THE GOVERNMENT'S ECONOMIC EVIDENCE TO PAY REVIEW BODIES 2018 to 2019

Introduction

1. The economic and fiscal context in which the Pay Review Bodies (PRBs) will make their recommendations was set out in detail in the November 2017 Budget. However, as in previous years, this chapter summarises points that may be of particular relevance to the pay review process, notably the latest Office for Budget Responsibility (OBR) projections for the economy, and recent trends in the labour market, both in the public and the private sector. This should be considered alongside the rest of this evidence when making recommendations.
2. In 2017 the Government adopted a more flexible approach to public sector pay, to address areas of skills shortages and in return for improvements to public sector productivity. The Government will continue to ensure that the overall package for public sector workers is fair to them and ensures that we can deliver world class public services, while also being affordable within the public finances and fair to taxpayers as a whole. This makes it all the more important that Pay Review Bodies continue to consider affordability, alongside wider economic circumstances, when making their recommendations.

Public Finances

3. As usual, it is important that the PRBs take into account the wider fiscal context when making their recommendations. As set out in the November Budget, the UK economy has demonstrated its resilience. Gross Domestic Product (GDP) has grown continuously for 19 quarters and employment has risen by 3 million since 2010 to a near record high. However, over the last year business investment has been affected by uncertainty, and productivity - the ultimate driver of wage growth - has been subdued. Productivity growth has slowed across all advanced economies since the financial crisis, but it has slowed more in the UK than elsewhere. The OBR has revised down expectations for productivity growth over the forecast period compared to Spring Budget 2017.
4. The government has made significant progress since 2010 in restoring the public finances to health. The deficit has been reduced by three quarters from a post-war high of 9.9% of GDP in 2009-10 to 2.3% in 2016-17, its lowest level since before the financial crisis. Despite these improvements, borrowing and debt remain too high. The OBR forecast debt will peak at 86.5 % of GDP in 2017-18, the highest it has been in 50 years. In order to ensure the UK's economic resilience, improve fiscal sustainability, and lessen the burden on future generations, borrowing needs to be reduced further.
5. The fiscal rules approved by Parliament in January 2017 commit the government to reducing the cyclically-adjusted deficit to below 2% of GDP by 2020-21 and having debt as a share of GDP falling in 2020-21. These rules will guide the UK towards a balanced budget by the middle of the next decade. The OBR forecasts that the government will meet both its fiscal targets, and that borrowing will reach its lowest level since 2001-02 by the end of the forecast period. Debt as a share of GDP is forecast to fall next year and in every year of the forecast. These targets will require ongoing discipline in public spending,
6. Public Sector pay currently accounts for around £1 in every £4 spent by the government and the public sector pay bill figure for 2016/17 is £179.41bn, up from £173.19bn in 2015/16. Public sector pay policy necessarily plays an important role in controlling public spending.
7. Departments are also facing longer-term pressures. The OBR's Fiscal Sustainability report highlighted the significant impact that demographic changes are likely to have on the public finances. Discipline in public spending remains central to achieving the government's fiscal targets. The last Spending Review budgeted for one per cent average basic pay awards, in addition to progression pay for specific workforces, and there will still be a need for pay discipline over the coming years to ensure the affordability of the public service and the sustainability of public sector employment.

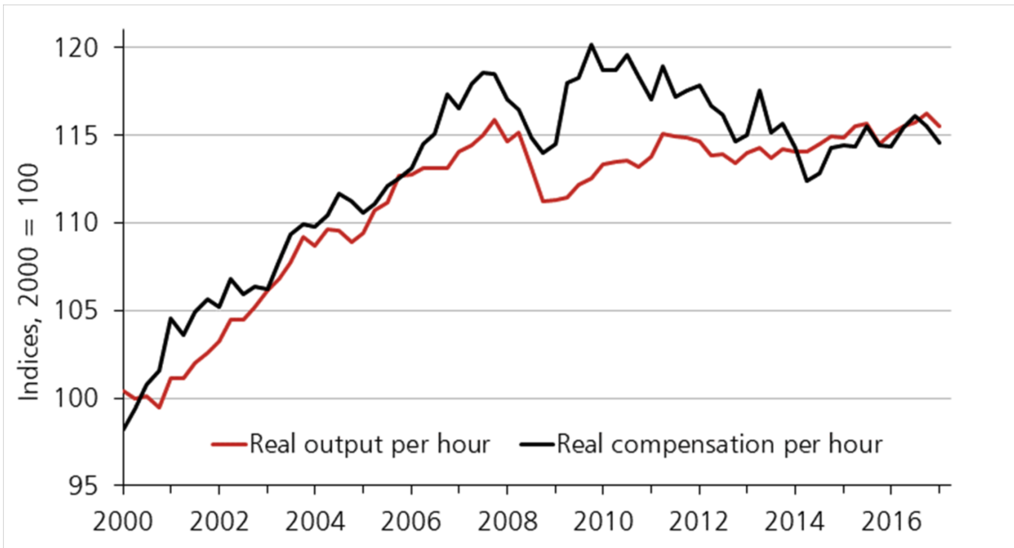
8. This makes it ever more important to ensure that our pay bill spending delivers maximum value for money. Between 2010 and 2016, public service productivity increased by 3%, an average of 0.5% per year. But although public service productivity has improved, further improvements are vital in order to deliver government objectives and meet rising demand. In its response to the PRBs Government will consider where pay awards can be agreed in return for improvements to public sector productivity, which also plays an important role in the UK's productivity growth overall.

Labour market

9. The UK labour market necessarily forms an important backdrop to the PRB process. The OBR forecast that the number of people in employment will continue to increase to 32.7 million in 2022. The unemployment rate is forecast to increase slightly over the forecast horizon as it returns to the OBR's new estimate of its equilibrium rate, remaining at 4.6% from 2020 onwards.

10. Despite the continued strength of the labour market, weak growth in labour productivity has been weighing down on wages and, ultimately, the public finances. As set out in the November 2017 Economic and Fiscal Outlook, the OBR expects productivity to remain flat in 2017, before increasing 0.9% in 2018 and 1.0% in 2019. Productivity growth is then forecast to increase to 1.3% in later years. This compares to the Spring Budget 2017 forecast of 1.7% on average over the forecast period.

Chart 1: Real output per hour and real compensation per hour, year on year growth (ONS November 2017)



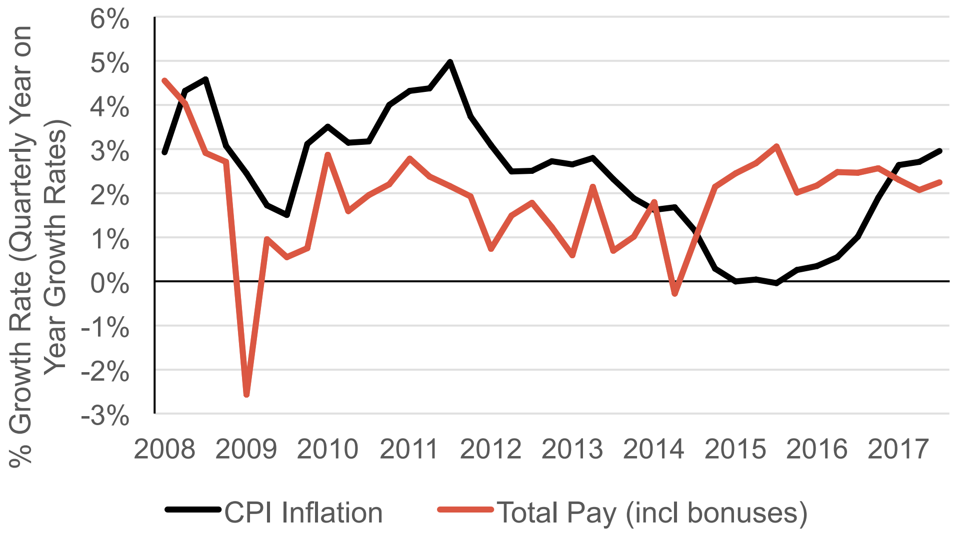
11. With a lower forecast for productivity growth the OBR expects average earnings growth of 2.3% in 2017, 2018 and 2019. It then increases to 2.6% in 2020, 3.0% in 2021 and 3.1% in 2022. A pickup in productivity is vital for the recovery of cross-economy wage growth rates to pre-recession levels. Public and private sector wages tend to move in similar directions, both because of pay expectations and the implications of tax receipts on public sector budgets. The £31 billion National Productivity Investment Fund and our Industrial Strategy will help to boost productivity and earning power throughout the UK.

12. We recognise that higher inflation is putting pressure on all households as well as our hardworking public servants. But historically the relationship between pay and inflation has been a weak one, in part due to the temporary nature of many inflation fluctuations. Most forecasters expect this period of above target inflation to be temporary, as inflation has been pushed above the target by the boost to import prices that had resulted from the past depreciation of sterling[1]. The OBR and the Bank of England both expect inflation to peak at the end of this year and then fall again over 2018 and 2019.

[1] Monetary Policy Summary and minutes of the Monetary Policy Committee meeting 13 December 2017

The appropriate level of public sector pay award is complex and determined by a variety of factors, notably retention and recruitment. Rates of price inflation are important, but not the only consideration.

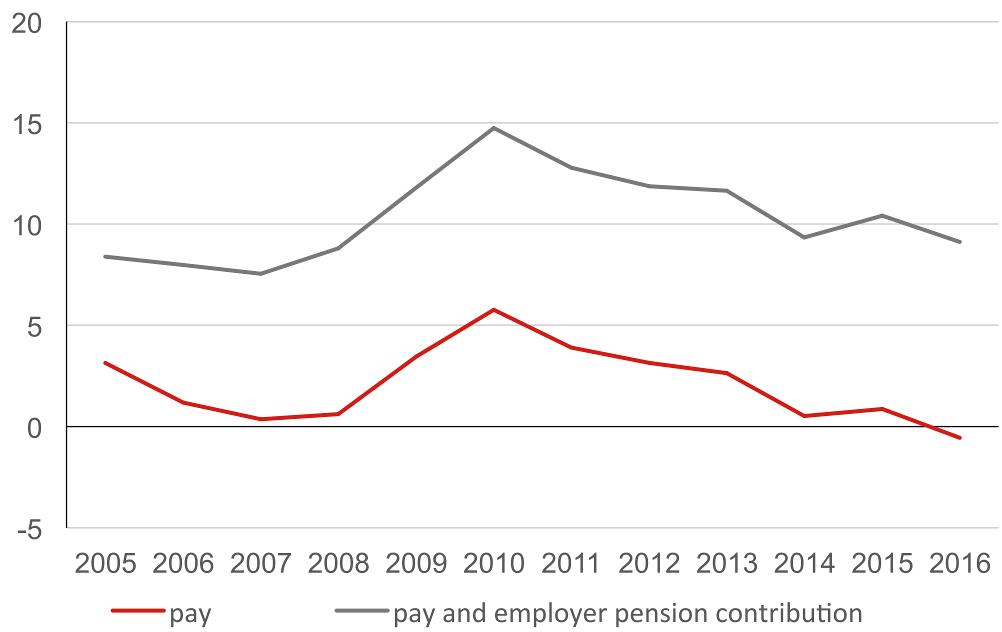
Chart 2: Whole economy average earnings growth and inflation (ONS November 2017)



Public sector pay and pensions

13. Specific evidence on the pay of the Senior Civil Service is presented elsewhere in this document. However, wider trends in pay and remuneration are also relevant. Following the last recession, public sector wages did not undergo the sharp fall seen in the private sector, and have since grown at a slower pace than private sector wages: for the three months to October 2017 private sector total pay grew by 2.7% on the same period the previous year, compared to 1.8% in the public sector (excluding financial services). However, the overall remuneration of public sector employees when taking employer pension contributions into account remains at a significant premium, as seen in Chart 3 below.

Chart 3: Percentage public sector pay premium, hourly pay for all employees, controlling for personal characteristics (ONS ASHE)



14. When considering changes to remuneration, PRBs should take account of the total reward package. Public service pension schemes continue to be amongst the best available and significantly above the average value of pension provision in the private sector. Around 17% of active occupational pensions scheme membership in the private sector is in defined benefit (DB) schemes, with the vast majority in defined contribution (DC) schemes. In contrast, over 95% of active members in the public sector are in DB arrangements.

15. In April 2016, the National Living Wage was introduced at £7.20 for workers aged 25 and over (increased to £7.50 an hour in April 2017, and will increase to £7.83 in April 2018). The introduction of the NLW marked an increase in pay for over a million workers across the UK labour market, including in the public sector. Estimates indicate that approximately 53,000 public sector workers were paid the NLW in 2017. In 2018-19, 1.2 million people on low incomes across the economy will have been taken out of income tax altogether (compared to 2015-16), and a typical taxpayer will pay £1,075 less income tax, compared to 2010-11. Overall, since 2015, we have cut income tax for 31 million people, while freezing fuel and alcohol duty.

Conclusion

16. This chapter summarises the economic and fiscal evidence which is likely to be relevant to the recommendations of the PRBs. This is intended to inform their usual consideration of the affordability of specific pay awards, on top of the workforce specific evidence presented elsewhere in this document.

17. Much of the evidence presented here will feed into retention and recruitment across public sector workforces. Retention and recruitment will vary considerably across geographies, specialisms and grades, where public sector workers face different labour market structures. We would welcome specific comment and analysis from the PRBs on any trends and how pay systems could help address these issues.