# Economic context and outlook for the economy

### Growth

**A1** The UK has been hit by the most damaging financial crisis in generations and the government inherited the largest deficit since the Second World War. Through this period of uncertainty, the governments long term economic plan has ensured economic stability and provided the foundations for the current recovery which is now gaining further momentum as the factors weighing on UK growth between 2010 and 2012 continue to ease.

**A2** The government's long-term economic plan is restoring the public finances to a sustainable path and the deficit as a percentage of GDP is forecast to have halved by 2014-15. The government's plan has ensured economic stability and provided the foundations for the recovery. The government continues to take decisive action through monetary activism and credit easing; deficit reduction; reform of the financial system; and a comprehensive package of structural reforms.

**A3** The UK economy gained momentum through 2013 and GDP growth exceeded forecasts. UK GDP grew by 1.9 per cent in 2013 following positive growth in all quarters. Growth was balanced across all the main sectors of the economy, with manufacturing, services and construction all growing strongly compared to a year earlier.

**A4** Reflecting increased momentum in 2013, the Office for Budget Responsibility's (OBR) Autumn Statement 2013 forecast revised up UK GDP growth in 2013 to 1.4% compared to 0.6% from the Budget forecast. GDP growth in 2014 was revised up to 2.4% from1.8%.

**A5** The factors which weighed on UK growth between 2010 and 2012 are abating. The effect of the financial crisis is easing and credit conditions have improved. The euro area sovereign debt crisis has stabilised, and the euro area grew in the second and third quarters of 2013, though activity remains subdued. Pressure from commodity price rises has eased, with prices generally stabilising through 2013, though they remain high. However, external risks remain, reinforcing the case for stability in the government's long term economic plan.

**A6** The Government is delivering ambitious structural reforms to enable the UK to compete in a rapidly changing global economy. These reforms are a key part of the Government's economic strategy, alongside fiscal consolidation, monetary activism, and reform of the financial system.

**A7** To help equip the UK to succeed in the global race the government is implementing the most radical programme of economic reform in a generation. These reforms include making the tax system more competitive, equipping the UK's young people for the future, reforming the welfare system, making the largest increase in the income tax personal allowance and delivering improvements in the UK's infrastructure.

**Table 1A: Forecasts for GDP growth 2013 to 2015**

| Forecasts for GDP growth (per cent) | 2013 | 2014 | 2015 |
|---|---|---|---|
| OBR (December Autumn Statement 2013) | 1.4 | 2.4 | 2.2 |
| IMF WEO (January 2014) | 1.7 | 2.5 | 2.2 |
| Avg. of independent forecasters (January 2014) | 1.7 | 2.6 | 2.4 |

## Inflation

**A10** Inflation has fallen significantly since its peak in September 2011. CPI inflation peaked at 5.2 per cent in September 2011 but fell back in 2012 as past rises in commodity and energy prices and VAT dropped out of the twelve month comparison. Inflation over the fourth quarter of 2013 was 2.6 per cent.

**A11** Compared to the August *Inflation Report*, the outlook for inflation in the November report is lower reflecting lower outturn and the appreciation of sterling. The Bank expects inflation to remain around the 2.0 per cent target from Q4 2013 onwards.

The OBR expects the rate of inflation to slow between 2013 and 2016, returning to the 2.0% target in the second half of 2016. This does not include the possible impact of reforms announced in Autumn Statement 2013 that will result in an average saving of £50 in household bills by reducing the impact of government policies on energy bills. The OBR state in its Economic and fiscal outlook that "inflation expectations are assumed to remain anchored to the target."

Table 2A: Forecasts for CPI Inflation 2013 to 2015

| Forecasts for CPI Inflation (per cent change on a year earlier) | 2013 | 2014 | 2015 |
|---|---|---|---|
| OBR (December Autumn Statement 2013) | 2.6 | 2.3 | 2.1 |
| IMF WEO (October 2013) | 2.7 | 2.3 | 2.0 |
| Avg. of independent forecasters* (January 2014) | 2.6 | 2.3 | 2.1 |

***Fourth quarter**

### Affordability

**A12** The Government inherited the largest deficit in post-war history due to the financial crisis and unsustainable pre-crisis increases in public spending. The historically high level of borrowing risked undermining fairness, growth and economic stability in the UK. In 2010 the Government set out clear, credible and specific medium-term fiscal consolidation plans to return the public finances to a sustainable path.

**A13** The Government's fiscal strategy has been effective in providing protection against a challenging backdrop of global uncertainty and fiscal vulnerabilities. This has restored fiscal credibility, allowing activist monetary policy and the automatic stabilisers to support the economy, and is consistent with the approach recommended by international organisations.

**A14** The Government remains committed to reducing the deficit and addressing the permanent structural deterioration in the public finances caused by the lasting impact of the financial crisis. By the end of 2012-13, around 60% of the annual consolidation planned for this parliament has been achieved, with almost 55% of the spending and around 80% of the tax consolidation in place. 80% of the total consolidation in 2015-16 will be delivered by lower spending. By the end of April 2013, the government had implemented measures to deliver over 90% of the total savings expected from reforms to the welfare system. The majority of tax consolidation measures will have been legislated by 6 April 2014.

**A15** The improved economic outlook supports the public finances, with the 'underlying deficit' now expected to be £73 billion lower over the forecast period than projected at Budget 2013. However, although the structural deficit continues to fall year on year, the OBR judges that it has not been improved by stronger economic growth. The government's long-term economic plan is restoring the public finances to a sustainable path and the deficit as a percentage of GDP is forecast to have halved by 2014-15.

**A16** With the deficit and debt still at unsustainable levels, deviating from the long-term economic plan as set out in 2010 now would be the biggest risk to recovery. Clear and credible consolidation plans remain essential for reducing the risk of a costly loss of market confidence in the UK. The UK's fiscal vulnerabilities argue strongly in favour of maintaining a credible path of deficit reduction. Despite significant progress since 2010, the UK is forecast to have the second largest deficit among the G7, behind Japan.

**A19** The implication of fiscal consolidation for departmental spending levels can be seen in table 3A below, which shows resource DEL budgets for each department from the Public Expenditure Statistical Analyses 2013. An estimated £166 billion in 2011-12 was spent on public sector pay, around 50% of departmental resource spending.

## Table 3A: Resource DEL Budgets for each Department (Excluding Depreciation)

### Table 1.5 Resource DEL excluding depreciation, 2008-09 to 2015-16

£ million

| | National Statistics | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2008-09 outturn | 2009-10 outturn | 2010-11 outturn | 2011-12 outturn | 2012-13 outturn | 2013-14 plans | 2014-15 plans | 2015-16 [1] plans |
| **Resource DEL excluding depreciation by departmental group** | | | | | | | | |
| Education | 46,637 | 49,385 | 50,568 | 50,265 | 50,239 | 52,442 | 53,181 | 53,168 |
| NHS (Health) | 86,671 | 93,237 | 96,260 | 99,070 | 101,416 | 105,519 | 108,340 | 110,372 |
| Personal Social Services (Health) [2] | 1,261 | 1,362 | 1,471 | - | - | - | - | - |
| Transport | 5,436 | 5,652 | 5,176 | 4,679 | 4,315 | 3,986 | 3,621 | 3,198 |
| CLG Communities | 4,084 | 4,299 | 3,649 | 1,745 | 1,309 | 2,561 | 2,085 | 1,134 |
| CLG Local Government [3] | 29,487 | 30,798 | 28,735 | 29,764 | 27,576 | 16,242 | 13,330 | 11,820 |
| Business, Innovation and Skills | 16,329 | 17,321 | 17,029 | 16,231 | 15,467 | 14,871 | 13,776 | 13,000 |
| Home Office | 9,009 | 9,268 | 12,288 | 11,904 | 11,199 | 10,977 | 10,359 | 9,901 |
| Justice | 8,633 | 8,529 | 8,614 | 8,453 | 8,067 | 7,216 | 6,793 | 6,235 |
| Law Officers' Departments | 712 | 697 | 658 | 611 | 591 | 597 | 532 | 519 |
| Defence | 25,410 | 27,587 | 28,090 | 28,142 | 26,415 | 26,470 | 24,386 | 23,896 |
| Foreign and Commonwealth Office | 1,946 | 2,022 | 2,091 | 2,052 | 1,987 | 1,920 | 1,158 | 1,102 |
| International Development | 4,742 | 5,234 | 5,909 | 6,167 | 6,105 | 8,556 | 8,273 | 8,499 |
| Energy and Climate Change | 288 | 1,216 | 1,146 | 1,144 | 1,117 | 1,375 | 1,078 | 952 |
| Environment, Food and Rural Affairs | 2,219 | 2,261 | 2,175 | 1,981 | 1,887 | 1,932 | 1,695 | 1,559 |
| Culture, Media and Sport | 1,502 | 1,457 | 1,471 | 1,473 | 2,059 | 1,239 | 1,134 | 1,098 |
| Work and Pensions | 7,689 | 8,549 | 8,685 | 7,286 | 7,117 | 7,612 | 7,412 | 5,988 |
| Scotland | 23,901 | 24,852 | 25,587 | 25,189 | 25,341 | 25,672 | 25,691 | 25,655 |
| Wales | 12,610 | 13,289 | 13,615 | 13,475 | 13,265 | 13,705 | 13,690 | 13,635 |
| Northern Ireland | 8,894 | 9,293 | 9,597 | 9,437 | 9,461 | 9,617 | 9,633 | 9,622 |
| Chancellor's Departments | 4,132 | 4,048 | 3,758 | 3,642 | 3,262 | 3,635 | 3,456 | 3,265 |
| Cabinet Office | 1,772 | 1,962 | 2,025 | 2,045 | 2,074 | 2,136 | 2,279 | 1,995 |
| Small and Independent Bodies | 1,649 | 1,587 | 1,552 | 1,624 | 1,394 | 1,468 | 1,434 | 1,295 |
| Spending commitments not yet in budgets [1] | - | - | - | - | - | - | - | 1,100 |
| Reserve | - | - | - | - | - | 2,200 | 2,800 | 2,800 |
| Special Reserve | - | - | - | - | - | 400 | 1,800 | 1,000 |
| Green Investment Bank | - | - | - | - | - | 1,000 | - | - |
| OBR allowance for shortfall | - | - | - | - | - | -1,200 | -1,000 | - |
| Adjustment for Budget Exchange [4] | - | - | - | - | - | -1,700 | -1,200 | - |
| **Total resource DEL excluding depreciation** | **305,012** | **323,905** | **330,149** | **326,380** | **321,663** | **320,700** | **315,700** | **312,900** |

[1] Figures are consistent with Table 1 of the Spending Round 2013 document (Cm8639) published on 26 June 2013.

[2] Personal Social Services (Health) are grants previously paid by the Department of Health that are now included in CLG Local Government's budget.

[3] Figures from 2013-14 onwards reflect adjustment to departmental plans for changes to local government funding for business rates retention and council tax localisation.

[4] Departmental budgets in 2013-14 and 2014-15 include amounts carried forward from 2012-13 through Budget Exchange. These increases will be offset by any deposits at Supplementary Estimates in future years so are excluded from spending totals.

*Source, HM Treasury, July 2013*

## *Labour market*

**A20** Headline labour market figures strengthened in the third quarter of 2013 after a weak start to the year. Employment rose by 177,000 in the third quarter of 2013 bringing the employment level to its highest ever level at 29.95m. The employment rate rose 0.3 percentage points to 71.8 for the same period. The OBR expects employment to continue to rise over the forecast period, but a slower pace than the increase over 2012. Unemployment fell by 48,000 over the quarter and is down 48,000 over the year. The unemployment rate fell 0.2 percentage points on the quarter, in-line with market expectations, down 0.2 percentage points compared to the same period last year and down from the peak of 8.4% in the final quarter of 2011. The OBR expect the unemployment rate to continue to fall in the final quarter of 2013 reaching 7.0% by the second quarter of 2015.

**A21** In the third quarter of 2013, the overall LFS employment level was 381,000 above its pre-recession peak in the three months to May 2008, but the employment rate at 71.8% was 1.2 percentage points lower than its pre-recession peak. Over the last year the composition of the labour market has continued to strengthen with the number of full-time employees increasing by 368,000, accounting for almost all (97%) of total employment growth over the year. The number of vacancies increased by 62,000 over the year to 542,000 in the three months to September 2013, the highest level since October 2008.

**A22** However, while employment growth remains robust and unemployment is falling wage growth remains weak. Regular pay growth (excluding bonuses) in the third quarter of 2013 slowed to 0.8% on the year, the weakest rate of growth in the series (back to 2001).

### Employment and unemployment

**A23** The increase in the level of employment of 378,000 over the year to the third quarter of 2013 continues to give indications of a positive change in the composition of employment, the number of employees increased by 361,000 while self employment increased by 6,000. The increase saw those working full-time increase by 412,000 over the year while those working part-time fell by 34,000 over the same period. It is also notable that over the last year employment in the UK has grown faster than in France, Italy, Japan, the EU28 and the G7 average.

**A24** The ILO unemployment rate, which rose from a low of 5.2% in the first quarter of 2008 to peak at 8.4% (2.66m people) in the final quarter of 2011, has subsequently fallen to 7.6% in the third quarter of 2013.

**A25** Long term unemployment (unemployment of 12 months or more) fell by 19,000 over the year up to the third quarter of 2013 to stand at 890,000.

**A26** Working age inactivity (16-64) was down by 149,000 over the year at 22.2%. This has been driven by the fall in female inactivity, which has fallen by 129,000 over the year while male inactivity fell by 20,000.

**A27** Youth unemployment (16-24) fell 9,000 on the quarter in the three months to September. Excluding people in full-time education (FTE), there were 664,000 unemployed 16-24 year olds in the three months to September, a decline of 13,000 over the quarter, with a corresponding unemployment rate of 19.0%.

**A28** The claimant count (the number of people claiming Jobseeker's Allowance) fell for the twelfth consecutive month, declining by 41,700 in October 2013.

Table 4A summarises these statistics:

### Table 4A: Labour market statistics summary (Levels in 1,000s, rates in %) [1]

| | 2009 | 2010 | 2011 | 2012 | 2013 Q3 |
|---|---|---|---|---|---|
| **Employment level**<br><br>**(All aged 16 and over)** | 28,960 | 29,019 | 29,166 | 29,519 | 29,953 |
| **Employment rate**<br><br>**(All aged 16-64)** | 70.9 | 70.5 | 70.5 | 71.1 | 71.8 |
| **Unemployment level**<br><br>**(All aged 16 and over)** | 2,390 | 2,476 | 2,564 | 2,548 | 2,466 |
| **Unemployment rate**<br><br>**(All aged 16 and over)** | 7.7 | 7.8 | 8.1 | 7.9 | 7.6 |
| **Youth unemployment level**<br><br>**(All aged 16-24)** | 912 | 932 | 986 | 992 | 965 |
| **Youth unemployment rate**<br><br>**(All aged 16-24)** | 19.1 | 19.8 | 21.1 | 21.2 | 21.0 |
| **Claimant Count** | 1,528 | 1,496 | 1,534 | 1,585 | 1, 306 |

* The latest public and private sector employment figures available are for the third quarter of 2013. These show that private sector employment rose by 246,000 on the quarter and was up by 537,000 over the year. This more than offset the fall in public sector employment which increased slightly by 4,000 on the quarter but fell by 52,000 over the year. This takes into account reclassifications of education corporations in the second quarter of 2012.

## Public and private sector earnings

**A29** Average total pay growth (including bonuses) increased by 0.7% in the three months to September compared to the same three month period in 2012. Regular pay growth (excluding bonuses) rose by 0.8% over the same period. In the third quarter of 2013 Consumer Price Index increased by 2.7% on the year, meaning that real pay growth continued to be negative over this period..

[1] Source: ONS

**A30** Average total private sector pay has recovered somewhat from its decline in 2009 but remains relatively weak, growing by just 2.0% in 2010 and 2.5% in 2011, compared to above 4% prior to the recession. Private sector pay growth weakened in 2012 to 1.5% and has continued to weaken into 2013. Total private sector pay weakened in the third quarter of 2013 to grow by 1.1% over the year. Average private sector regular pay grew by 1.4% in 2010, it gained some strength in 2011 to grow by 2.0% however it weakened in the latter half of 2012, with growth of 1.9% over the year. In 2013 growth has weakened further to just 1.2% and 1.1% in the second and third quarters of this year.

**A31** Public sector (excluding financial services) average regular pay was 2.3% in 2010 and 1.8% in 2011. While this recovered slightly in the middle of 2012, growing by 2.4% in the third quarter of 2012, it weakened towards the end of the year and continued to weaken in 2013 growing by 1.2% in the second quarter of 2013 before weakening further to 0.1% in the third quarter of 2013.

**A32** The sharp drop in bonuses seen in 2009 put more downward pressure on total pay (pay including bonuses), while there were some tentative increases in the levels during 2010 and 2011, it has remained mostly subdued. Whole economy bonus pay growth has seen large fluctuations during 2013 with a fall of 8.1% in March 2013 but an extremely large single month increase in April 2013 of 62.3% likely due to the timing of annual bonus payments. In September whole economy bonus pay growth on the year was weak at 1.1%.

**A33** Table 5 sets out the differences in regular and total pay growth across years in the public and private sector.

**Table 5A: regular pay (excluding bonuses) and total pay growth[2]**

| | Total Pay, annual growth | | | Regular pay, annual growth | | |
|---|---|---|---|---|---|---|
| | **All** | **Private** | **Public[3]** | **All** | **Private** | **Public[2]** |
| 2009 | -0.1% | -1.0% | 2.8% | 1.8% | 1.2% | 3.0% |
| 2010 | 2.4% | 2.0% | 2.2% | 1.9% | 1.4% | 2.3% |
| 2011 | 2.4% | 2.5% | 1.5% | 2.0% | 2.0% | 1.8% |
| 2012 | 1.4% | 1.5% | 1.7% | 1.7% | 1.9% | 1.6% |
| *Q3 2013* | 0.7% | 1.1% | -0.4% | 0.8% | 1.1% | -0.1% |

All data on employment, unemployment, claimant count and earnings is collected from the monthly Labour Market Statistics, released monthly by the ONS. Available at: http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/index.html

## *Public sector pensions*

**A34** When considering changes to remuneration, it is important to consider the overall value of the public sector reward package. As set out above, pay in the public sector continues to be above that of the private sector on average. However, there are many reasons aside from pay that may drive an individual's decision as to whether they will work in the public or private sector.

**A35** One major factor in the overall reward package is pension provision. In the last few decades pension provision in the public and private sectors has diverged, in response to pressures around longevity, changes in the business environment and investment risk. This has led to a sharp decrease in the provision of defined benefit schemes in the private sector. Around 85% of public sector employees are members of employer-sponsored pension schemes, compared to only 35% in the private sector.

**A36** Following a fundamental review of public service pension provision by the Independent Public Service Pensions Commission, the Government is introducing key changes to the

[2] Source: ONS, AWE; HMT calculations annual percentage change for quarter one.

[3] Public Sector excluding financial services

pension element of the remuneration package. New public service pension schemes will be introduced in April 2015, which will:

- calculate pension entitlement using the average earnings of a member over their career , rather than their salary at or near to retirement;
- calculate pension benefits based on Normal Pension Age linked to the member's State Pension Age; and
- include an employer cost cap mechanism, where unforeseen changes in scheme costs are shared by members and employers (based on 2% of the scheme's total pensionable pay bill).

**A37** The changes being introduced through the Public Service Pensions Act 2013 will save an estimated £65 billion by 2061-62.

**A38** Wider changes to public service pension provision have also taken place. Progressive increases in the amount that members contribute towards their public service pension began in April 2012. Members will contribute an average of 3.2 percentage points more, phased in over three years (increases will be finalised in April 2014). This will deliver £2.8 billion of savings a year by 2014-15.

**A39** Protections from the impact of the contribution changes have been put in place for the lowest paid. Those earning less than £15,000 will see no increases; and those earning up to £21,000 (£26,000 for Teachers) will not see increases of more than 1.5 percentage points by 2014-15.

**A40** Public service pensions will remain among the best available and will continue to offer members guaranteed, index-linked benefits in retirement that are protected against inflation. Private sector workers buying benefits in the market would have to contribute over a third of their salary each year to buy an equivalent pension.

**A41** Putting together the evidence on pension provision and pay levels – and recognising that there will be significant variation between and within individual workforces – the overall remuneration of public sector employees is above that of the market. The Government is therefore clear that any changes to public service pensions, including the progressive increase in contributions from 2012-13, do not justify upward pressure on pay.