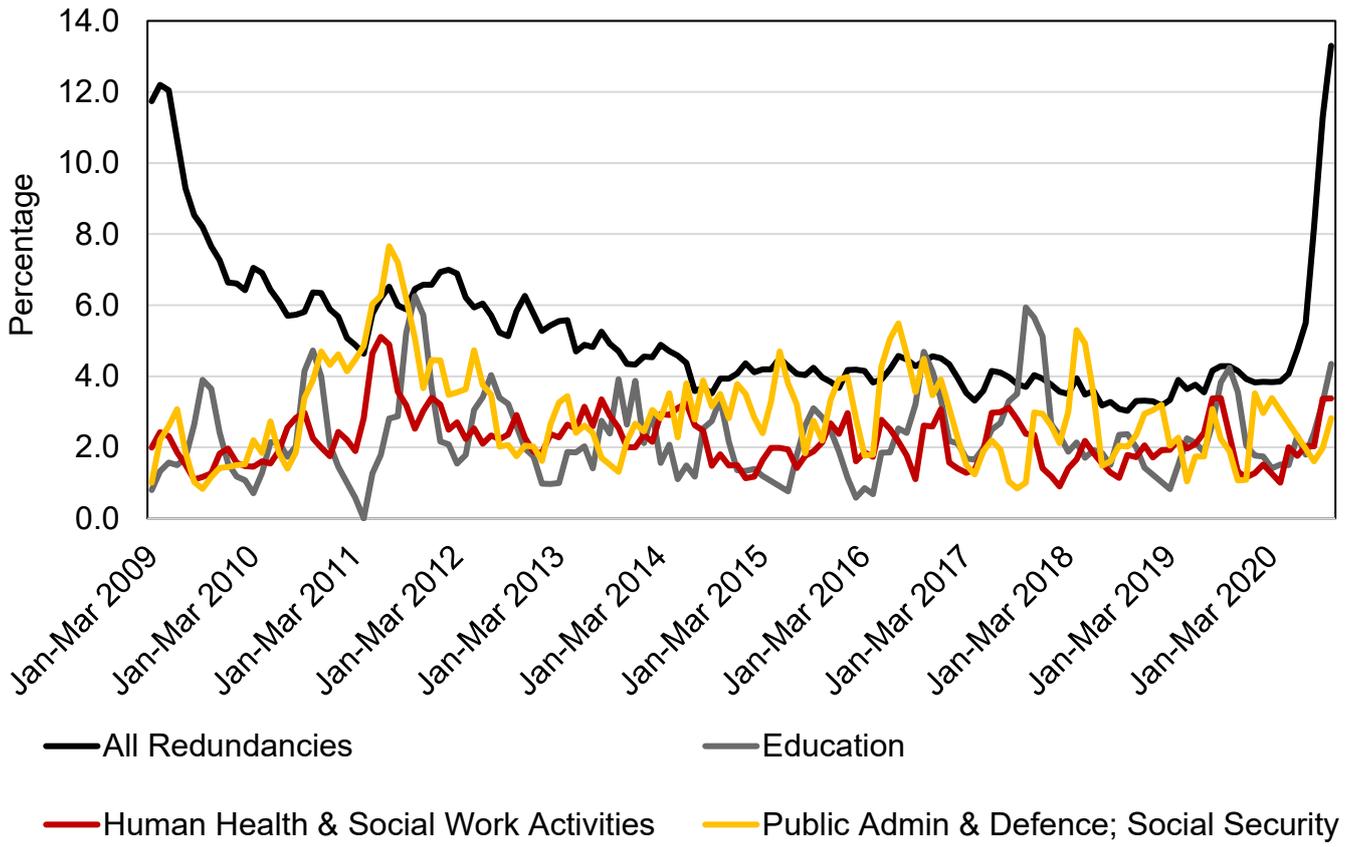


- 4.3 ONS redundancy data in Chart 4.2 shows that redundancies for the whole economy are increasing, while the redundancy rate for workers in education and human health & social work activities, some of the largest public sector industries, are broadly stable⁴⁴.

⁴³ ONS, summary of labour market statistics, table 4

⁴⁴ ONS, red02: Redundancies by age, industry and region

Chart 4.2: Redundancy Rate per thousand (%)



Section 5 – Conclusion

- 5.1 The current Covid-19 crisis has had a significant impact across the economy, but particularly in the private sector labour market where, despite unprecedented action unemployment is rising and many have seen significant reduction in wages. As the Chancellor set out at the Spending Review launch, in the interest of fairness we must exercise restraint in future public sector pay awards, ensuring that in the medium-term public sector pay growth retains parity with the private sector.
- 5.2 While the OBR expect wages to continue to grow modestly into 2021/22, the whole economy earnings forecast is currently 1.2 percentage points lower in 2021/22 compared to the March forecast. The outlook for both unemployment and wages remains uncertain, reflecting the wider position in the economy as a whole. Note that these forecasts are predicated on the OBR central scenario. A more positive outlook may mean the wage forecast is revised upward. This uncertainty is a key variable in our approach to public sector pay, which is why the policy will be revisited once the outlook is clearer for 2022/23.
- 5.3 However, regardless of these scenarios pay awards agreed since 2018/19 mean that we have entered the 2021/22 pay round from a position of relative strength. Given this, and against this backdrop the government feels that restricting pay growth, and targeting it where it is most needed, is appropriate. This policy also ensures that any further expansion of the gap between public and private sector pay is minimised, ahead of revisiting pay policy once the economic recovery is established and the outlook clearer.