HM Treasury

Economic Evidence to Pay Review Bodies: 2023-24 Pay Round

January 2023

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Contents

Chapter 1	**Background**	**4**
Chapter 2	**Economic Context**	**5**
Chapter 3	**Labour Market Context**	**10**
Chapter 4	**Macroeconomic Policy Context**	**22**
Chapter 5	**Conclusion**	**27**

Chapter 1
Background

1.1 At Spending Review 2021 (SR21), the Chancellor announced that all public sector workers will see pay rises from 2022-23 to 2024-25. SR21 also set out that, to ensure fairness and the sustainability of the public finances, public sector earnings growth across this period should retain broad parity with the private sector.

1.2 The government accepted the pay recommendations of the independent Pay Review Bodies (PRBs) for the NHS, teachers, police and the armed forces for 2022-23 which gave the highest uplifts in nearly twenty years. This reflects the vital contributions public sector workers make to our country and the importance the government attaches to the recommendations of the independent PRBs.

1.3 The government has fully remitted PRBs for the 2023-24 Pay Round. PRBs will provide evidence-based advice to the government on levels of pay, taking account of a range of factors including the need to recruit, retain and motivate suitably able and qualified people, the government's inflation target, and the financial circumstances of the government. Pay awards this year should find a careful balance between recognising the vital importance of public sector workers, whilst delivering value for the taxpayer, not increasing the country's debt further, and supporting the government's macroeconomic framework.

1.4 It is particularly important that pay awards do not exacerbate the current inflationary pressures which are the reason behind many workers' choosing to take industrial action. Higher and/or more persistent inflation would erode the real value of savings and incomes and could lead to interest rates being elevated for longer. This would have implications for the borrowing costs of households, businesses and the government, increasing mortgage costs for the former and risking burdening future generations with even higher debt.

1.5 This document sets out further the economic, labour market and fiscal context within which we ask the independent Pay Review Bodies to consider their recommendations for 2023-24 pay awards.

Chapter 2
Economic Context

Overview

2.1 Despite the after-effects of the COVID-19 pandemic and an increase in global energy prices, the economy continued to grow in the first half of 2022 by 0.7% and 0.2% in Q1 and Q2 respectively. However, Putin's weaponisation of gas supplies to Europe has pushed gas prices to record levels, which has led to a deterioration in the UK's terms of trade (the relative prices of exports compared with imports) and exposed the UK economy to an inflationary shock.

2.2 This sharp rise in the price of energy has contributed to a slowdown in the global economy, and the International Monetary Fund (IMF) is now forecasting that more than a third of the global economy will contract in 2022 or 2023.[1] Open economies like the UK are particularly exposed to these external pressures. The UK is a net energy importer with a high dependence on gas and oil. Energy price increases have therefore made the country unavoidably worse off, with the UK now expected to spend the equivalent of 8% of its GDP on energy compared to 2% prior to the pandemic. High inflation is restraining consumer demand, increasing costs for businesses, limiting investment, and slowing growth.

Inflation

2.3 Driven primarily by the impact of energy prices described above, inflation has risen steadily above target since the middle of 2021, coming in above the Office for Budget Responsibility's (OBR) March 2022 forecast. However, over the course of the last year price pressures have become more widespread[2] as domestic factors, such as wage growth, have also played an increasing role. For example, services price inflation (often used as a proxy for domestically-generated inflation) is running above long-term averages at 6.3% in November 2022.

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1 World Economic Outlook Report October 2022 – International Monetary Fund (imf.org)

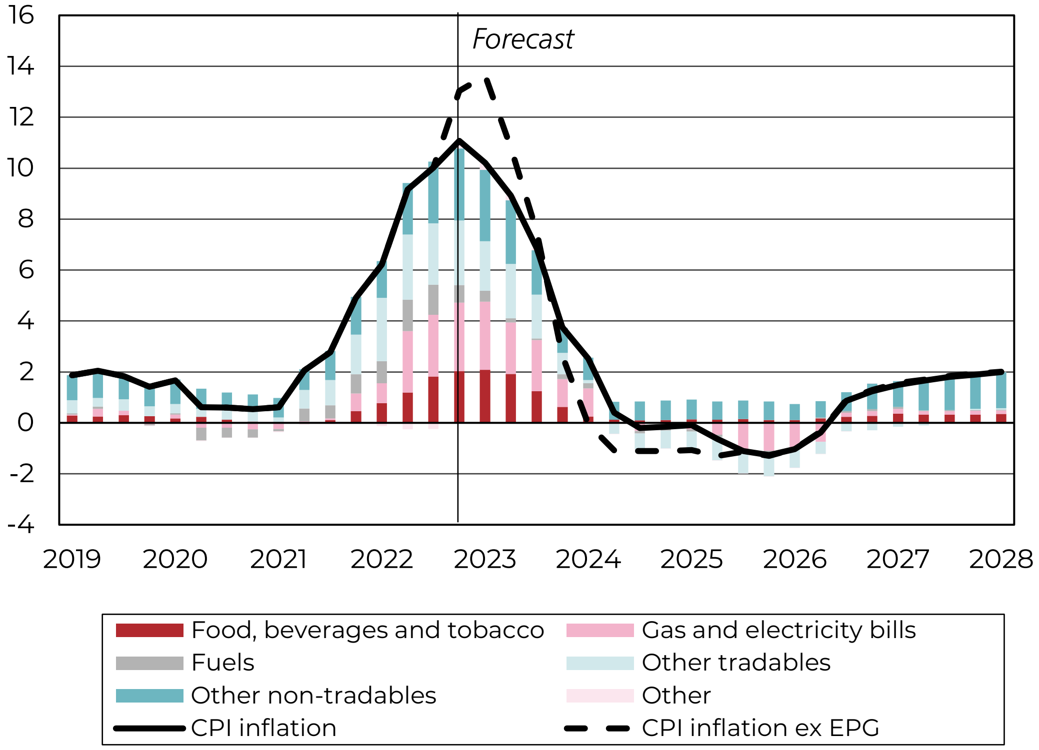
2 A third (32%) of the CPI inflation basket experienced inflation above 10% in November 2022

2.4 Households' inflation expectations remain elevated. Short-term household inflation expectations, which tend to be responsive to current inflation, have increased to above 7%, as measured in YouGov-Citi's survey. Longer-term expectations, for 5-10 years' time, which are generally less volatile, have also increased to nearly 4%. This is well above their long-run average and above the 2% inflation target. The Monetary Policy Committee (MPC) of the Bank of England is acting to ensure that longer-term inflation expectations are anchored in line with its inflation target.

2.5 CPI inflation was 10.0% in 2022 Q3, and the OBR expects it to have peaked at 11.1% in 2022 Q4 and then to begin to fall sharply, averaging 5.5% over 2023-24 and turning negative in 2024-25. The breakdown of contributions to CPI inflation shown in Figure 2.A illustrates that global factors are forecast to continue to be the main drivers of inflation across 2023-24, but that broader factors will continue to play a role as well. The OBR's forecast is contingent on the path of fiscal policy set out in Chapter 4. Any expansion of fiscal policy beyond this could pose upside risks to inflation.

2.6 The OBR forecast that the Energy Price Guarantee (EPG), which caps typical household energy bills at £2500, will reduce the winter peak of inflation by 2.5 percentage points, and will continue to hold inflation down by 2 percentage points when the EPG increases to £3000 in April 2023.

Figure 2.A Contributions to Consumer Price Index (CPI) Inflation (percentage points)



Source: OBR and HM Treasury calculations

GDP

2.7 Driven by falling consumption, primarily as a result of the high rate of inflation discussed, the OBR is now forecasting a recession. The economy contracted by 0.2% in 2022 Q3, and the OBR do not expect this recession to end until 2023 Q4, with a peak to trough fall of 2.1%. The economy is forecast to grow from 2023 Q4 through to the end of the forecast period in 2027.

2.8 In their November Economic and Fiscal Outlook, the OBR said that "*the two most important drivers of changes to the economic outlook since our March forecast have been higher energy prices and higher interest rates*".[3] However, they have also assessed that the EPG and other cost-of-living support measures announced will boost private demand over the winter, leading to the recession being 1.1 percentage points shallower overall.

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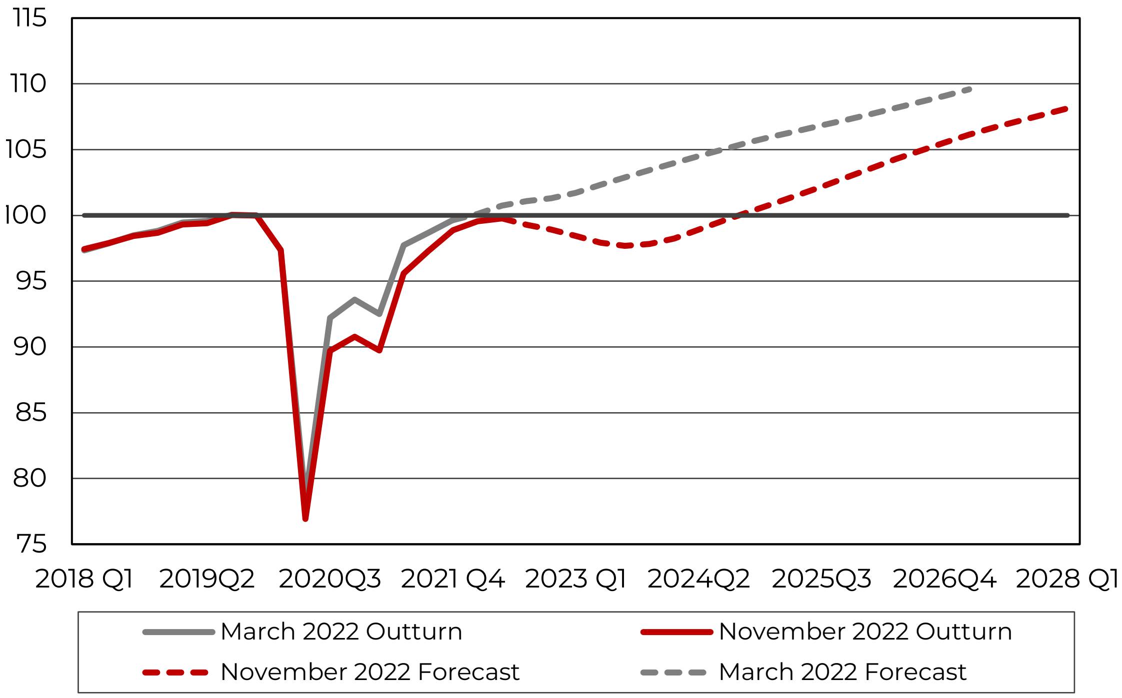
[3] Economic and fiscal outlook - November 2022 - Office for Budget Responsibility (obr.uk)

Figure 2.B Real GDP (2019, Q4 = 100)



Source: ONS, OBR

Uncertainties

2.9 The OBR have said that uncertainty around the economic outlook remains "*considerable*"[4] whilst the Bank of England have assessed that risks to the inflation outlook remain "*significant*".[5] While inflation is expected to fall and the OBR's forecast recession is expected to last until 2023 Q4, there remain significant risks with consequences for both inflation and the scale of the forecast economic downturn.

2.10 In their November Monetary Policy Report (MPR), the Bank of England assessed that risks around inflation were skewed to the upside, an assessment which they reiterated in their December meeting.[6] These risks include the possibility of elevated inflation expectations becoming embedded due to greater persistence in wage and price setting, for example as a result of increased pay awards. There is also the possibility of a further escalation in the war in Ukraine, intensifying pressures on European energy supplies, inflation, and interest rates, which the OBR has

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[4] Economic and fiscal outlook - November 2022 - Office for Budget Responsibility (obr.uk)

[5] Monetary Policy Report - November 2022 | Bank of England

[6] Monetary Policy Summary and minutes of the Monetary Policy Committee meeting on 14 December 2022 (bankofengland.co.uk)

described as the "*main adverse risk*"[7] to the outlook, and which would affect growth as well as inflation.

[7] Economic and fiscal outlook - November 2022 - Office for Budget Responsibility (obr.uk)

Chapter 3

Labour Market Context

Public Sector Remuneration

3.1 The public sector remuneration package remains competitive, when taking account of pay, pensions, and wider benefits including job security.

1) **Pay**

- Median pay, shown in Figure 3.A, remained 11% greater in the public sector than private sector in 2022, broadly in line with and slightly greater than the average gap between the two sectors since 2009.[8] This is based on Annual Survey of Hours and Earnings (ASHE) data which is measured in April of each year and therefore won't reflect 2022-23 awards in the public sector, which didn't reach pay packets until later in the year. However, it will capture some 2022 pay awards in the private sector, which are concentrated in January and April. ASHE data provides the best measure of earnings levels in the public and private sector, due to its large sample size and coverage of the entire United Kingdom and is recommended by the ONS as the principal source of data for estimates of the public and private sector pay differential.[9]

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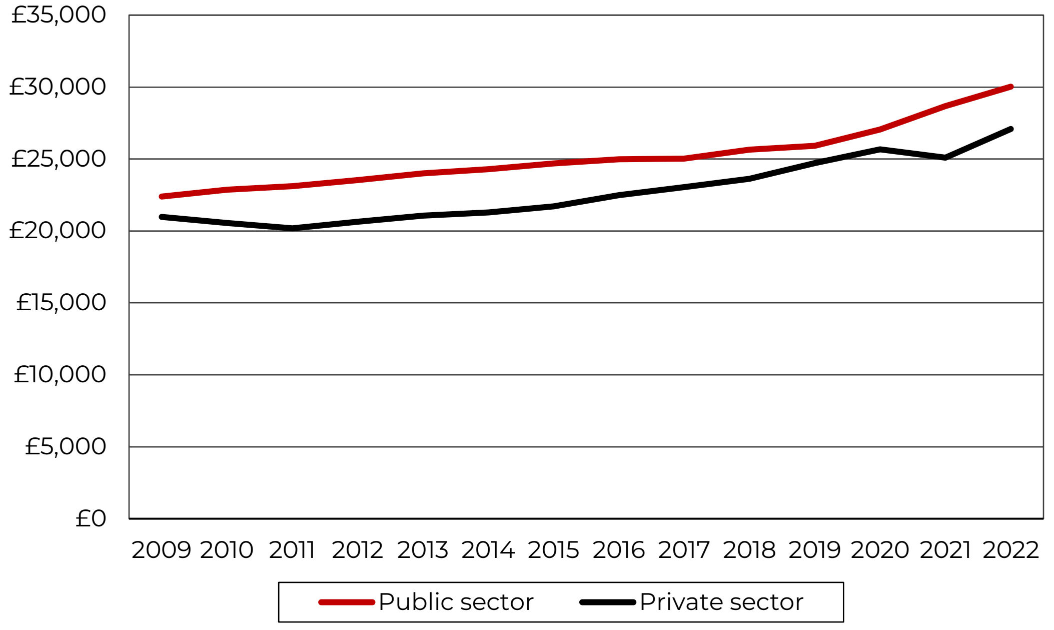
8 Annual Survey of Hours and Earnings (ASHE) - Office for National Statistics (ons.gov.uk); calculation based on annual median pay (gross) for all employees

9 https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/methodologies/aguidetosourcesofdataonearningsandincome

Figure 3.A Annual median pay (gross) - for all employees



Source: ASHE (ONS)

- Median private sector pay settlements, the best comparator to PRB decisions in previous years, were 3.5% in the last quarter on 2021-22 and 4% in the first quarter of 2022-23.[10] This is broadly in line with or lower than 2022-23 awards for PRB workforces.

2) **Pensions**

- On average, pensions in the public sector are substantially more generous than pensions in the private sector. Over 80%[11] of public sector workers are part of Defined Benefit schemes where employers contribute around 20% or more of earnings to the pension. This compares to most private sector employees who receive Defined Contribution pensions where employer contributions are significantly lower, with average employer contributions to Defined Contribution schemes being ~6%.[12] Indeed, in 2021, for employees with a workplace pension, the average value was £65,400 in the public sector compared with £10,300 in the private sector.[13]

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10 XpertHR, December 2022

11 Employee workplace pensions in the UK - Office for National Statistics

12 https://www.pensionspolicyinstitute.org.uk/media/4217/29112022-the-indicator-appendix-final.pdf

13 Employee workplace pensions in the UK - Office for National Statistics

3) **Job Security**

- This is likely to be particularly applicable over 2023-24 as unemployment is forecast to rise (more details in 3.12).

3.2 Recruitment and retention (R&R) generally improved throughout the pandemic, however the latest data for 2021-22 shows these trends beginning to gradually unwind.

- The pandemic had a positive effect on retention across the public sector, with leaving rates falling to historical lows for some workforces. Latest data, however, does show leaving rates have generally begun to increase in 2021-22.
- On recruitment, latest data shows the joining rate decreasing in some workforces compared to the previous year.
- Despite this, the gap between joining rates and leaving rates remains positive for most workforces, with the majority of workforces seeing an increase in full-time equivalent staff from 2021 to 2022 and some reaching their largest size since individual censuses began.

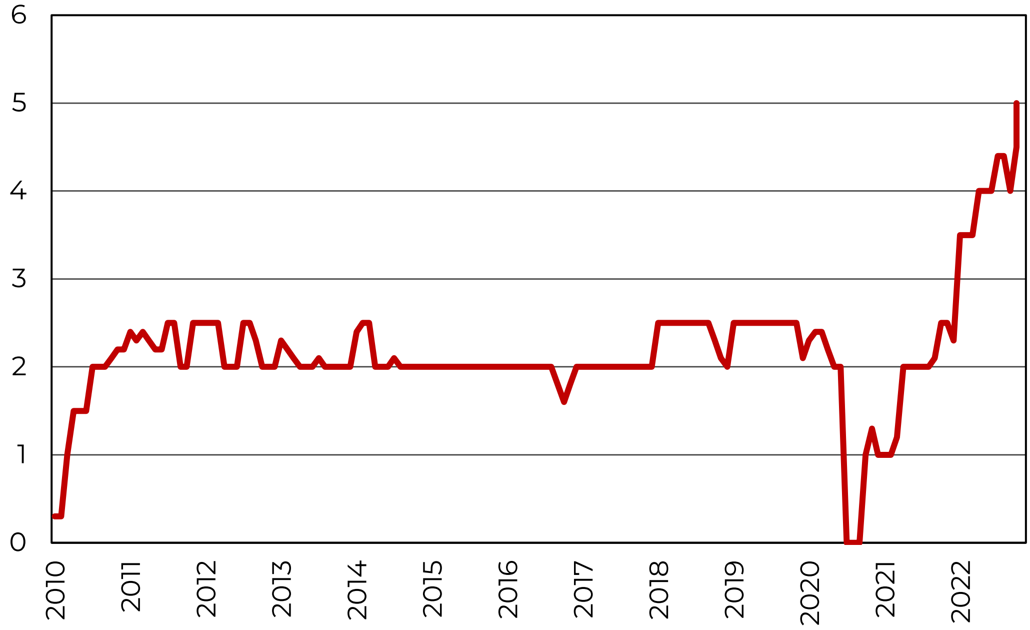
3.3 It remains the case that the most significant R&R challenges are found in specific roles, with pay not always being stated as the primary cause. The government has introduced measures in response to acute R&R issues which have had a positive impact where implemented. Departments will set out the relevant R&R data for their workforces and how they are responding to areas of concern in their evidence to PRBs.

Earnings growth

3.4 Median private sector pay settlements provide the best comparator to public sector pay settlements in 2022-23. According to data from XpertHR, these were 4.0% in Q2 and Q3 2022.[14]

[14] It increased to 5.0% in the three months to November, but this was based on a small sample of 20 private sector settlements in comparison to 470 settlements in Q2

Figure 3.B Median private sector pay settlements, three month rolling average (%)



Source: XpertHR

3.5 Average earnings growth (whole economy, regular pay) was 6.1% in the latest data for the three months to October. This measure is generally higher than average pay settlements, with median pay settlements typically averaging 0.5-1.5 percentage points lower than headline average earnings growth prior to the pandemic.[15] This reflects the fact that average earnings growth is affected by movements of people between jobs, generating a compositional effect which typically lifts average earnings growth above average pay settlements as people move to higher paying occupations. Average earnings data is also affected by broader pay drift from factors such as changes in working hours and overtime. These affect both measures of public and private sector average earnings.

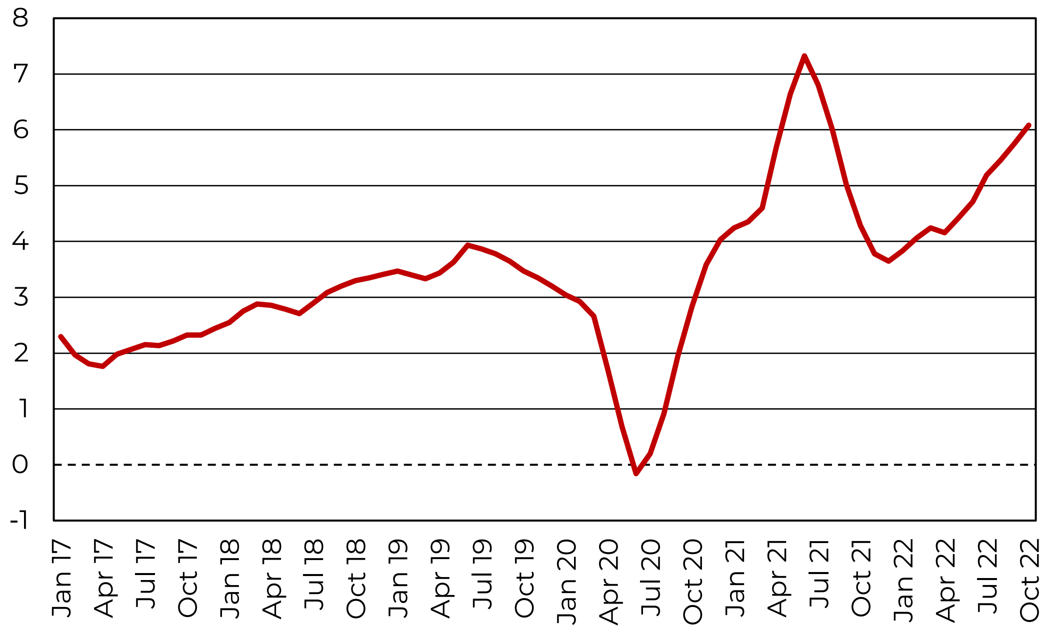
3.6 A base effect from comparisons of current pay levels with those in August and September 2022, when the furlough scheme meant that the measured pay of over a million employees was below typical levels,[16] will be further increasing the wedge between annual average earnings growth and median pay

[15] See discussion of settlements on page 13 of: https://www.niesr.ac.uk/publications/recovery-stalling-not-soaring?type=uk-economic-outlook

[16] See statistics on employees furloughed in August and September 2021 here: https://www.gov.uk/government/statistics/coronavirus-job-retention-scheme-statistics-16-december-2021/coronavirus-job-retention-scheme-statistics-16-december-2021

settlements at present.[17] Data on average private sector pay settlements therefore provides the most comparable measure of pay growth to public sector pay settlements.

Figure 3.C Average weekly earnings whole economy regular pay growth (%)



Source: ONS

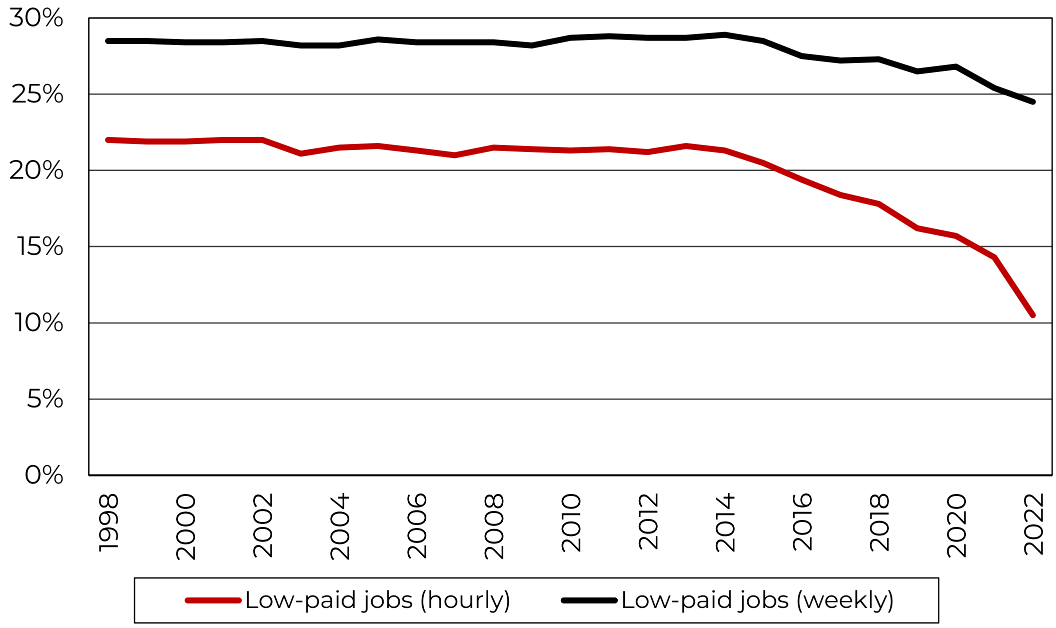
3.7 Private sector regular pay growth increased to 6.9% in the three months to October, and currently exceeds regular pay growth in the public sector (2.7% in the three months to October). This estimate of public sector regular pay growth does not yet fully capture the effect of public sector pay settlements agreed for 2022-23, which, as above, were backdated, with many not reaching pay packets until after October. For example, we expect that many teachers received their 2022-23 awards (the implementation of which is up to individual schools) in November, whilst the vast majority of local government employees will have received their awards in November at the earliest. Public sector regular pay growth was 3.8% for the single month of October, reflecting the effect of more of these settlements being implemented in October.

3.8 Earnings growth has been strongest amongst those at the lower end of the earnings distribution over the past year. The

[17] See discussion of how the furlough scheme has generated base effects in earnings growth statistics here: https://blog.ons.gov.uk/2021/07/15/far-from-average-how-covid-19-has-impacted-the-average-weekly-earnings-data/\f

proportion of jobs that are low paid fell to a record low in terms of hourly pay (10.5% of jobs were low paid on this basis in 2022, down from 14.3% in 2021) and weekly pay (24.5% of jobs were low paid on this basis in 2022, down from 25.4% in 2021).[18]

Figure 3.D Proportion of low paid employee jobs for hourly pay and gross weekly pay



Source: ASHE (ONS)

3.9 Earnings growth is currently elevated, and the Bank of England have noted in the November MPR that '*there have been continuing signs of firmer inflation in domestic prices and wages that could indicate greater persistence*'.[19] Increases in nominal unit labour costs, which provide a measure of wage inflation which adjusts for productivity growth, are indicative of this upwards inflationary pressure through wages. Nominal unit labour costs increased by 5.8% in the year to 2022 Q2,[20] above levels of growth in unit labour costs consistent with the inflation target.

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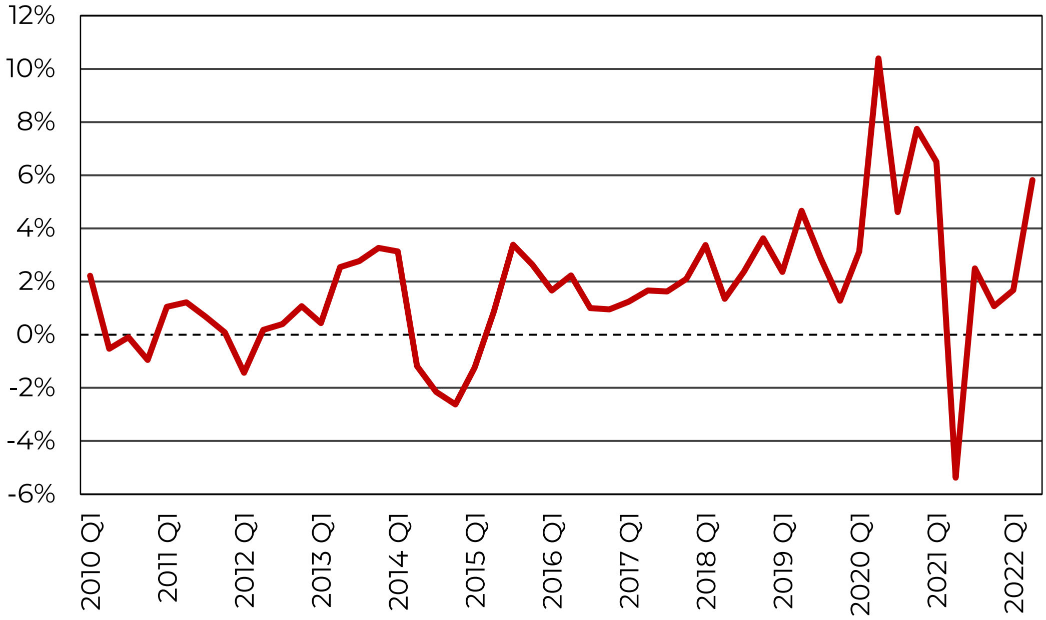
18 ONS ASHE 2022; low pay is defined as the value that is two-thirds of median hourly or weekly earnings

19 Monetary Policy Report - November 2022 | Bank of England

20 Labour costs and labour income, UK (ONS) https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/datasets/labourcostsandlabourshare

Figure 3.E Nominal unit labour costs: quarter on year growth



Source: ONS

3.10 There is uncertainty around the magnitude of any wage-price spillovers in the public sector, but it is a risk the government cannot ignore. Academic evidence highlights the possibility of short-run spillovers from public sector pay growth to the private sector[21] and there is international evidence of spillovers from earnings growth to price growth – with the Bank for International Settlements writing that the risk of a "*wage-price spiral… should not be underestimated*".[22] In their December 2022 meeting the Monetary Policy Committee also discussed how the evidence of "*inflationary pressures in domestic prices and wages*" could indicate "*greater persistence*" in inflation, which they argue justified the increase in Bank rate by 0.5ppts.[23] Public sector pay awards significantly above the private sector could therefore risk higher and more persistent inflation, requiring further interest rate rises to offset this effect. More detail on monetary policy is provided in Chapter 4.

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21 https://www.niesr.ac.uk/publications/dynamics-public-and-private-sector-wages-pay-settlements-and-employment?type=report

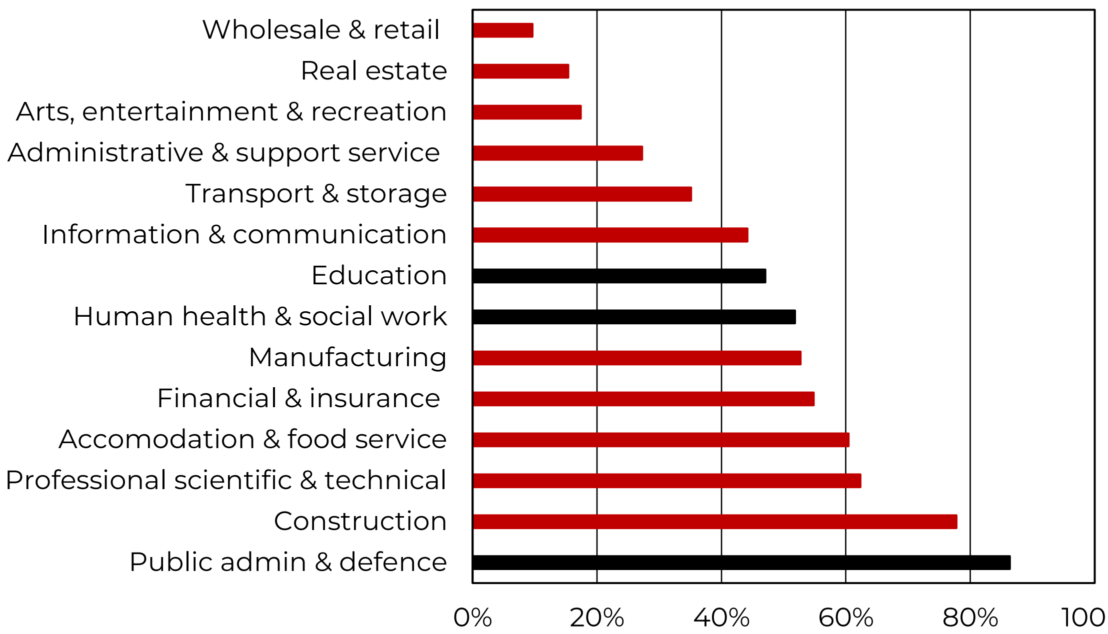
22 Are major advanced economies on the verge of a wage-price spiral? (bis.org)

23 Monetary Policy Summary and minutes of the Monetary Policy Committee meeting on 14 December 2022 (bankofengland.co.uk)

Labour market overview

3.11 There are recruitment challenges across the whole economy, in both the public and private sectors. In the Bank of England's Decision Maker Panel survey for December 2022, 71% of firms reported that they were finding it harder to recruit new employees compared to normal. Furthermore, vacancies in the three months to November were 44% above pre-pandemic levels and elevated in every sector of the economy (Figure 3.F).

Figure 3.F Vacancy changes on pre-pandemic levels (3 months to Feb 2020) by industry[24]



Source: ONS

Labour market outlook

3.12 Reflecting the expected recession, the OBR forecast that unemployment will rise from 3.7% in the latest data for the three months to October to 4.3% in 2022-23 and 4.9% in 2023-24. There are signs of a loosening in the labour market in more timely economic data, with the number of online job postings falling by around a quarter over the past nine months.[25] This loosening of the labour market should, over time, contribute to normalisation of nominal pay growth. At Autumn Statement 2022, the government also announced a review of economic inactivity, to

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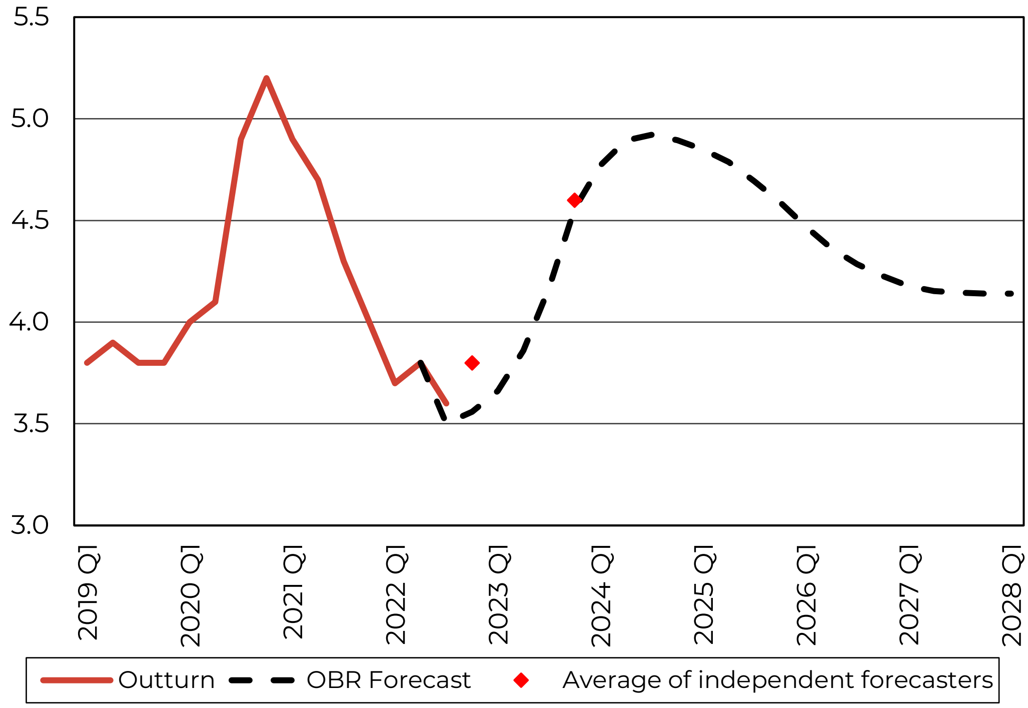
[24] Public sector facing sectors are highlighted in black here

[25] https://www.ons.gov.uk/economy/economicoutputandproductivity/output/datasets/onlinejobadvertestimates

conclude early this year, to prioritise reducing labour market inactivity as this labour market loosening occurs.

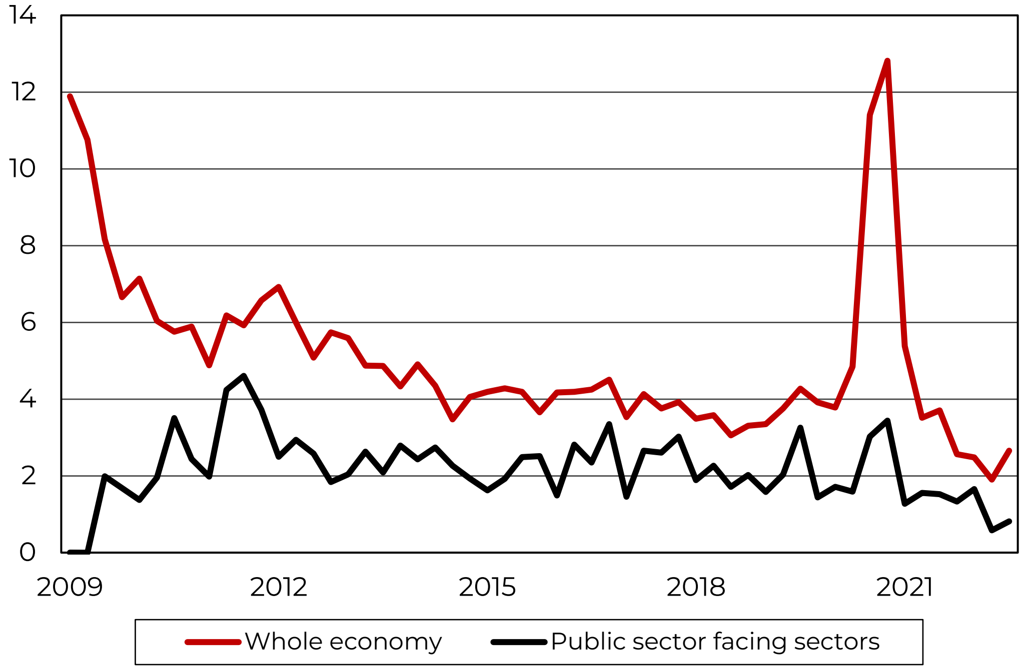
Figure 3.G Unemployment rate (%)



Source: OBR, ONS, Forecasts for the UK economy: December 2022

3.13 The public sector is likely to continue to provide greater job security during a period when the economy is slowing and unemployment is expected to rise. Redundancy rates are generally lower in public sector facing sectors than across the whole economy, while redundancies have historically been concentrated in the private sector during periods of rising unemployment (figure 3.H).

Figure 3.H Redundancy rates per 1,000 employees[26]



Source: ONS

3.14 Employment has declined in the private sector since the start of the pandemic, while employment has increased across this period in the public sector. There were 286,000 more people in employment in September 2022 in the public sector than in December 2019, whilst private sector employment has fallen by 498,000 over this period.

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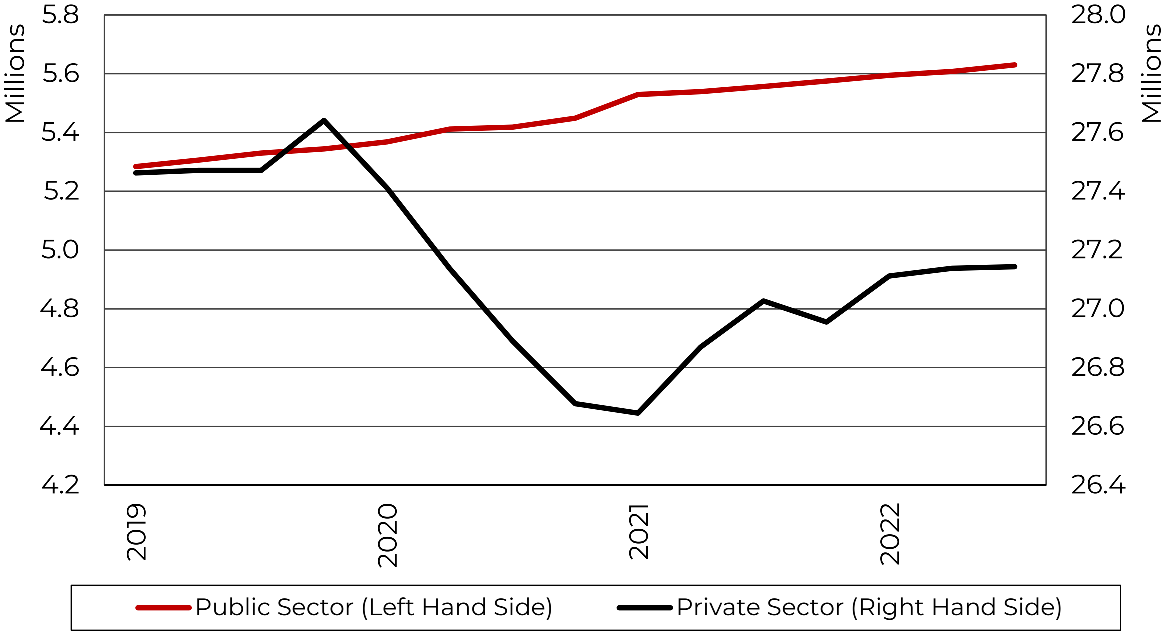
[26] Public sector facing sectors defined here as education, human health and social work activities and public administration and defence. In some quarters for some sectors, redundancies are sufficiently low that they are suppressed on disclosure grounds by the ONS, and this has been treated as zero values for the calculation here.

Figure 3.I Public and private sector employment (excluding reclassifications)



Source: ONS

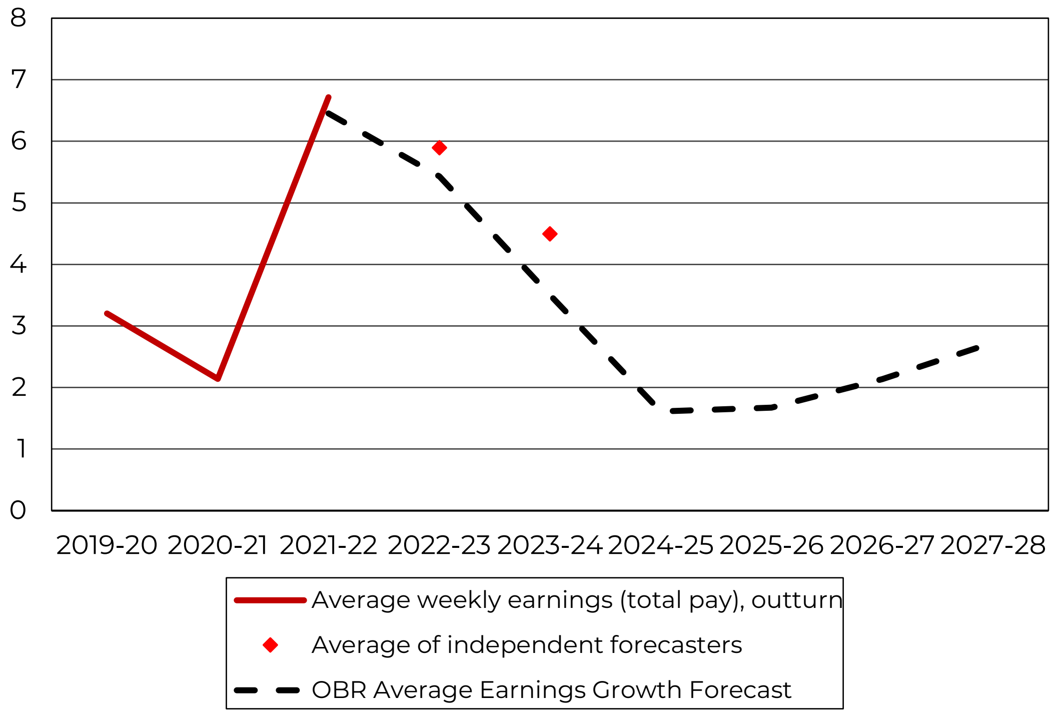
3.15 The OBR forecast average earnings growth, which is the most appropriate comparator for private sector earnings growth in future years given 82% of employment is in the private sector, will fall to 3.5% across 2023-24 and 1.6% across 2024-25. This measure of average earnings growth has historically been higher than settlements, for the reasons set out above. There are signs of easing pay pressures in more timely data on pay, with the Recruitment and Employment Confederation (REC) survey measure of average pay growth slowing in recent months, with their November report showing the softest increase in permanent starters' salaries in 19 months.[27]

3.16 The OBR do not produce a forecast for private sector pay settlements, which is the most comparable measure of earnings growth to PRB decisions. In the absence of an explicit forecast of private sector pay settlements, the OBR's average earnings forecast remains the most appropriate comparator for awards in 2023-24. This measure of average earnings growth will be affected by compositional changes in the labour force and broader pay drift, although wider evidence suggests that these

[27] https://www.rec.uk.com/our-view/news/press-releases/report-jobs-candidate-shortages-and-economic-uncertainty-weigh-permanent-placements-november#

effects tend to be smaller on average during periods of labour market loosening.[28]

Figure 3.J Average earnings growth forecast (%)



Source: ONS, OBR, HMT Forecasts for the UK Economy, December 2022

[28] See discussion of compositional effects in What Can Wages and Employment Tell Us about the UK's Productivity Puzzle?, Blundell, Crawford and Jin, 2014

Chapter 4
Macroeconomic Policy Context

4.1 Low and stable inflation is an essential pre-requisite to achieve strong, sustainable, and balanced growth in all parts of the UK and sectors of the economy. Bringing inflation under control is therefore the number one priority for the government, and this is evidenced through the government's commitment to the 2% inflation target and the Prime Minister's commitment to halve inflation by the end of 2023.

4.2 The Bank of England is responsible for controlling inflation in the UK. In response to high levels of inflation, the Bank of England have raised interest rates steadily from 0.1% in December 2021 to 3.5% in December 2022, the highest rate since October 2008. As discussed in Chapter 2, the Bank of England have assessed risks around inflation to be skewed to the upside, with strong wage growth being one of these, whilst, as detailed in Chapter 3, academic evidence highlights the risk that public sector wage growth could contribute to longer-lasting inflation. The Bank of England have been clear that if the outlook suggests more persistent inflationary pressures, they will respond forcefully to return inflation to target, and to prevent high inflation becoming embedded.

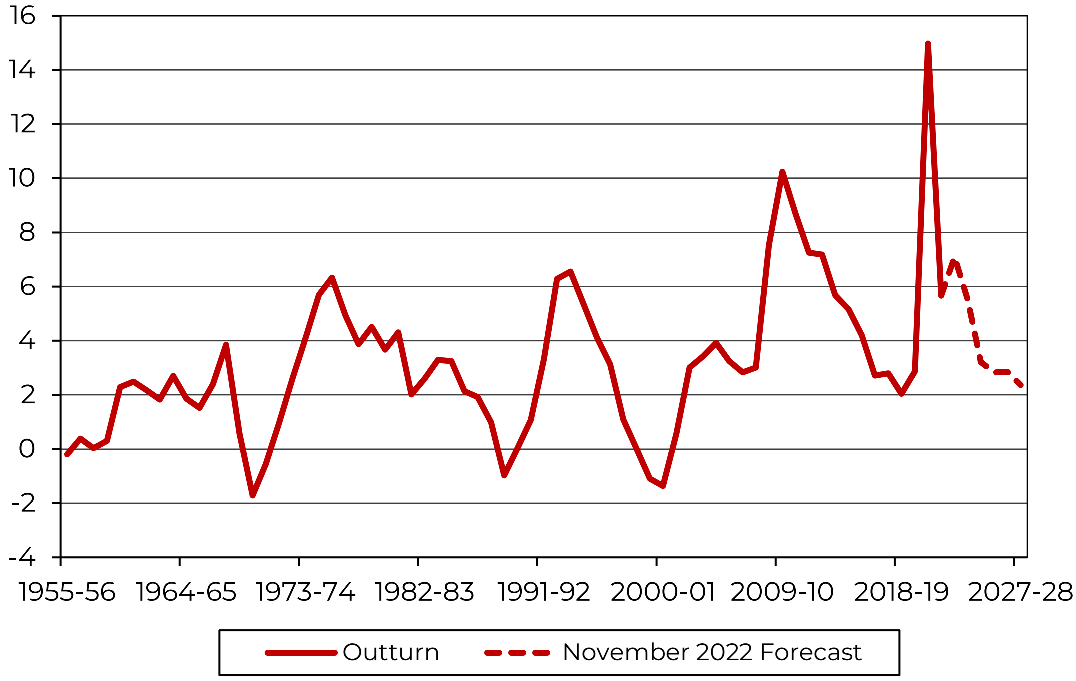
4.3 To support the Bank of England in their fight against inflation, the government must demonstrate fiscal discipline. In general, fiscal loosening will add to inflationary pressures, which will in turn reduce real incomes and likely push up interest rates even further, and cause them to remain higher for longer, increasing borrowing costs for households, businesses, and the government. To illustrate, a 1 percentage point rise in Bank rate would cost the average fixed-rate mortgage holder an extra £850 per year.

4.4 The government is therefore getting the public finances under control. The UK's fiscal outlook deteriorated significantly over the course of 2022 as substantial increases in global energy prices brought higher inflation and interest rates, coupled with slower economic growth, which hit the public finances. In response, the government took tough, but necessary, decisions on tax and spending to return the public finances to a sustainable footing and ensure economic stability.

4.5 The need to get the public finances on a sustainable footing was carefully balanced against the need to support vulnerable households and businesses through this period of rising costs. In response to high inflation the government is therefore providing targeted support to households. This includes additional cost-of-living payments to the most vulnerable, including £900 for those on means-tested benefits, and the EPG, which is forecast to reduce inflation, and means the average household will pay £3000 in 2023-24.

4.6 Figures 4.A and 4.B show that even after the difficult decisions made at Autumn Statement 2022, borrowing is forecast by the OBR to remain high in 2023-24 at £140.0 billion, whilst public debt increases across the OBR's forecast until falling marginally from 2026-27.[29]

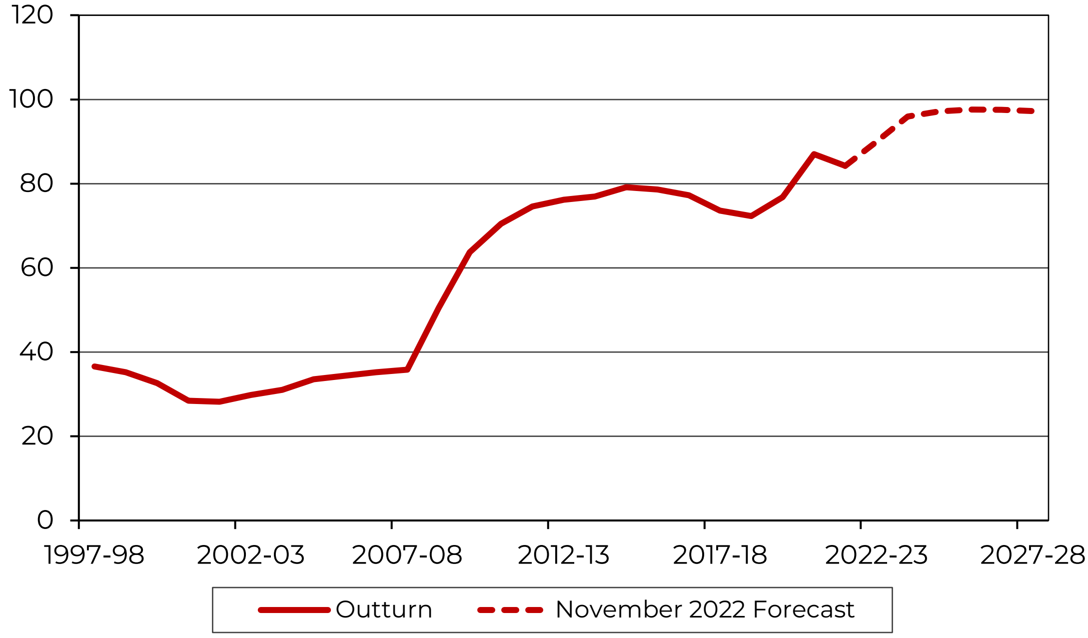
Figure 4.A Public sector net borrowing, % GDP



Source: ONS, OBR

[29] Economic and Fiscal Outlook, Office for Budget Responsibility , November 2022

Figure 4.B Public sector net debt (excluding Bank of England), % GDP



Source: ONS, OBR

4.7 The deterioration in the fiscal outlook is largely explained by higher debt interest costs. Debt interest costs are expected to reach £120.4 billion in 2022-23 - the highest since the late 1940s, both as a share of GDP and as a share of revenue. Debt interest costs remain elevated over the medium term, which is partially explained by the UK's economic outlook deteriorating significantly over the course of 2022, as detailed in Chapter 2. If debt interest spending were a government department, its departmental budget would be second only to the Department for Health and Social Care. The government is expected to spend more than 11% of its revenue on debt interest in 2022-23, the highest level since the 1960s. This is spend which could have otherwise been spent on funding vital public services.

4.8 Without the actions taken at Autumn Statement 2022, underlying debt (public sector net debt excluding the Bank of England) would have been rising by 1.0% of GDP in 2027-28; the public finances would have been on an unsustainable path. The government's commitment to sustainable public finances over the medium term is underpinned by new fiscal rules set out at Autumn Statement 2022. These require public sector net debt (excluding the Bank of England) to be falling as a percentage of GDP and public sector net borrowing to be below 3% of GDP by the fifth year of the rolling forecast. They therefore ensure policy decisions are consistent with debt falling over the medium term. The OBR forecast confirms that the government is on track to meet both fiscal rules, with underlying debt falling to 97.3% of

GDP and borrowing falling to 2.4% of GDP in the target year (2027-28).

4.9 Despite the tough decisions taken, headroom against both rules is historically low – £9.2 billion against the debt rule and £18.6 billion against the borrowing rule in the target year (2027-28). OBR analysis highlights that the headroom to underlying debt falling could be wiped out by a 0.4 percentage point increase in interest rates at all maturities. To continue to meet these rules and ensure debt falls in this challenging context, spending must be restrained.

4.10 In order to put the public finances on a sustainable footing, Autumn Statement 2022 maintained the majority of department budgets in cash terms meaning departments will be required to absorb various sizeable pressures that have materialised since SR21, including:

- Consolidating 2022-23 pay awards which were significantly above the ~3% funding provided at Spending Review 2021. The consolidation of these has led to an estimated pressure of c.£3bn for PRB workforces alone (England-only) in 2023-24. This is broadly equivalent to the original funding provided at SR21 for 2023-24 awards for these workforces which, at this point in time, were expected to be in the region of 2%.
- Impact of higher inflation on public sector spending on areas such as energy and procurement.
- Additional demands on public services which have materialised since SR21 (e.g. Ukraine resettlement, asylum, greater than expected impact of Covid-19 on NHS productivity).

4.11 Given the above pressures, departments have already undertaken significant reprioritisation to make funding available for pay awards in 2023-24. Pay rises above affordability would require further reprioritisation and savings by departments. Illustratively, every additional 1% increase for all PRB awards in 2023-24 would cost c.£1.6bn in England.[30] Increases above affordability increase costs in future years; firstly by being consolidated, and secondly, as pay is increased from a higher base.

4.12 In practice, the difficult reprioritisation decisions already made and existing significant pressures departments currently face leave little room in departmental budgets for pay awards above affordability without materially impacting the government's ability to deliver policy outcomes and programme commitments.

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30 This figure rises to £2.5bn when considering all public sector workers on a UK-wide basis

This includes recruitment and other investments that impact retention of public sector workers. There is therefore a direct trade-off between recruiting more staff, investing in public services, and giving higher pay rises.

Chapter 5
Conclusion

5.1 This paper has outlined how the public sector remuneration package remains competitive, when taking account of pay, pensions and wider benefits including job security. This last benefit will likely be particularly applicable over the coming period where unemployment is expected by the OBR to rise.

5.2 Recognising the continued need to recruit, retain and motivate suitably able and qualified people across the public sector, PRBs should consider 2023-24 pay awards in relation to those in the private sector. As detailed in this paper, positive R&R trends in the public sector over the pandemic are starting to unwind, and there are areas of R&R concern within certain roles. High levels of vacancies are an economy-wide phenomenon, which are expected to ease as the labour market loosens. However, where there are acute R&R issues, pay awards should be targeted at those areas of challenge, as opposed to taking a broad-based approach. They should also complement existing measures being used by the government and recognise the other factors beyond pay at play.

5.3 PRBs should also consider the broader macroeconomic and fiscal context set out in this paper, paying particular attention to the government's inflation target. Inflation hurts people, the economic outlook, and the public finances, so ensuring it falls back to target is the number one priority for government, as evidenced by the PM's commitment to halve inflation by the end of 2023 and to a 2% target for inflation in the medium term. Inflation is forecast to have peaked and is expected to fall to 5.5% on average across 2023-24, although this is contingent on continued fiscal discipline and significant upside risks remain.

5.4 To keep public finances on a sustainable path, pay must be funded from existing budgets, because any increase in borrowing beyond the government's current fiscal plans could add to inflationary pressures. Furthermore, the Bank of England have highlighted that greater persistence in wage setting represents an upside risk to inflation. Both of these factors mean that higher pay awards could risk higher and more persistent inflation. This would in turn reduce real incomes and could push interest rates up even further, increasing borrowing costs for households and government, wiping out the limited headroom against the government's fiscal rules, and potentially burdening future generations with higher debt.

5.5 Recognising the broader fiscal context, PRBs should also note the significant pressures departments are facing on their budgets. The original funding provided at SR21 for 2023-24 pay awards has already been consumed by above-affordability pay rises in 2022-23, and significant reprioritisation has therefore been undertaken by departments to release funding for pay in 2023-24. Pay rises above affordability will therefore require further trade-offs against other priorities, including funding for frontline public services, and investment in non-pay R&R activities.

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