

Evidence on the general economic outlook

Introduction

The UK economy grew faster in 2014 than any other major advanced economy at 2.9%, its best performance since 2005. The Spending Review and Autumn Statement set out the government's long term economic plan to fix the public finances, return the country to surplus and run a healthy economy that starts to bear down on the excessive national debt. It recognises the risks from abroad and the need to secure Britain's economic future.

Public sector pay restraint has been a key part of the fiscal consolidation so far. It helped save approximately £8bn in the last Parliament and is expected to save another £5bn in the current Parliament. At a time when further spending reductions are required to complete the repair of the public sector finances, a policy of pay restraint makes a significant contribution to protecting jobs and maintaining public services.

At Summer Budget 2015 the government announced that it would fund public sector workforces for pay awards of 1% for four years from 2016-17 onwards. The OBR estimates that this policy will protect 200,000 jobs by 2019-20. The government expects that pay awards will be applied in a targeted manner to support the delivery of public services, ensuring that flexibility exists to meet any recruitment and retention pressures.

The UK economy is fundamentally stronger than five years ago, with positive growth since the first quarter of 2013. The UK economy grew by 0.4 per cent in the third quarter of 2015 and the Office for Budget Responsibility (OBR) forecast the UK economy to grow by 2.4 per cent in 2015 overall.

Since 2010 the deficit has halved as a share of GDP and for the first time since 2001-02, the national debt is forecast to fall in 2015-16, meeting the target set out in 2010. However, risks remain to the recovery, including from slower growth in the global economy. Debt stands at its highest share of GDP since the late 1960s, and the deficit remains among the highest in advanced economies. At Spending Review and Autumn Statement, the government set out the action it would take to complete the job of repairing the public finances started in the last Parliament. The government will reduce the deficit at the same rate as in the previous Parliament (around 1.1% of GDP a year on average) to reach an overall surplus of £10.1bn in 2019-20. Running a surplus on the headline measure of borrowing is the most reliable way to bring down debt as a share of GDP in the long term.

Inflation is forecast by the Bank of England and OBR to remain low for rest of the year, before returning gradually to the 2 per cent target in the medium term. The OBR forecast inflation of 0.1 per cent in 2015 and 1.0 per cent in 2016. The Bank of England's latest inflation forecast, published in the November *Inflation Report* has been revised down compared to the August report. The Monetary Policy Committee

(MPC) expect inflation at 0.1 per cent (down from 0.4 per cent) in the year to Q4 2015, 1.25 per cent (down from 1.6 per cent) in the year to Q4 2016, and unchanged at 2.1 per cent in the year to Q4 2017.

Headline employment and unemployment figures were strong in 2013 and 2014. This trend has continued in 2015 with employment almost continuously rising, reaching a record high in the three months to October of 31.3m, at a record rate of 73.9 per cent. The OBR expects employment to increase by 1.1 million over the forecast period, representing employment growth of 3.5 per cent. Unemployment fell by 244,000 in the year to Aug-Oct 2015 to a level of 1.71m. The unemployment rate in the three months to October 2015 stood at a 9 year low of 5.2 per cent, down from the peak of 8.5 per cent in the three months to November 2011. Real wage growth has remained at pre-recession rates. In the three months to October, total pay grew by 2.4 per cent in both nominal and real terms, compared to the same period last year. Regular wages grew by 2.0 per cent in nominal terms and 2.1 per cent in real terms. Total pay in the private sector grew by 2.7 per cent, while in the public sector (excluding financial services) it grew by 1.6 per cent. Average earnings have outstripped inflation for 13 consecutive months, the longest period of real earnings growth since before the recession, and are forecast by the OBR to continue to grow faster than inflation for the entire forecast period.

Growth

1. In 2008 the UK was hit by the most damaging financial crisis in generations. Between Q1 2008 and Q2 2009 the UK economy contracted by 6.1%, greater than the reductions in growth in the US, France, and Canada.
2. The government's long term economic plan has secured the recovery. The government's fiscal responsibility has allowed monetary activism to support demand in the economy alongside repair of the financial sector. This has been supported by supply-side reform to deliver sustainable increases in standards of living.
3. UK GDP growth has been positive since the first quarter of 2013 and GDP is now 6.1% above its pre-crisis peak. Growth in 2014 was 2.9%, above the Office for Budget Responsibility's (OBR) March forecast of 2.6%. The UK economy grew by 0.4 per cent in the third quarter of 2015, following 0.5 per cent growth in the second quarter. The recovery is broad-based with widespread growth across all major sectors since the start of 2013, and production, services and construction all growing in the third quarter on a year earlier. The OBR's forecast at Autumn Statement 2015 confirmed the UK recovery is well established with growth of 2.4% in 2015 and 2016 at 2.4%, before rising to 2.5% in 2017.
4. However, external risks remain, reinforcing the case for stability in the government's long-term economic plan. The global economic recovery remains uneven and the

risks from the world economy demonstrate the need to continue to fix the economy to ensure the UK can deal with risks from abroad.

5. As a part of its economic policy, the government has announced its intention to improve the UK's productivity performance. Improving productivity is key to increasing living standards and delivering strong growth. The government has published a productivity plan ('Fixing the foundations: Creating a more prosperous nation') which tackles the UK's serious long-term challenges, with major reforms to improve the UK's infrastructure, tackle failures in the skills system, improve the planning system, encourage long-term finance for productive investment and give cities the governance and powers they need to succeed.
6. In the Autumn Statement the government announced further measures to improve productivity in the UK including protecting per pupil funding for schools, providing an additional £1.3 billion (until 2019-20) to attract new teachers into the profession, protecting today's £4.7bn science funding in real terms for the rest of the Parliament, investing up to £6.9bn in the UK's research infrastructure up to 2021; and proposing a new University focusing on Engineering, to be located in Hereford.

Figure 1: Forecasts for GDP growth 2015 to 2017

Forecasts for GDP growth (per cent)	2015	2016	2017
OBR (Summer Budget 2015)	2.4	2.3	2.4
IMF WEO (July 2015 update)	2.4	2.2	2.2
Avg. of independent forecasters (August 2015)	2.6	2.4	2.4

Inflation

7. November's annual CPI inflation rate was 0.1%, up from -0.1% in August. External factors, such as oil and commodity prices, continue to exert significant downward pressure on inflation. Recently low inflation is good news for working families, helping their budgets stretch further with lower food and fuel costs. In the year to November 2015, food prices fell by -2.7% and prices of motor fuels fell by -12.9%.
8. Compared to the Bank of England's August 2015 *Inflation Report*, the outlook for inflation in the August report has been revised downwards. The MPC judged that CPI inflation is likely to remain close to zero in the near term, before rising as past falls in energy prices begin to drop out of the annual comparison. The Monetary Policy Committee (MPC) expect inflation at 0.1 per cent (down from 0.4 per cent) in the year to Q4 2015, 1.25 per cent (down from 1.6 per cent) in the year to Q4 2016, and unchanged at 2.1 per cent in the year to Q4 2017.

Inflation is forecast by the Bank of England and OBR to remain low for rest of the year, before returning gradually to the 2 per cent target in the medium term. The OBR forecast inflation of 0.1 per cent in 2015 and 1.0 per cent in 2016.

Figure 2: Forecasts for CPI Inflation 2015 to 2017

Forecasts for CPI Inflation (per cent change on a year earlier)	2015	2016	2017
OBR (Autumn Statement 2015)	0.1	1.0	1.8
IMF WEO (October 2015)	0.1	1.5	2.0
Avg. of independent forecasters (December 2015)	0.1	1.3	1.9

Affordability and Fiscal Strategy

9. Since 2010 the government has taken action to cut the deficit which has more than halved as a share of GDP from its 2009-10 post-war peak. However, the job is not yet done. The deficit remains high compared to advanced economies and public sector net debt as a share of GDP has more than doubled since the pre-recession period. The government remains committed to eliminating the deficit and to getting debt as a share of GDP on a declining path across the forecast period to return the public finances to a more sustainable position.
10. At Summer Budget the government announced its intention to reduce the deficit at the same average rate as over the previous Parliament. That means reducing the deficit by around 1.1 percent a year on average over the next four years. The government is maintaining this same pace of deficit reduction and has taken the decisions necessary to finish the job of repairing the public finances. Public sector net borrowing as a share of GDP is forecast to fall year-on-year across the forecast period and the government is expected to achieve a surplus of £10.1bn in 2019-20.
11. However continued action will be required in order to bring debt down to more sustainable levels. Last year, net debt as a share of GDP reached its highest level since the late 1960s. By 2020-21, it is still forecast to be 71.3%, significantly above the pre-recession level in 2007-08. High debt increases the UK's vulnerability to future shocks. Evidence suggests that at higher debt levels, the scope for fiscal policy to stabilise the economy is reduced.
12. A strategy for debt reduction must also take into account the possibility of future economic shocks. Independent monetary policy now delivers low and stable medium-term inflation to the benefit of the whole economy. This contrasts with the experience after World War II, when very high inflation, together with artificially low interest rates, played a major role in reducing debt. The UK economy has been

subject to relatively frequent shocks in the past, and though their nature and timing are unpredictable, responsible fiscal policy should allow for them. Once future economic shocks are allowed for, running a deficit to finance capital investment (balancing only the current budget) and relying on trend economic growth is insufficient to bring down debt, as set out in HM Treasury analysis at Budget 2014. In a low inflationary environment, with economic shocks, the most reliable way to bring down debt as a share of GDP is to run an overall surplus in normal times. Substantial debt reduction in future will depend on responsible management of the public finances and sustainable economic growth.

Proposed new Charter for Budget Responsibility

13. On 14 October 2015, Parliament approved the government's updated Charter for Budget Responsibility. The new fiscal rules commit the government to delivering a surplus by the end of the Parliament, and every year thereafter when the economy is in normal times, entrenching a commitment to long-term fiscal sustainability. The Charter sets out:

- A target for a surplus on public sector net borrowing in 2019-20, and a supplementary target for public sector net debt to fall as a share of GDP in each year from 2015-16 to 2019-20.
- A target, once a surplus is achieved in 2019-20, to run a surplus each subsequent year as long as the economy remains in normal times.

14. Under the updated Charter, the surplus rule will be suspended if the economy is hit by a significant negative shock (defined as 4 quarter-on-4 quarter GDP growth below 1%). This provides flexibility to allow the automatic stabilisers to operate freely when needed. Following a shock, the government of the day will be required to set a plan to return to surplus, including appropriate fiscal targets. The framework does not prescribe what the targets should be, allowing the government of the day to respond to the circumstances. However, the targets will be voted on by the House of Commons and assessed by the OBR.

15. The end goal is to ensure that long-term debt reduction continues, leaving the country better placed to withstand future economic shocks. Returning to a surplus in normal times will provide the government of the day with the fiscal space to allow appropriate action to be taken in the face of future shocks.

Labour market

16. After strong rises in 2013 and 2014, headline labour market figures slowed in the first half of 2015. 2014 saw the employment level increasing by over 600,000, and the employment rise in the first half of 2015 was 139,000, taking the level of employment to 31.0m. Since then, employment has risen to record levels of 31.3m. In the three months to September, the employment rate rose by 1.0 percentage point

on the year to 73.9%, the highest rate on record. The unemployment rate fell by 0.8 percentage points on the year, and by 3.3 percentage points since the peak of 8.5% in the 3 months to November of 2011, to a 9 year low of 5.2 per cent. The OBR forecast the rate to stabilise at 5.4% by the end of the forecast period.

14. The number of vacancies in the three months to November 2015 stood at record levels, having increased by 45,000 over the year to 747,000. The number of unemployed people per vacancy fell to 2.3 in the three months to October 2015, down from a high of 5.9 following the recession.
15. Wage growth picked up in 2015, reaching levels of up to 3.3 per cent in the three months to May. The most recent data shows more moderate total pay growth of 2.4 per cent in the three months to October, in both nominal and real terms, with real wage growth remaining at pre-recession rates.

Employment and unemployment

16. Over the year to the three months to October 2015, employment grew by 505,000. The majority of this growth was among full-time employees, whose numbers increased by 348,000 on the year. The number of people in self-employment rose slightly on the year (71,000).
17. Over the year to Aug-Oct 2015, unemployment fell by 244,000 to 1.71m, down 995,000 from the peak in the three months to November 2011.
18. Long term unemployment (unemployment of 12 months or more) stood at 509,000 in Aug-Oct 2015, down by 175,000 over the year. Over 70% of the fall in total unemployment over the year came from the decrease in long term unemployment.
19. Working age inactivity (16-64) fell slightly on the year to the three months to October 2015, with the level and rate at 8.93m and 21.9% respectively. The female inactivity rate also continued to decline, dropping 0.4 percentage points on the year.
20. Youth unemployment (16-24) fell by 129,000 over the year to Aug-Oct 2015. This was primarily amongst those not in full-time education. The youth unemployment rate stood at 13.6%, down 2.9 percentage points on the year. Excluding people in full-time education, there were 416,000 unemployed 16-24 year olds, with a corresponding unemployment rate of 12.2%.
21. The claimant count fell by 112,400 in the year to November 2015. The claimant count rate stood at 2.3%, the lowest level since February 1975. Figure 4 summarises these statistics:

Figure 4: Labour market statistics summary (Levels in 000s, rates in %)*

	2010	2011	2012	2013	2014	Aug-Oct 2015
Employment level (All	29,228	29,376	29,696	30,043	30,726	31,302

aged 16 and over)						
Employment rate (All aged 16-64)	70.4	70.3	71	71.5	72.9	73.9
Unemployment level (All aged 16 and over)	2,497	2,593	2,572	2,476	2,027	1,713
Unemployment rate (All aged 16 and over)	7.9	8.1	8	7.6	6.2	5.2
Youth unemployment level (All aged 16-24)	933	996	1005	969	783	625
Youth unemployment rate (All aged 16-24)	20	21.4	21.4	20.8	17	13.6
Claimant Count	1,496.4	1,534.4	1,585.6	1,421.0	1,037.6	796.2

* The latest public and private sector employment figures available are for the third quarter of 2015. These show that private sector employment rose by 226,000 on the quarter and was up by 554,000 over the year. This more than offset the fall in public sector employment which decreased by 19,000 on the quarter and by 48,000 over the year. Over this period over 6 private sector jobs have been created for every public sector job lost. These series exclude the effects of major reclassifications where large bodies employing large number of people have moved between the public and private sectors.

** Monthly data used (November 2015)

Public sector pay and pensions

22. The recent recession saw a significant fall in UK wage growth, particularly in the private sector. Analysis by IFS and ONS shows that over the last few years public sector workers have benefitted from a higher pay growth on average compared to workers with similar characteristics in the private sector. While the pay differential between public and private sector workers is narrowing, the overall remuneration of public sector employees when taking employer pension provision into account continues to be above that of the market.

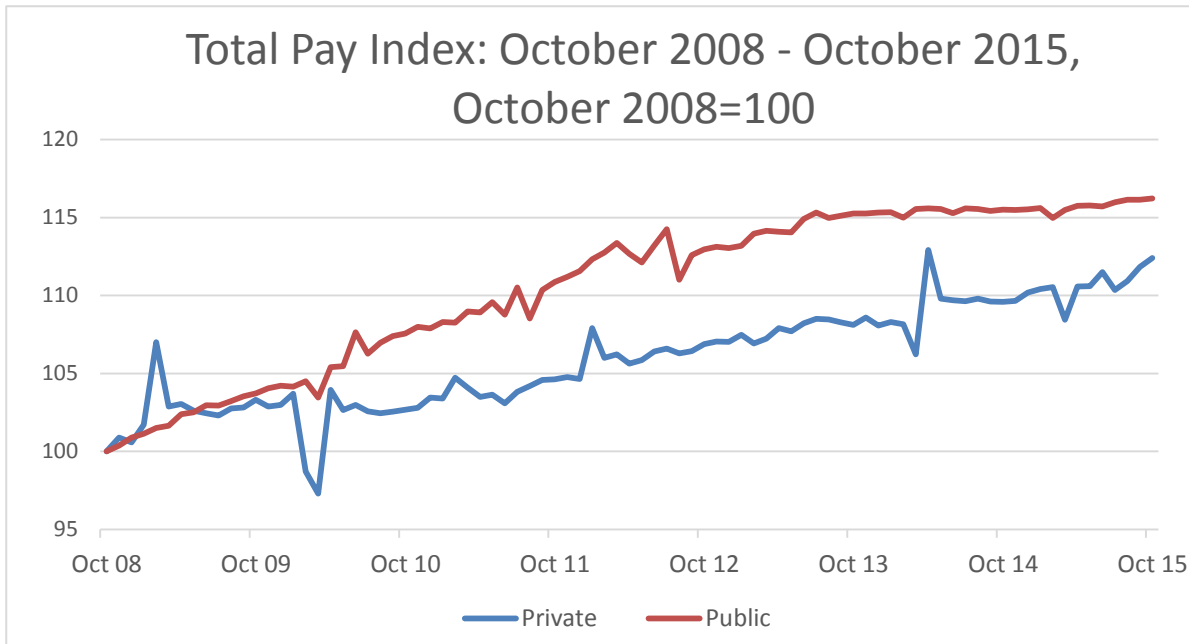
23. Earnings growth in the private sector has been strong throughout 2015 and in the three months to October, total pay growth (including bonuses) stood at 2.7%, while private sector regular pay growth (excluding bonuses) also stood at 2.3%. Although low inflation has helped boost real wages, nominal private sector wage growth remains below rates seen before the recession (about 4-5% per annum).

24. Public sector average earnings growth was 1.3% in the three months to October 2015. Regular earnings (excluding bonuses) also grew by 1.3% over the same period. These rates stood above the rate of inflation in this period (-0.1%) but still below the pre-recession average growth rate, as in the private sector.

25. Historically, public sector wages tend to fall and recover at a slower pace during economic cycles than private sector wages – i.e. there can be a delay between a recession occurring and public sector wage adjustment. Since July 2014, private sector earnings growth has been faster than growth in public sector wages, but this

follows on from sustained public sector wage growth in the years immediately following the recession. From the three months to March 2008 to the three months to October 2015, total average private sector earnings have increased by 10.4%, while those in the public sector have increased by 16.1%. The overall level of public sector average weekly wage remains above that of the private sector. Figure 5 compares the growth in average public and private sector weekly earnings since 2008.

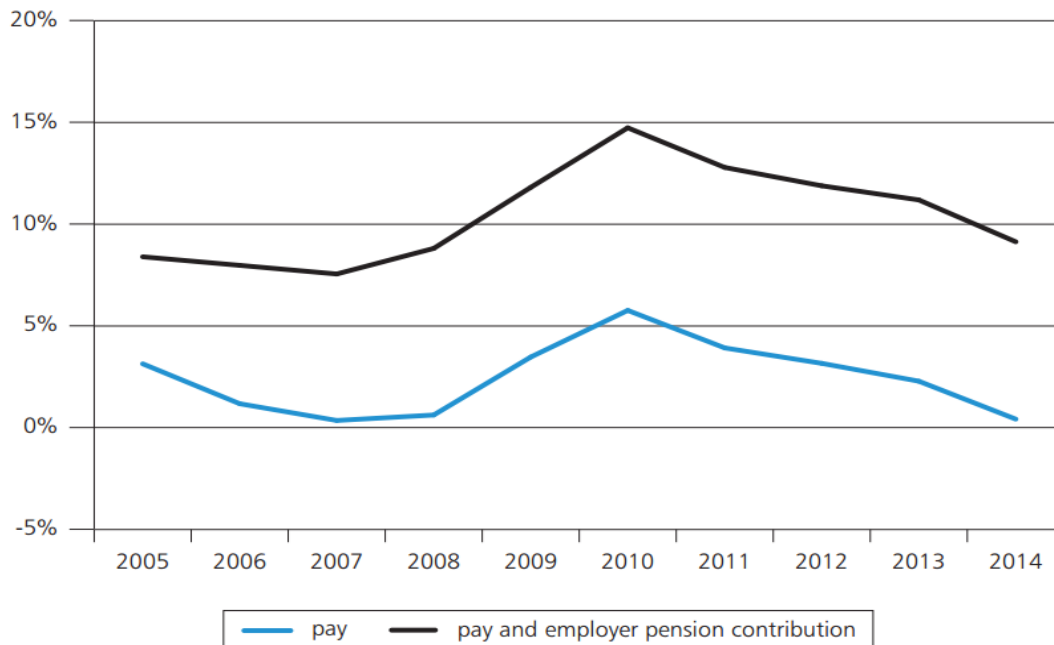
Figure 5: Total pay comparison



Source: Average Weekly Earnings, ONS Labour Market Statistics, December 2015

26. When considering changes to remuneration, it is important to consider other elements of the total reward package. Including hourly employer pension contributions to hourly pay and bonus, recent HMT analysis finds that public sector workers benefit from an 8% premium compared with their private sector counterparts. This is supported by the IFS (October 2014 paper), who found that a 4.6% pay premium continues to exist in favour of public sector workers and that the premium increases significantly if one incorporates pension payments in the analysis. This premium is driven by a number of factors including high pay for women, and protection for the low paid in the public sector. Figure 6 shows the comparison of average hourly earnings for public and private sector workers with similar characteristics across time.

Figure 6: Estimated public-private hourly pay differential



Source: HM Treasury analysis based on Annual Survey of Hours and Earnings data, comparing the average hourly earnings of public and private sector workers with similar characteristics.

27. The government wants to move from a low wage, high tax, high welfare society to a higher wage, lower tax, lower welfare society and wants to do this in a fair way by ensuring that low wage workers take a greater share of the gains from growth. An essential part of this is the introduction of a new National Living Wage (NLW) for workers aged 25 and above.

28. At Summer Budget 2015, it was announced that the NLW will increase pay to £7.20 per hour from April 2016, rising to £9.00 per hour by 2020, benefitting workers across the economy. Estimates indicate that the NLW policy is expected to directly benefit approximately 200,000 public sector jobs.

Pension reforms

29. 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.

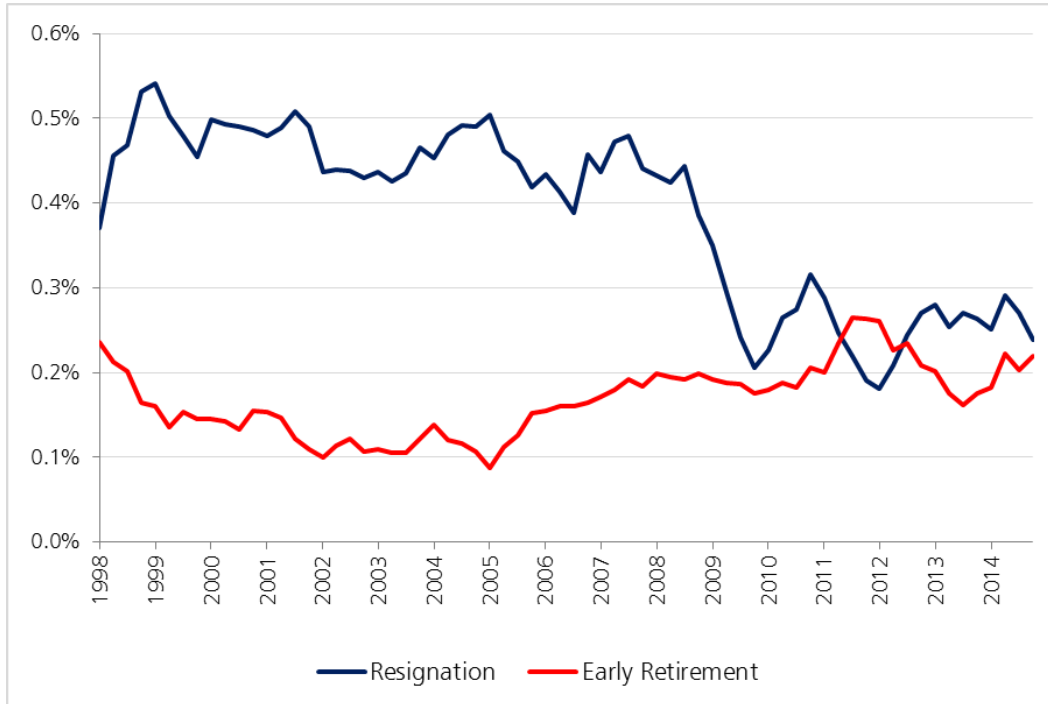
30. Following a fundamental review of public service pension provision by the Independent Public Service Pensions Commission, the government has introduced key changes to the pension element of the remuneration package. New public service pension schemes introduced in April 2015:

- 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, which will ensure that the risks associated with pension provision are shared with scheme members to provide backstop protection for the taxpayer.
- 31.** The changes introduced through the Public Service Pensions Act 2013 will save an estimated £65 billion by 2061-62.
- 32.** 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 and were phased in over three years, with the final increases made in April 2014. Members are now contributing an average of 3.2 percentage points more, delivering £2.8 billion of savings a year by 2014-15.
- 33.** Protections from the impact of the contribution changes have been put in place for the lowest paid. Those earning less than £15,000 were not subject to increases; and increases for those earning up to £21,000 (£26,000 for Teachers) were capped at 1.5 percentage points.
- 34.** 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.
- 35.** 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.

Recruitment and Retention

- 36.** Across the whole economy there is evidence that the labour market is performing strongly. There has been strong growth in employment and tightening of labour market slack, a record high number of vacancies. However, there is limited evidence of widespread recruitment and retention issues within the public sector, and resignation rates continue to be below pre-recession levels in this sector. Figure 7 demonstrates recent resignation and early retirement rates in the public sector.

Figure 7: Resignation and Early Retirement Rates (up to Q4 2014)



Source: Labour Force Survey Microdata, ONS and HM Treasury analysis

- 37.** The rate at which people are resigning from the public sector remains substantially below re-recession levels. Within the public sector, the resignation rate was relatively constant prior to the recession, in the region of 0.4 – 0.5%. From the middle of 2008 this rate fell sharply to 0.2 – 0.3%, potentially relating to opportunities outside the public sector becoming scarcer. Since then it has made little sustained recovery and remained within the range up to 2014. The early retirement rate figures increased between 2010 and 2011, but have subsequently fallen back again.
- 38.** The CIPD Labour Monthly Outlook, Autumn 2015, indicates that amongst all private sector firms, where pay has increased by 2% or more, in only 22% of cases were pay awards set at that level because of recruitment and retention issues.
- 39.** There is limited evidence of widespread recruitment and retention issues in the public sector. The government’s expectation that the 1% pay award for 2016-17 will be applied in a targeted manner to support the delivery of public services ensures that flexibility exists to meet any recruitment and retention pressures.