HM Treasury

Economic Evidence to the Pay Review Bodies

2025-26 Pay Round

December 2024

This publication is available at: www.gov.uk/official-documents.

Any enquiries regarding this publication should be sent to us at public.enquiries@hmtreasury.gov.uk

ISBN: 978-1-917151-76-4 PU: 3482

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2025-26 Pay Round

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Background

1.1 The government is committed to the independent Pay Review Body (PRB) process as the means for setting pay for frontline public sector workers and is acting to restore confidence in this process.

1.2 The government faced an immediate decision on how to respond to the PRBs' recommendations for 2024-25 pay awards when it entered office. After careful consideration of a range of factors, set out as part of the Chancellor's July spending audit in *Fixing the Foundations*,[1] the government decided to accept the headline pay recommendations in full, providing PRB workforces with the first meaningful real-terms pay increases for several years. While this was the right decision, it involved difficult trade-offs, given the challenging fiscal position that the government inherited.

1.3 The government moved swiftly after accepting the PRBs' 2024-25 recommendations to remit the PRBs for the 2025-26 pay round in September, three months earlier in the year than for 2024-25, and a step towards ensuring public sector workers receive more timely pay awards. The 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.

1.4 This document sets out the economic, labour market and fiscal context to support the independent PRBs in reaching their recommendations for 2025-26 pay awards.

[1] Fixing the foundations

Chapter 2
Macroeconomic context

Overview

2.1 A series of shocks to the UK economy in recent years contributed to Consumer Prices Index (CPI) inflation reaching its highest level in almost fifty years in October 2022. Inflation is now normalising, and maintaining low and stable price inflation is an essential pre-requisite to sustainable long-term growth.

2.2 The UK economy has flatlined in recent years having experienced low productivity, leading to stagnating growth and real wages. Productivity growth has slowed across advanced nations since the Global Financial Crisis (GFC) but has been particularly stark in the UK, leading to sizeable productivity gaps. Only sustained productivity growth over the medium term can deliver sustainable long-run economic growth and real-terms wage rises, which is why increasing productivity growth is core to the government's growth mission.

Inflation

2.3 Low and stable price inflation is an essential element of a stable macroeconomic environment, and a pre-requisite for sustainable economic growth and improving living standards.

2.4 The UK economy has faced unprecedented shocks in recent years, including the Covid-19 pandemic and Russia's illegal invasion of Ukraine, which contributed to the largest increase in inflation in almost 50 years. CPI inflation is normalising having peaked at 11.1% in October 2022 and spent 33 consecutive months above its target rate of 2.0%.

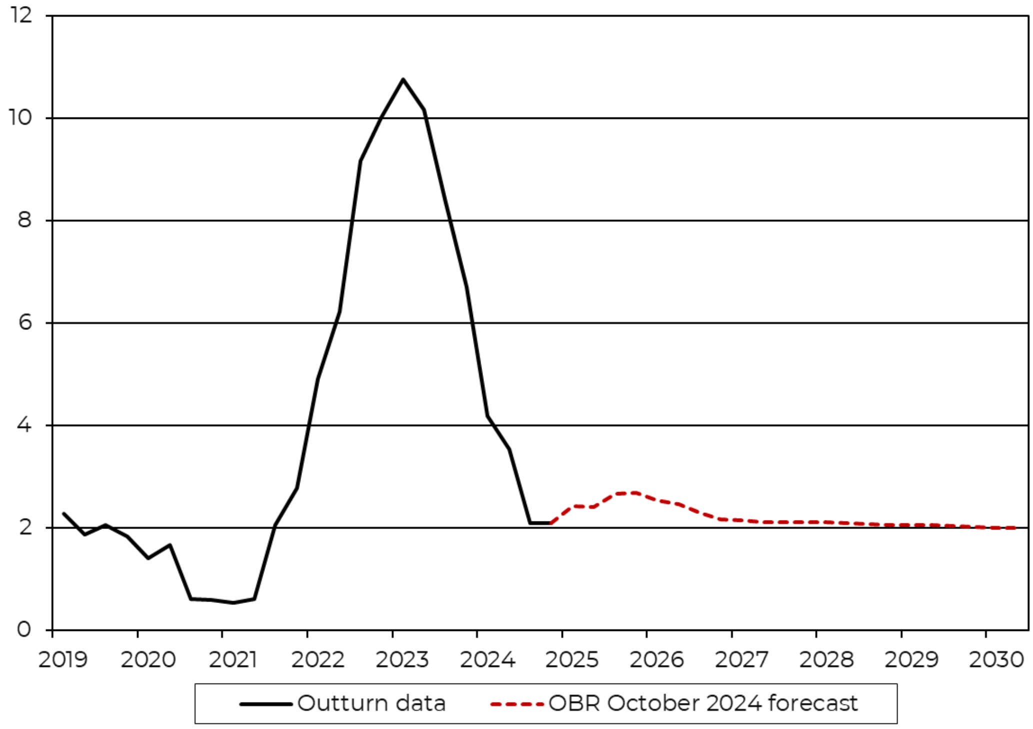
2.5 The independent Monetary Policy Committee (MPC) of the Bank of England is responsible for controlling inflation in the UK. Independent operation of monetary policy, targeting low and stable inflation, is at the heart of the macroeconomic framework. The government has reaffirmed its commitment to maintain the MPC's target of 2% inflation, as measured by the 12-month increase in the CPI.

2.6 To combat high inflation over recent years, the MPC raised interest rates to 5.25%, from 0.1% in December 2021. Although interest rates were cut to 4.75% in November 2024, they remain close to the peak of the recent tightening cycle and have resulted in higher costs for mortgage holders, businesses, and government. The MPC have recently remarked that a gradual approach to removing policy restraint remains appropriate, which itself is reliant on the economy and disinflation process evolving as expected.

2.7 The government is supporting low and stable inflation by reducing borrowing year on year, after taking the action necessary to address inherited unfunded spending pressures and protect public services in 2024-25, further detail on which is in chapter 4. As set out in the Bank of England's most recent Monetary Policy Report, this tightening of the fiscal stance helps to reduce inflationary pressure and supports the independent MPC in returning inflation sustainably to target.[2]

2.8 In their October 2024 forecast, the Office for Budgetary Responsibility (OBR) expect annual CPI inflation to remain close to the 2.0% target throughout the forecast period. The OBR forecasts inflation to average 2.3% in 2024-25, increasing slightly to 2.6% in 2025-26. It is expected to fall towards target across the final three years of the OBR's forecast period.

Figure 2.A CPI Inflation (%)



Source: ONS[3], OBR October Economic & Fiscal Outlook[4]

2 Monetary Policy Report - November 2024 | Bank of England

3 Office for National Statistics

4 Economic and fiscal outlook – October 2024 - Office for Budget Responsibility

Output

2.9 UK economic growth has been weak since the GFC, driven by low productivity growth. Annual real productivity growth (GDP per hour worked) fell by around 1.5 percentage points, from an average of 2.1% in the decade prior to the GFC, to 0.6% between 2010 and 2019. Weak economic performance has undermined living standards and contributed to the challenging fiscal position. If the UK economy had grown at the average rate of Organisation for Economic Co-operation and Development (OECD) economies over the last 14 years[5] then our GDP would be over £150 billion larger than current levels.[6]

2.10 The slowdown in productivity growth in the decade following the GFC has been observed across advanced economies, but it has been particularly sharp in the UK. Lower productivity growth has exacerbated the sizable productivity gaps between the UK and other countries, such as Germany and the US, in the decade following the GFC. The benefits of closing these productivity gaps are significant. If the UK were as productive as Germany, GDP per capita would be around £8,000 higher in today's prices. If it reached US levels, it would be around £9,000 higher.[7]

2.11 Productivity and real wages are highly correlated over the medium term. In real terms, wages across the economy (deflated by CPI) are only 1% higher than their pre-GFC level.[8] Only sustained productivity growth over the medium term can deliver sustainable long-run economic growth and real-terms wage rises. Through the growth mission, the government is restoring stability, increasing investment, and reforming the economy to drive up prosperity and living standards across the UK. Increasing productivity growth is core to the growth mission.

2.12 In their October 2024 forecast, the OBR forecast the economy to grow by 1.5% in 2024-25, before growth increases to 2.0% and 1.7% in 2025-26 and 2026-27, and then falls to around 1.5% over 2027-28, 2028-29 and 2029-30. The OBR judge that policies announced at Autumn Budget 2024 boost output in the near term and expect the package as a whole to have a net positive effect on potential output beyond the forecast horizon.

2.13 Real household disposable income (RHDI) per capita, a measure of living standards, is forecast by the OBR to grow by 1.4% in 2024-25 and 1.1% in 2025-26 and is no longer set to decline in the

5 Q2 2010 – Q3 2024

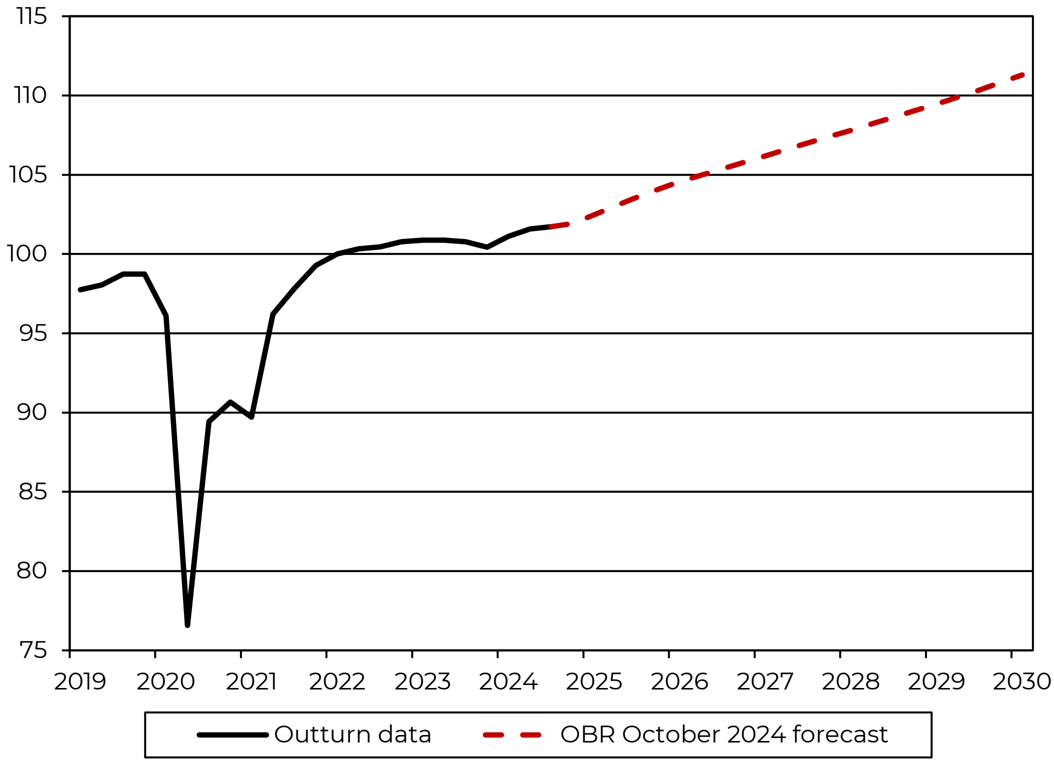
6 HMT calculations based on ONS and OECD data.

7 HM Treasury calculations based on ONS and OECD data: UK GDP per head at current market prices in 2023 (ONS IHXT) uplifted by the percentage difference in UK and Germany/US output per hour worked (OECD Productivity levels, US dollars per hour PPP converted, current prices).

8 Real Average Weekly Earnings using CPI (seasonally adjusted) in the latest data for the three months to September 2024, relative to the 2007 average.

near term, as it was projected to in the OBR's March forecast. RHDI per capita increases by 2.1% over the forecast period as a whole. RHDI captures only household income net of taxes and benefits and therefore does not reflect the benefits to households of investment in public services. GDP per capita, an alternative measure of living standards that captures higher spending on public services, is set to grow more rapidly than RHDI per capita, rising by 5.9% in total between 2024-25 and 2029-30.

Figure 2.B Real GDP (2022 Q1 = 100)



Source: ONS[9], OBR October Economic & Fiscal Outlook[10]

Uncertainties

2.14 The UK economy is exposed to risks from shifts in global trade, global spillovers from declining demand in China, and any sudden increases in financial market volatility which could tighten financial conditions. The OBR's October 2024 Economic and Fiscal Outlook particularly highlights the risk of an embedded higher path for inflation resulting from further

[9] Gross Domestic Product: chained volume measures: Seasonally adjusted £m - Office for National Statistics

[10] Economic and fiscal outlook – October 2024 - Office for Budget Responsibility

escalation of geopolitical tensions.[11] As part of this, the OBR point to the prospect of widening conflict in the Middle East and continued war in Ukraine posing a significant risk to energy prices and supply chain resilience.

2.15 The OBR have also highlighted that fiscal forecasts are highly sensitive to interest rates and inflation, given the level of debt, emphasising the uncertainty of the fiscal forecast. Further detail on fiscal policy can be found in chapter 4. Overall, economic and fiscal risks are elevated and skewed to the downside.

[11] Economic and fiscal outlook – October 2024 - Office for Budget Responsibility

Chapter 3
Labour market context

Overview

3.1 ONS data suggests that public sector pay fell relative to the private sector from the early 2010s, with previous governments having capped or frozen public sector pay in several years. Recruitment and retention has deteriorated across many public sector workforces across this period. In July, the government accepted the PRBs' 2024-25 pay recommendations, which are above forecast economy-wide average earnings growth across 2024-25. The 2024-25 pay awards should therefore support a partial reversal of the relative fall in public sector pay, and a general improvement of recruitment and retention across the public sector.

3.2 Data has shown a decline in earnings growth since the start of 2024, and this slowing is forecast to continue into the medium term, with the OBR forecasting that average earnings growth will fall to 3.0% in 2025-26. Other indicators also show that the labour market is continuing to loosen, with vacancies falling across the public and private sectors, and growth in employee numbers slowing.

Public and private sector remuneration

3.3 As the private sector is an alternative source of employment for public sector workers (and vice versa), comparisons between public and private sector remuneration are important for understanding recruitment and retention trends across public sector workforces.

ONS Annual Survey of Hours and Earnings (ASHE) data

3.4 The Annual Survey of Hours and Earnings (ASHE) has generally been recommended by the ONS as the principal source of data for comparing levels of public and private sector pay due to its large sample size and coverage of the entire United Kingdom.[12] Caution should be applied when interpreting recent ASHE data, as data for 2020 and 2021 are subject to uncertainty due to data collection issues resulting from the Covid-19 pandemic, while

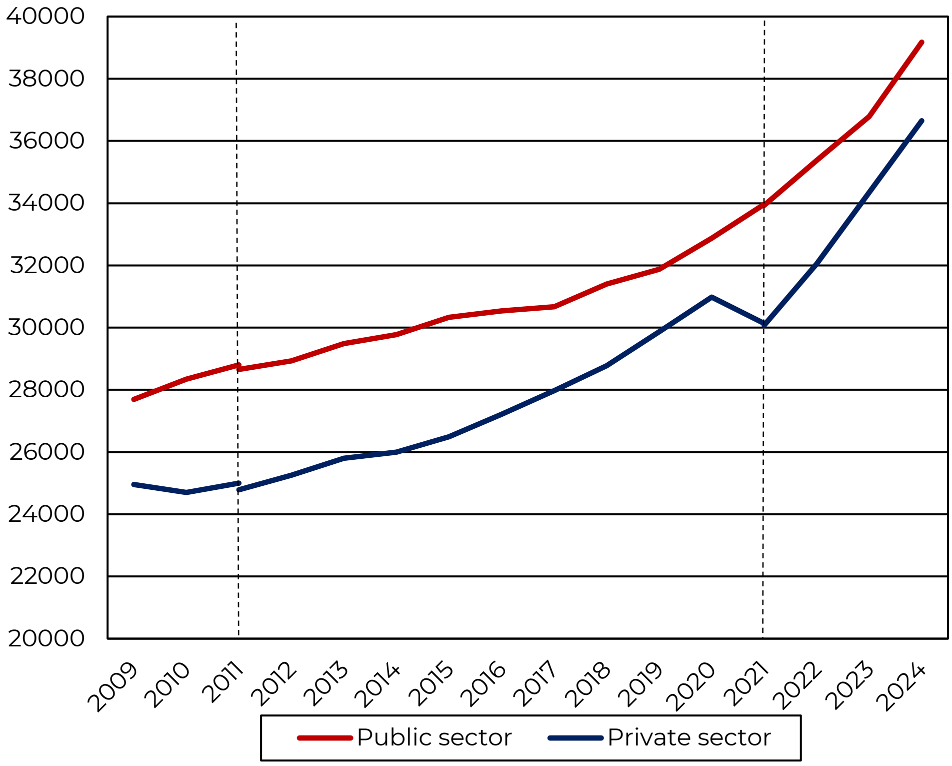
[12] Income and earnings statistics guide - Office for National Statistics

trends in pay growth in ASHE have diverged from other data sources since 2020.[13] The ONS implemented some methodological adjustment to their 2023 revised and 2024 provisional data that reduces this divergence, but have not applied this to the entire data back series.

3.5 According to ASHE data, and as shown by Figure 3.A, there has been a general decline in the gap between public and private sector median annual earnings across full-time employees since 2011, although median annual pay remained 7% higher in the public sector than the private sector in 2024.

3.6 Importantly, ASHE data is measured in April of each year. The 2024 data therefore does not reflect 2024-25 awards to PRB workforces, which did not reach pay packets until later in the year. However, the data will capture many 2024 pay awards in the private sector, which are concentrated in January and April.

Figure 3.A Median annual pay across full-time employees (£)



Source: ONS[14]. Dotted lines indicated breaks in the series due to changes in occupational classifications.

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[13] IFS – What has happened to earnings since 2019?

[14] Employee earnings in the UK - Office for National Statistics

ONS Labour Force Survey (LFS) Data

3.7 Simple comparisons of average pay across the public and private sectors do not account for the variation in employees' characteristics across the two sectors. They therefore do not give an accurate sense of the different earning potential individuals will experience between the public and private sectors. In particular, public sector workers are, on average, slightly older[15] (indicating greater experience in the labour market) and more educated[16] than their private sector counterparts, resulting in a higher average earnings potential[17] regardless of which sector they work in.

3.8 HMT regression analysis, using individual-level LFS data on gross hourly pay, controls for a range of observable characteristics to obtain a more robust estimate of the difference in earnings potential across the public and private sectors. In particular, this analysis controls for individuals' sex, age, highest level of education and region, along with whether their role is temporary or permanent, and full-time or part-time. More detail on the methodology used for this analysis is available in the annex.

3.9 Figure 3.B shows both the raw average public-private sector pay differential (the "unconditional (raw) pay differential") and the estimated differential when controlling for individual characteristics (the "conditional pay differential"). Both estimates are for public sector pay relative to the private sector (i.e., a positive differential implies public sector pay is above the private sector, and vice versa for a negative differential). Throughout the period of this analysis, the conditional pay differential is lower than the unconditional pay differential, implying that, on average, public sector workers have a higher earnings potential than their private sector counterparts, regardless of the sector they work in. However, the gap between the unconditional and the conditional differential falls over time, indicating structural changes in the composition of employees between the two sectors.

3.10 In line with the ASHE data outlined above, this analysis suggests a narrowing of the gap between public and private sector pay levels from the early 2010s. The estimated conditional pay differential falls from 7-8% in the early 2010s to -1% in the most recent outturn data for 2023-24. The results of this analysis are broadly consistent with those from the Institute for Fiscal Studies

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[15] According to the LFS data in 2023-24 the average age of those working in the public sector was 43, compared with an average age of 40 across those working in the private sector.

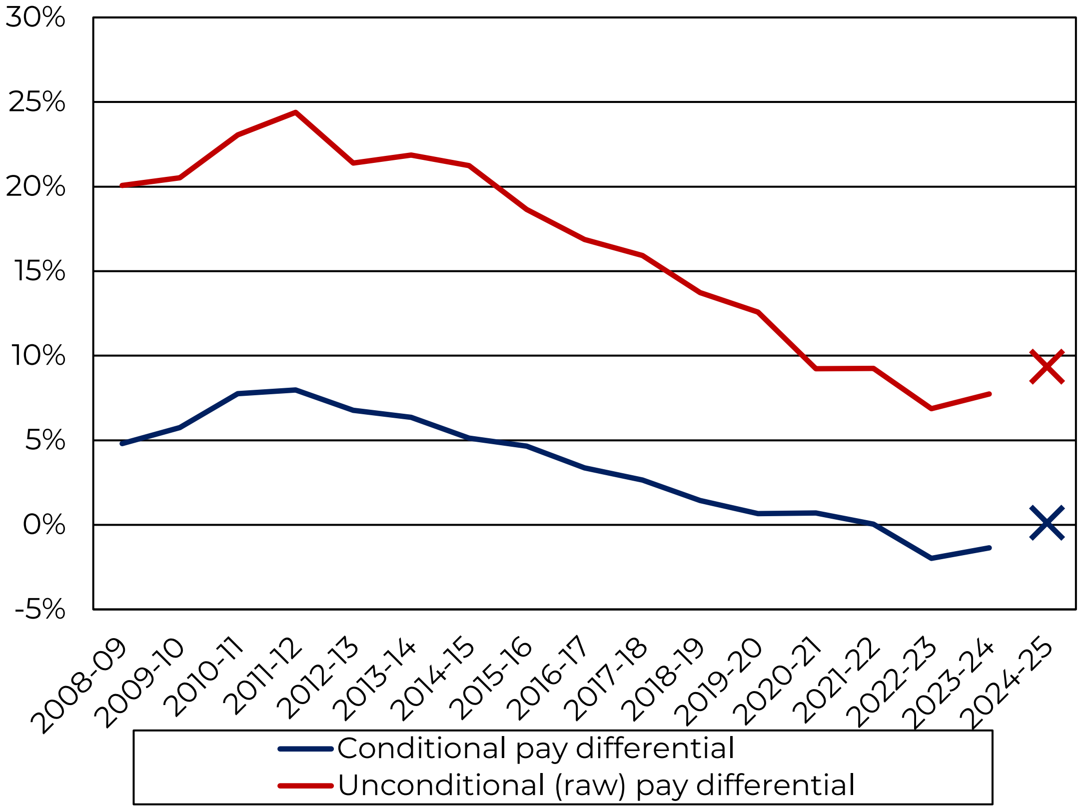
[16] According to LFS data, in 2023-24 58% of individuals working in the public sector had a degree of equivalent, compared with 39% in the private sector.

[17] Mincer's earnings function explains that earnings are a function of education and experience. Mincer, 1974 available here: c1767.pdf

(IFS)[18] and Resolution Foundation[19] who also find a fall in the pay differential from the early 2010s, and that the conditional differential becomes negative in the early 2020s.

3.11 The crosses in figure 3.B indicate HMT's analysis of the average differential after accounting for 2024-25 public sector pay awards, and the OBR's forecast for average earnings growth in 2024-25. Most 2024-25 public sector pay awards are in the region of 5-6%, and above the OBR's forecast for average earnings growth across the economy of 4.5%. Public sector pay is therefore expected to increase relative to the private sector in 2024-25, reversing some of the falls since the early 2010s. The conditional public-private pay differential is forecast to return to broadly 0%,[20] meaning that workers with similar observable characteristics will, on average, earn roughly the same across the public and private sectors. More detail on the assumptions underpinning this are available in the annex.

Figure 3.B Estimated public and private sector hourly pay differential (%)



Source: Internal analysis using ONS LFS microdata

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18 IFS Green Budget 2022 Chapter 4: Public spending, pay and pensions

19 The Resolution Foundation Labour Market Outlook Quarterly Briefing Q2 2023: LMO-Q2-2023.pdf

20 0.1% to one decimal place.

Pensions

3.12 The evidence above only accounts for pay, but pensions are also a key part of the overall remuneration package that workers receive. Public service pension schemes remain among the most generous schemes available in the UK.

3.13 Over 80% of public sector workers are part of defined benefit schemes in which employers typically contribute around 20% of earnings for future service (as of the 2020 valuations). This compares to most private sector employees who receive defined contribution pensions, and for whom employer contributions are significantly lower, with most (over 80% of) employees receiving less than 10% employer contributions.[21]

3.14 Under defined contribution schemes volatility in investment markets can affect pension outcomes for members, in contrast with the more stable level of pensions members can expect in the current public service schemes.

3.15 Excluding pensions can significantly understate the value of public sector remuneration relative to the private sector. For example, the IFS estimated in 2022 that including pensions in their analysis, referenced above, would significantly increase the conditional differential between public and private sector remuneration by around 9 percentage points.[22]

Public sector labour market

3.16 The government is changing the way in which public services are delivered, by embedding a mission-led approach. Public sector workers have a critical role to play in achieving these missions: both directly, improving public services, and indirectly, as those public services are essential to growing the economy across the country and so delivering the government's central growth mission.

Recruitment & retention across public sector workforces

3.17 Recruiting and retaining individuals with the right skills is vital for public services delivery. Recruitment and retention generally worsened across the public sector between the early 2010s and early 2020s, although has improved more recently. This is likely to have been, at least in part, a result of the fall in public sector pay relative to the private sector, as set out above. Worsening

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21 Employee workplace pensions in the UK - Office for National Statistics; Public Service pensions: 2020 actuarial valuation reports - GOV.UK

22 IFS Green Budget 2022 Chapter 4: Public spending, pay and pensions – the IFS' estimate of the conditional differential in remuneration goes from -3% in 2021 when employer pension contributions are excluded, to 6% when employer pension contributions are included.

recruitment and retention has been accompanied by a general deterioration across public services outcomes.[23]

3.18 As shown by chart 3.C, public sector employment (as a proportion of total employment) fell between the early 2010s and start of the Covid-19 pandemic. Despite the fall in employment, vacancies across public sector facing industries actually increased over this period.

3.19 After a fall during the pandemic, vacancies increased sharply across public sector facing industries[24] in its aftermath, in line with the trend across the wider economy. Vacancies have since eased back closer to pre-pandemic levels, but remain high by historical standards. Over this period, public sector employment has increased, from its low of 16.1% in late 2018, to 17.6% in the most recent data for June 2024. This primarily reflects an expansion of employment in the health sector.

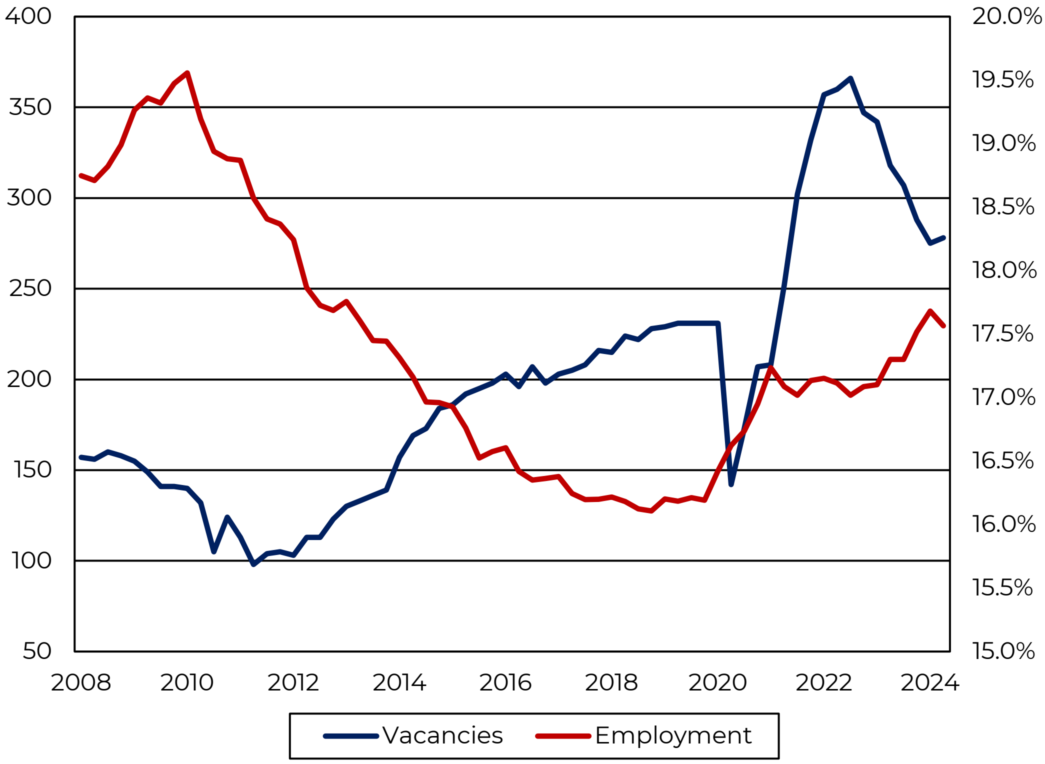
3.20 In line with these more recent trends, and the loosening of the wider labour market (on which there is more detail later in this chapter) recruitment and retention across most public sector workforces has generally improved in recent quarters. There are, however, important variations in this general position, and recruitment and retention remains a challenge for some workforces. Departments are setting out in their evidence to PRBs detail on the recruitment and retention position across their workforces.

3.21 It is expected that the anticipated improvements in relative public sector pay set out above should support a further improvement of recruitment and retention across the coming year. The government is also taking broader action to support participation in the labour market, for instance, through strengthening women's employment rights, increasing the Carer's Allowance weekly earnings limit, expanding government-funded childcare, and through the reforms included in the *Get Britain Working* White Paper. Departments' evidence will also set out any measures they are taking to support recruitment and retention, including to support wellbeing and morale and promote flexible working opportunities, where applicable.

[23] For instance, the NHS elective waiting list in England has been on an upward trend since 2010 (where is started at 2.3 million in January 2010), and has increased sharply since the start of the pandemic - from 4.4 million in December 2019, to 7.6 million in the latest data for September 2024.

[24] As some macroeconomic data does not split out activity by whether it is in the public or private sectors, the phrase 'public sector facing industries' is used to refer to the education, human health and social work, public administration and defence and arts, entertainment and recreation sectors, where public sector employment is concentrated.

Figure 3.C Vacancies across public sector facing industries (000s, left-hand side) and proportion of total employment in the public sector, excluding reclassification effects (%, right-hand side)



Source: ONS[25]

Industrial Relations

3.22 Following a period of unrest, the government has taken action to reset relations between government and public sector workforces, including by resolving the dispute with the Resident Doctor workforce.

3.23 This has involved taking action to improve confidence in the PRB process, which the government is committed to as the means for setting pay for frontline public sector workers. Following acceptance of the PRBs' headline recommendations for 2024-25, the government remitted the PRBs for the 2025-26 pay round in September, three months earlier in the year than for 2024-25, a step towards ensuring public sector workers receive more timely pay awards.

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[25] Proportion of total employment in public sector excluding classification effects calculated from ONS data available here: Public sector employment - Office for National Statistics. Vacancies across public sector facing industries calculated using ONS data available here: VACS02: Vacancies by industry - Office for National Statistics

3.24 The government is also taking steps to modernise the UK's labour market and employment rights framework, through the Plan to Make Work Pay agenda. This includes the Employment Rights Bill, which was recently introduced to Parliament. The Bill strengthens the role of trade unions and provides enhanced or new employment rights to workforces.

Labour market context

Earnings Growth

3.25 There are several different sources for timely estimates of earnings growth, although they can diverge due to differences in measurement. Despite this, most sources suggest that earnings growth has declined over the past year, with volatility in more recent public sector pay growth estimates partly reflecting the effect of one-off payments which were largely concentrated in June and July 2023.

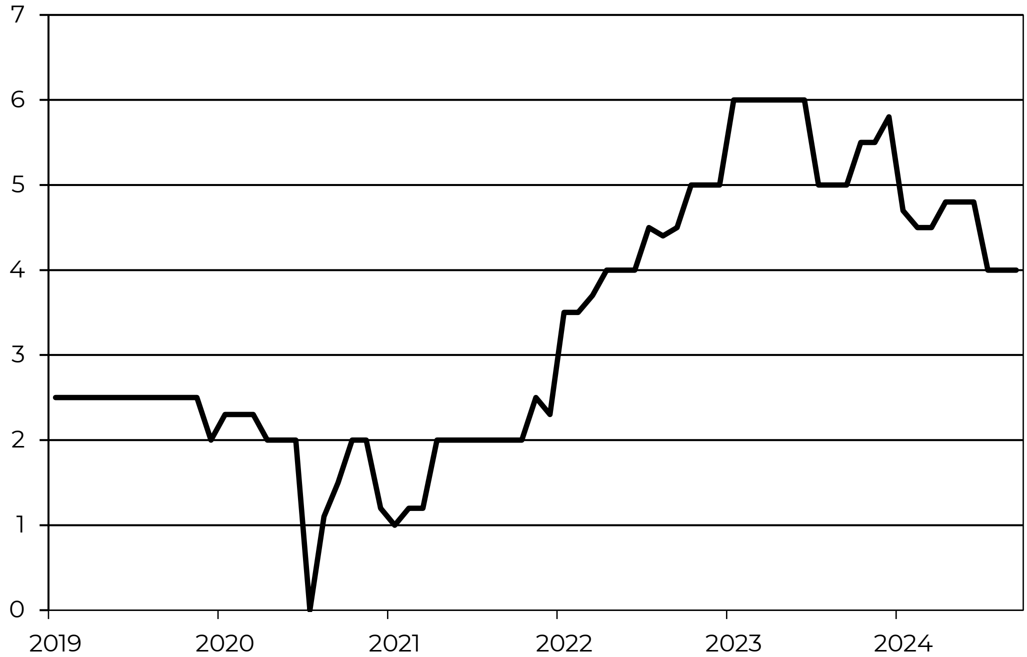
A) Settlement data

- Settlement data are the most comparable data to PRB decisions, as they are a direct measure of consolidated pay awards, and so are not affected by broader factors such as changes to working hours or changes in workforce composition, unlike many other measures of earnings growth. These estimates are therefore typically lower than headline wage growth.
- Brightmine settlement data[26] has shown pay settlements falling over the year, with median whole economy pay settlements falling to 4.0% in Q3 2024, compared to 5.0% in Q3 2023.
- The PRBs' 2024-25 recommendations averaged just under 6% in cost terms.[27] This can be compared to average whole economy pay settlements so far in 2024-25, in which median settlements were at 4.8% in Q2 2024 and 4.0% in Q3 2024.

[26] Formerly XpertHR, as referenced in HMT's Economic Evidence to the Pay Review Bodies, February 2024.

[27] Equivalent to average increase in paybill per head, which is the typical way that departments measure pay awards. This can differ from average pay awards in the case of targeted pay awards.

Figure 3.D Whole economy median pay settlements (3-month average, %)



Source: Brightmine

B) Average Weekly Earnings (AWE) data

- The ONS recommends AWE data for assessing trends in near-term earnings growth. This data provides a useful complement to ASHE data. It shows splits between the public and private sectors and across total and regular pay, which is pay including and excluding bonuses respectively, and is available on a timelier basis than ASHE data. AWE data is affected by broader pay drift, as well as pay awards, from factors such as changes in working hours and overtime. These factors affect both measures of public and private sector average earnings. As a result of this, median pay settlements were typically 0.5-1.5 percentage points lower than headline average earnings growth prior to the pandemic.[28]
- AWE data shows pay growth has fallen over the last year. Whole economy total pay growth[29] fell to 4.3% in Q3 2024, compared to 7.5% in Q3 2023. Whole economy regular pay

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[28] Page 13 National Institute UK Economic Outlook: Autumn 2021: UK-Economic-Outlook-Autumn-2021.pdf

[29] AWE data distinguishes between total pay growth, including bonuses and non-consolidated payments, and regular pay growth, excluding these payments.

growth also shows a fall to 4.8% in Q3 2024 compared to 7.8% in Q3 2023.

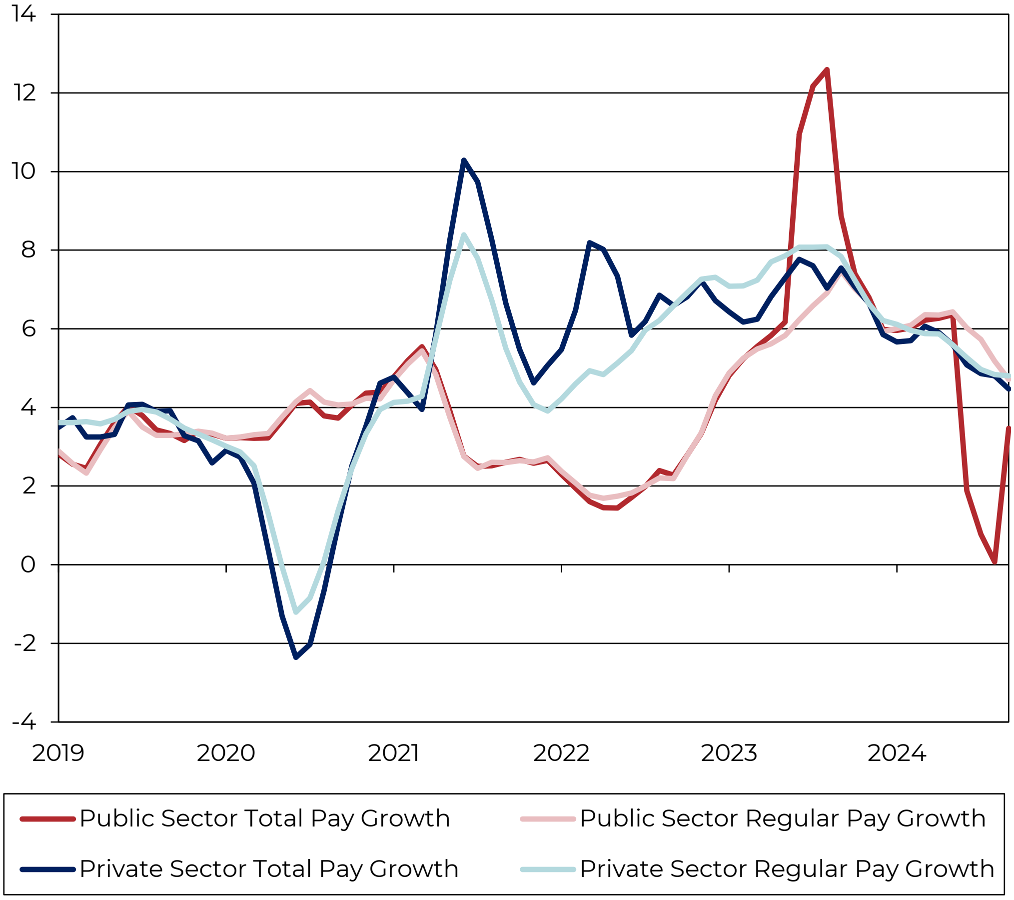
- Total pay growth data shows more of an easing than regular pay growth data, reflecting the effect of large one-off public sector payments which were largely concentrated in in June and July 2023. This includes the non-consolidated awards given to the NHS Agenda for Change workforce which averaged 6% of an individual's 2022-23 pay, and the £1,500 non-consolidated payments made in the delegated Civil Service. Public sector total pay growth fell to 3.5% in Q3 2024 in part due to these base effects, from 8.9% in 2023 Q3. Given the skews in the data, regular pay growth provides a more accurate account of underlying trends in public sector pay growth at present. This fell to 4.7% in 2024 Q3.
- Private sector regular pay growth was 4.8% in Q3 2024, broadly in line with public sector regular pay growth of 4.7%. The public sector AWE data does not yet capture the impact of many 2024-25 public sector pay awards, including the PRB awards, many of which did not reach pay packets until after Q3 2024.[30]
- In the near term, payment of 2024-25 awards for PRB workforces is expected to increase public sector earnings growth for Q4 2024. The OBR note in their October 2024 Economic and Fiscal Outlook that increases in public sector pay announced in July add around 0.5 percentage points to their forecast for whole economy pay growth in 2024.[31] Similarly, the Bank of England expect these public sector pay awards to raise whole economy average weekly earnings by around 0.5 percentage points once they are fully implemented.[32]

[30] For example, the NHS pay awards were largely paid in October.

[31] Page 42 – Office for Budget Responsibility – available here: OBR Economic and Fiscal Outlook – October 2024

[32] Page 46 – Bank of England November MPR – available here: Bank of England Monetary Policy Report November 2024

Figure 3.E Average weekly earnings total and regular pay growth (three month on year, %)



Source: ONS[33]

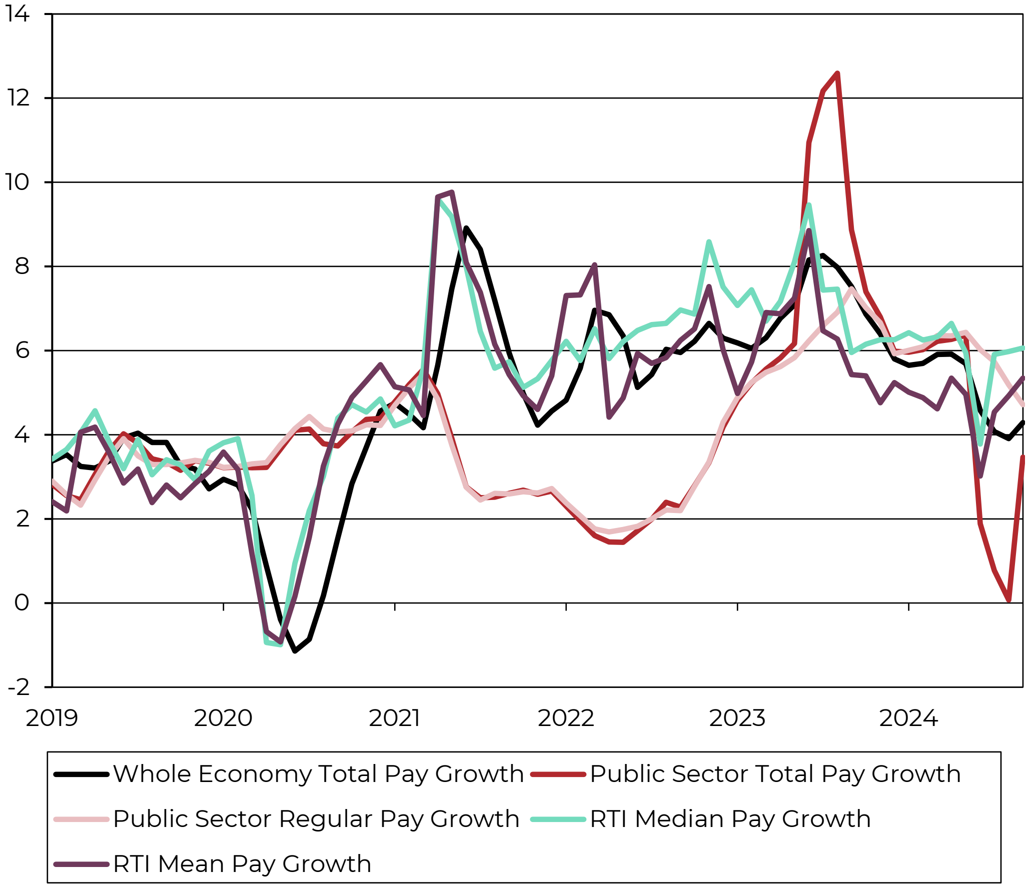
C) Other supplementary measures of wage growth

- Other measures of earnings include HMRC's Pay As You Earn (PAYE) Real Time Information (RTI), an administrative dataset covering all employees on payrolls. The RTI estimate of whole economy mean pay growth in Q3 2024 was 4.9%, a fall from 6.1% in Q3 2023. The RTI estimate of whole economy median pay growth, which is available on a timelier basis, was 6.3% in the three months to October 2024, the increase in part reflecting the implementation of more 2024-25 public sector pay awards.

[33] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/summaryoflabourmarketstatistics

- Across wider measures of pay growth, the REC/KPMG Report on Jobs shows that the rate of increase of permanent staff salaries has been falling throughout 2024. The Bank of England staff's indicator model of underlying pay growth, which is based on a statistical combination of signals from a range of pay indicators,[34] has also declined in recent quarters.
- Overall, these wider measures are also pointing to an easing in wage growth in recent quarters.

Figure 3.F Average weekly earnings and RTI pay growth measures (%)



Source: ONS[35], HMRC[36]

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[34] https://www.bankofengland.co.uk/monetary-policy-report/2024/november-2024

[35] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/summaryoflabourmarketstatistics

[36] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/realtimeinformationstatisticsreferencetableseasonallyadjusted

Employment and unemployment

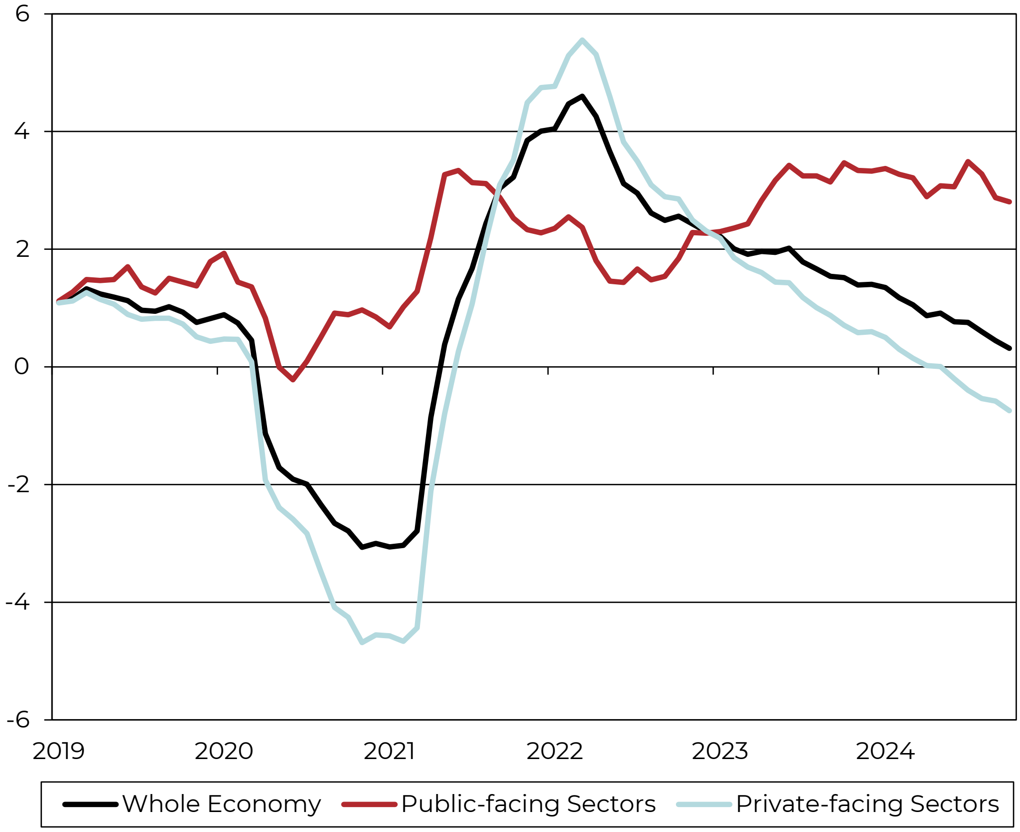
3.26 Estimates of employment growth have diverged significantly across sources in recent years. The ONS have highlighted the increased volatility of LFS estimates, resulting from smaller achieved sample sizes, and advised that estimates based on the LFS should therefore be treated with caution. The ONS recommend using a range of different sources to assess the labour market, including RTI and Workforce Jobs data.

3.27 RTI employee numbers provide a reliable account of recent trends in the number of people in work. This measure indicates that growth in employee numbers has gradually slowed over the last year, with growth at 0.3% on the year in October, compared to growth of 1.5% over the previous year. Employee numbers continued to increase in public sector facing sectors, with growth of 2.8% in the year to October 2024, but they fell by 0.7% over the same period in private sector facing sectors.

3.28 LFS data estimate total employment at 33.1 million in Q2 2024, with returns from public sector organisations estimating there are 5.9 million public sector employees, making up 17.9% of total employment.

3.29 According to LFS data, the unemployment rate in the Q3 2024 was 4.3%. This is a slight increase compared to the same point the previous year when it was 4.1%, although this data remains volatile. The Bank of England note in their latest Monetary Policy Report that broader estimates outside the LFS also suggest that the unemployment rate has been broadly flat over the last few quarters, although there remains a high degree of uncertainty around recent trends.

Figure 3.G RTI employee growth (% change on year)



Source: ONS[37]

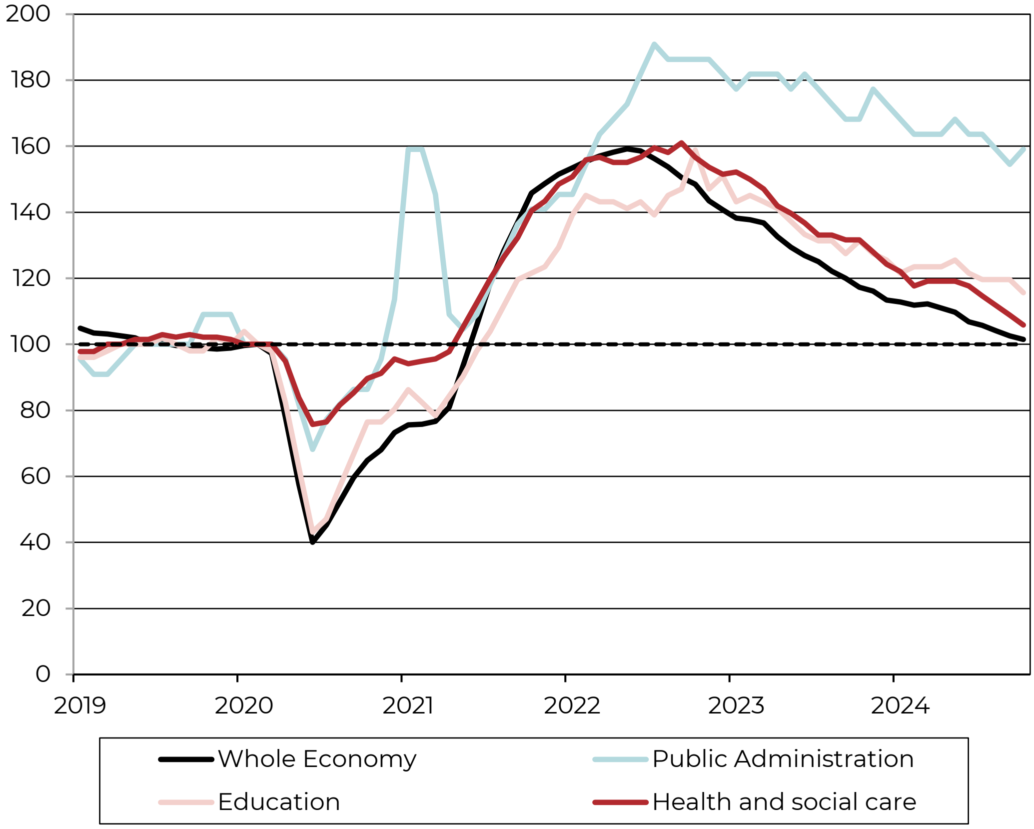
Vacancies

3.30 Vacancies have continued to fall over the last year, and had broadly returned to pre-pandemic levels in the latest data for Q3 2024, having reached record highs in 2022. Across all public sector facing sectors, vacancy levels rose from 2021 to peak in 2022 before steadily falling since then. They have fallen by 16% over the last twelve months.[38] While vacancies in education and health and social care sectors have returned to near pre-pandemic levels, vacancies in the public administration sector have remained elevated.

[37] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/realtimeinformationstatisticsreferencetableseasonallyadjusted

[38] Data for August-October 2024 compared with August-October 2023

Figure 3.H Vacancy levels (indexed, three months to Feb 2020=100)



Source: ONS[39]

3.31 Alternative measures of labour market tightness also point to a loosening in the labour market over the past year, with labour demand falling and recruitment difficulties continuing to ease across various measures. The REC/KPMG report on jobs has found that their index of demand for staff has fallen for 12 successive months. The Bank of England's Agents' measure of recruitment difficulties has fallen back to levels last seen in 2017.

[39] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/summaryoflabourmarketstatistics

Labour market outlook

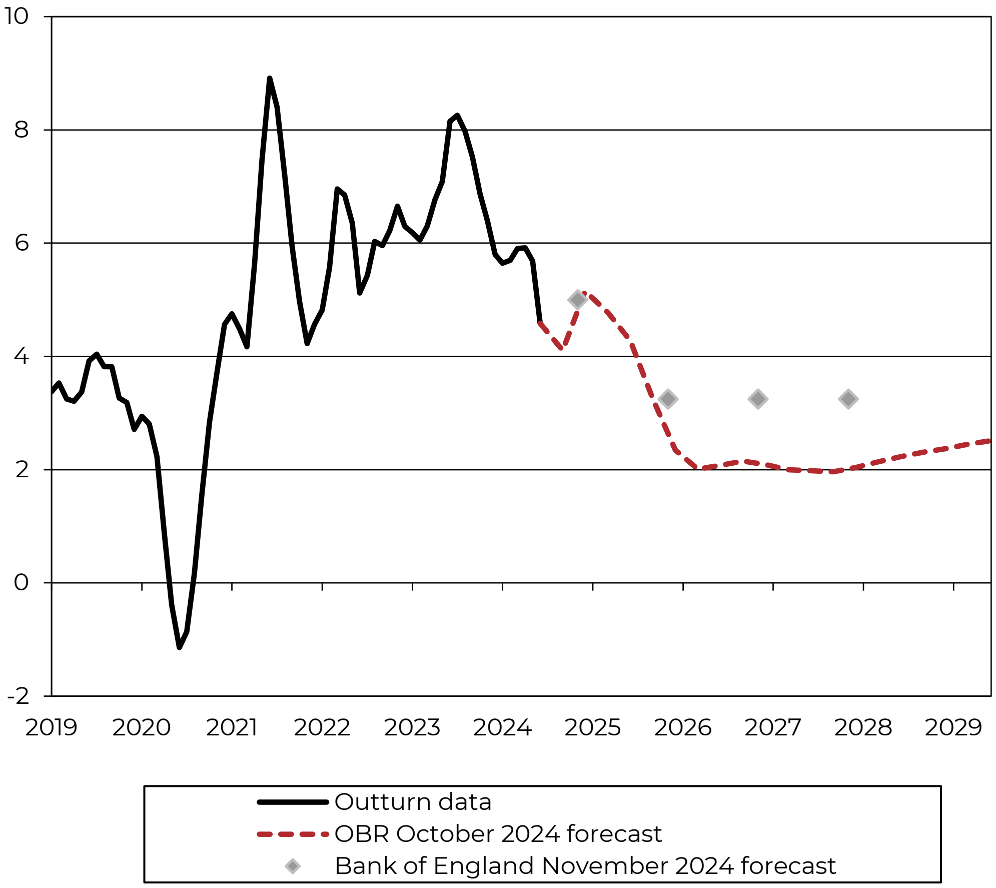
Earnings

3.32 Wage growth is expected to continue to ease over the coming year. In their October 2024 forecast, the OBR expect nominal average earnings growth to decline to 3.0% in 2025-26, and remain close to 2% between 2026-27 and 2028-29. In their November 2024 Monetary Policy Report, the Bank of England also anticipate a slowing in private sector regular pay growth, which they expect to reach 3.2% in Q4 2025. The November 2024 Comparison of Independent Forecasts points to a similar trend, indicating an average independent forecast for wage growth of 3.7% in 2025, falling to 3.3% in 2028.

3.33 As discussed above, average earnings growth has historically been higher than average pay settlements, as it is affected by compositional changes in the labour force and broader pay drift. Pay settlement data therefore provide a more directly relevant data point to the PRBs' recommendations. Brightmine conducted a survey in late October, which suggested a median pay award of 3% for the period from September 2024 to August 2025 covering a sample representing just under half a million UK employees. They note that there is little variation in forecasted pay awards between organisations. Contacts of the Bank of England's agents also expect that pay settlements will fall back to around 2%-4% in 2025.

3.34 The accelerated timing of the 2025-26 pay round, launched three months earlier than the 2024-25 round, means that greater weight should be given to forecast earnings growth.

Figure 3.I Average earnings growth (%)



Sources: ONS[40], OBR October Economic & Fiscal Outlook[41], Bank of England November Monetary Policy Report[42]

Employment

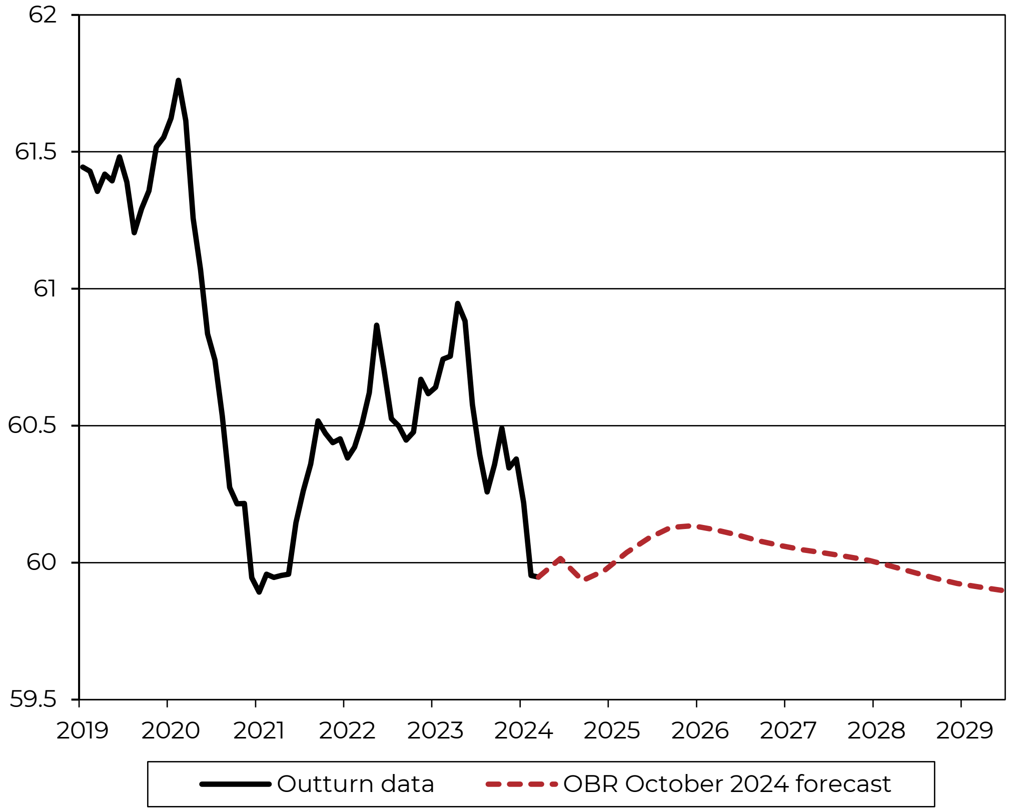
3.35 Employment levels are expected to continue to rise over the OBR's five-year forecast horizon. The OBR forecast that the employment rate is expected to remain roughly stable, at around 60% over the next five years. In their November 2024 Monetary Policy Report, the Bank of England note that an indicator-based model of employment points to a slow but positive employment growth continuing into the near term.

40 https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/summaryoflabourmarketstatistics

41 https://obr.uk/efo/economic-and-fiscal-outlook-october-2024/

42 https://www.bankofengland.co.uk/monetary-policy-report/2024/november-2024

Figure 3.J Employment Rate Outturn and Forecast (16+, %)



Sources: ONS[43], OBR October Economic & Fiscal Outlook[44]

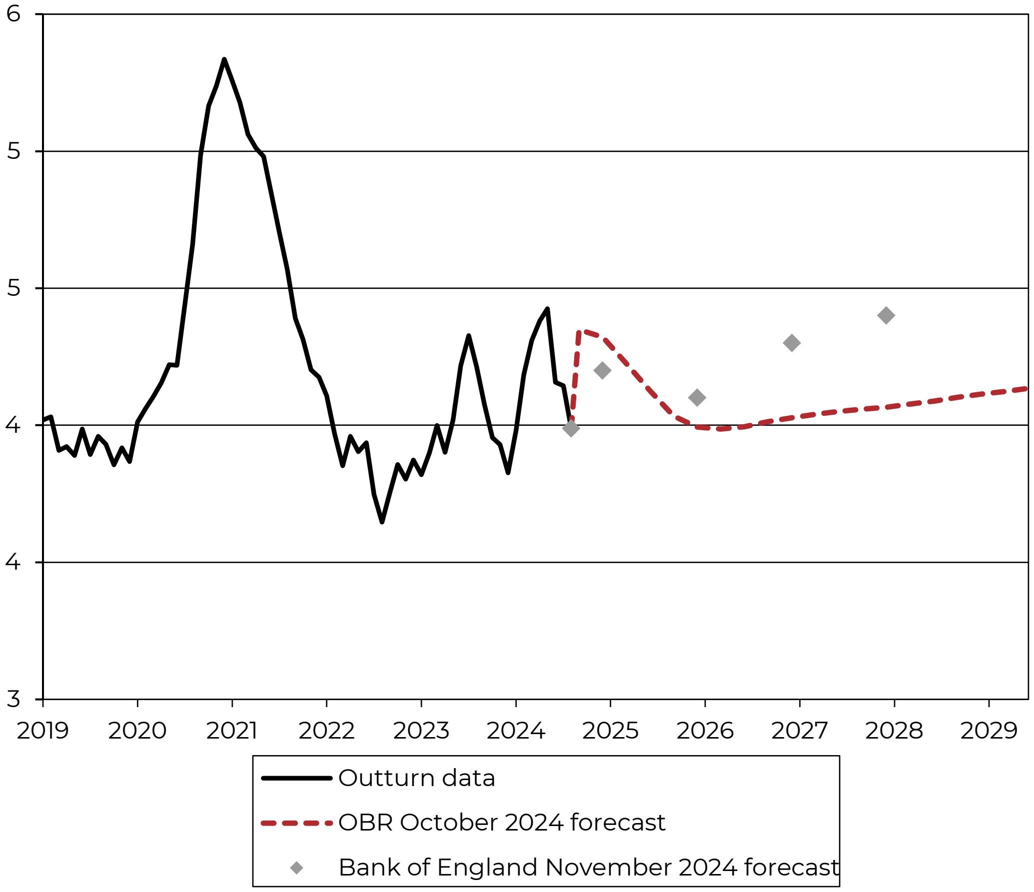
Unemployment

3.36 The OBR forecast that the unemployment rate will decline back to 4.0% in 2026 and remain at 4.1% between 2027 and 2029. The Bank forecast that the headline unemployment rate will remain at 4.3% in the medium term.

43 https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/summaryoflabourmarketstatistics

44 https://obr.uk/efo/economic-and-fiscal-outlook-october-2024/

Figure 3.K Unemployment rate Outturn and Forecast (16+, %)



Source: ONS[45], OBR October Economic & Fiscal Outlook[46], Bank of England November Monetary Policy Report[47]

45 https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/summaryoflabourmarketstatistics

46 https://obr.uk/efo/economic-and-fiscal-outlook-october-2024/

47 https://www.bankofengland.co.uk/monetary-policy-report/2024/november-2024

Chapter 4
Fiscal policy

Overview

4.1 Sustainable public finances are the foundations upon which we can grow the economy. The government announced changes at Autumn Budget 2024 which fix the foundations by supporting economic and fiscal stability, boosting investment and increasing funding for public services.

4.2 The government inherited a challenging fiscal position, and in July published an audit of public spending setting out £22 billion of in-year pressures, of which the vast majority recur in future years. To repair the public finances and help raise the revenue required to increase funding for public services, the government made difficult decisions on tax at Autumn Budget 2024 – changes worth £41.5 billion by 2029-30 – and increased borrowing by £28.1 billion in 2025-26. These changes allow for increased funding for public services, including an extra £44 billion in 2025-26. To set the public finances on a sustainable path over the medium term and beyond, the government also announced new fiscal rules which will see day-to-day spending is met by revenues and borrowing will only be for investment.

4.3 The spending envelope for the parliament and departmental budgets for 2025-26 have now been fixed, and the government is committed to living within them. The Chancellor has said that Autumn Budget was a once in a Parliament Budget to wipe the slate clean, repair the nation's finances and begin to fix public services. The government has pledged not to increase taxes on working people, protecting their payslips against higher taxes. This means no increase to the basic, higher or additional rates of income tax, no increase to employee National Insurance Contributions and no increase to VAT.

4.4 In light of this context, pay awards must be affordable within departments' budgets. Unlike in recent years, departments will not be given additional funding for pay awards in 2025-26, should the PRBs' recommendations prove unaffordable.

2024-25 pay awards

4.5 The PRBs' recommendations for 2024-25 pay awards came in materially above the funding that departments were provided for at the 2021 Spending Review, for 2% pay awards. The government accepted these recommendations. These pay awards formed part of the £22 billion of in-year pressures the government inherited and identified in its July spending audit. Given these pressures, acceptance of the 2024-25 PRB recommendations was not a decision the government took lightly.

4.6 Against the OBR's forecast for CPI inflation for 2.3% across 2024-25, the PRB awards generally in the 5-6% range provide the first meaningful real-terms pay increases for several years.

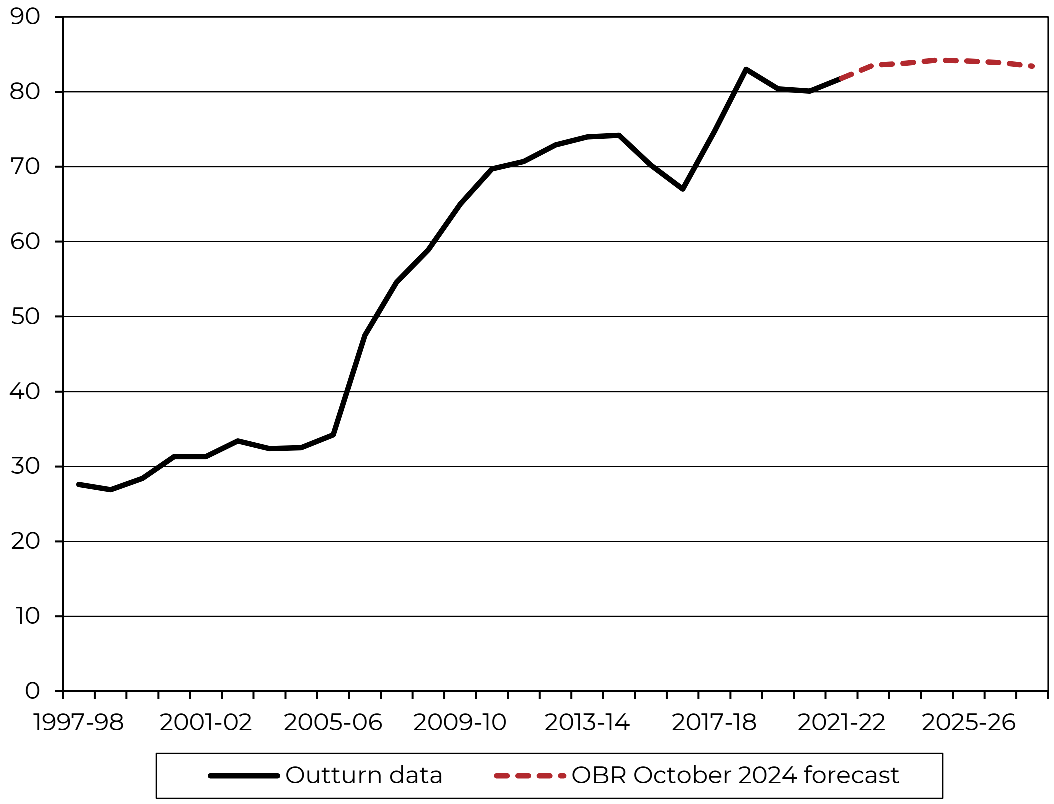
Fiscal context

4.7 The effect of the in-year pressures identified in the July spending audit are apparent in public sector finances data, where current spending for the first half of the year is £18.2 billion higher than forecast by the OBR in March 2024.[48]

4.8 Borrowing and debt remain high by historic standards. Public sector net borrowing is forecast to increase to £127.5 billion in 2024-25. This is £40.3 billion higher than the OBR forecast in March 2024, largely reflecting higher debt interest spending and in-year pressures, including as a result of public sector pay awards. Public sector net financial liabilities (PSNFL, or 'net financial debt' for short) is forecast to reach 83.5% of GDP in 2024-25, which remains close to its highest recorded level reached in the Covid-19 pandemic.

[48] Public sector finances, UK - Office for National Statistics

Figure 4.A Public sector net financial liabilities



Source: ONS[49], OBR October Economic & Fiscal Outlook[50]

4.9 The government set out changes at the Autumn Budget to set the public finances on a sustainable path, supporting economic and fiscal stability. These are essential foundations for long run-economic growth that will provide the basis for funding public services.

4.10 These changes included new fiscal rules. The first is the stability rule, to move the current budget into balance, so that day-to-day spending is met by revenues. This rule (which is the government's fiscal mandate) requires that the current budget must be in surplus in 2029-30, until 2029-30 becomes the third year of the forecast period. From that point, the current budget must then remain in balance or in surplus from the third year of the rolling forecast period. This ensures that, over the medium term, borrowing is only for investment and future generations will not be burdened with the cost of public services today and means higher day-to-day spending (such as on pay) must be funded through offsetting revenue in future years.

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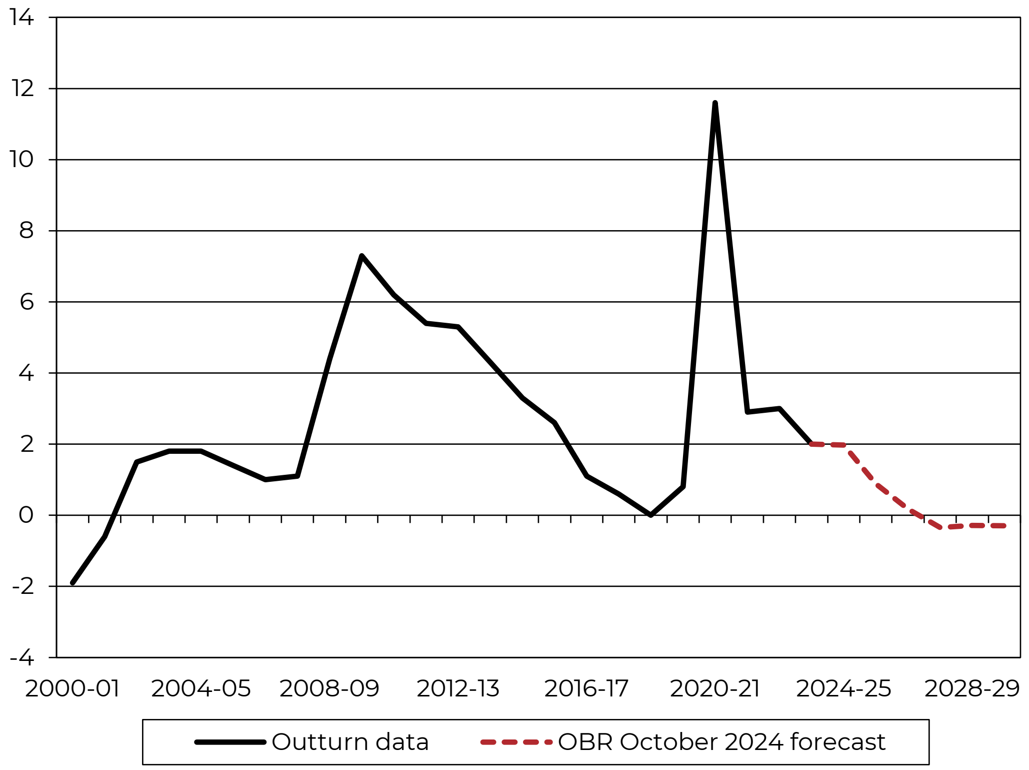
49 Public Sector Finances, Office for National Statistics, November 2024.

50 Economic and Fiscal Outlook, Office for Budget Responsibility, October 2024.

4.11 The second is the investment rule, to reduce net financial debt (defined as public sector net financial liabilities) as a share of the economy by 2029-30, until 2029-30 becomes the third year of the forecast period. Debt should then fall by the third year of the rolling forecast period.

4.12 The OBR has confirmed that the government is on track to meet its stability and investment rules. The current budget is in surplus by £9.9 billion in the target year, 2029-30. Net financial debt falls in the final year of the forecast with a £15.7 billion buffer. However, risks to these buffers remain. The OBR set out in its October 2024 Economic and Fiscal Outlook that the current budget surplus would fall to zero if, compared to their current forecast, effective interest rates were 0.3 percentage points higher at 3.7% by 2029-30, if nominal GDP growth was 0.7 percentage points lower in 2029-30, or RPI inflation was 1.1 percentage points higher by 2029-30. The OBR conclude that margins to the fiscal rules are "very small"[51] in the context of the uncertainties and risks around their central forecast.

Figure 4.B Current budget deficit, % GDP



Sources: ONS[52], OBR October Economic & Fiscal Outlook[53]

51 Page 16, Economic and Fiscal Outlook, Office for Budget Responsibility, October 2024.

52 Public Sector Finances, Office for National Statistics, November 2024.

53 Economic and Fiscal Outlook, Office for Budget Responsibility, October 2024.

Spending and taxation across the parliament

4.13 The decisions taken at Autumn Budget 2024 set realistic plans for public spending for the duration of Parliament, and the tax changes needed to ensure the government meets its new fiscal rules.

4.14 First, the government reset departmental spending for 2024-25. Building on the immediate savings identified in the July spending audit, the government increased departmental day-to-day budgets so they are now growing by 4.2% in real terms in 2024-25, enabling departments to fund 2024-25 pay awards, alongside the other pressures outlined in Fixing the Foundations.

4.15 Second, the Autumn Budget reset spending growth beyond 2024-25 to place it on a more sustainable path, settling budgets for 2025-26 and setting the resource and capital spending envelopes for Phase 2 of the Spending Review.

4.16 Under the plans set at Autumn Budget, day-to-day budgets will grow at an average of 3.3% per annum in real terms from 2023-24 to 2025-26 (totalling a £35.9 billion increase in real terms over the period), and then at a slower rate of 1.3% from 2025-26 to 2028-29 (totalling a £19.1 billion increase in real terms over the period). This is still much faster than both the period from 2010-11 to 2014-15 (-3.1%) and from 2014-15 to 2019-20 (0.1%), and faster than the 1% real-terms average growth set under the previous government's spending plans.

4.17 The government is committed to living within the spending envelope set out in the Autumn Budget. Spending beyond this would require further borrowing beyond current plans, or tax rises.

- **Borrowing**. Borrowing for current expenditure, such as pay awards, would not be sustainable over the long term. Spending needs to be considered within the constraints of the government's stability rule and investment rule where headroom is low. Additional borrowing to fund current expenditure would also increase inflationary pressures and place upward pressure on interest rates, delaying future cuts. Higher interest rates mean higher costs for mortgage holders, businesses and government, whilst OBR analysis shows a persistent 1 percentage point increase in Bank Rate and Gilt rates relative to their forecast level would increase current borrowing costs by £16.6 billion by 2029-30.

- **Tax**. The government took difficult decisions on tax at the Autumn Budget which announced tax changes worth £41.5 billion in 2029-30. The government pledged not to increase taxes on working people, protecting their payslips against higher taxes. This means no increase to the basic, higher or additional rates of income tax, no increase to employee National Insurance Contributions and no increase to VAT.

Living within the spending envelope

4.18 Departmental settlements for 2025-26 and beyond will need to fund the next round of public sector pay awards. Unlike recent years, there will be no additional funding available for pay. The Treasury has set a £4.1 billion Resource Departmental Expenditure Limit (RDEL) reserve for 2025-26, which, at 0.8 per cent of total RDEL, is just below the 1.2 per cent average RDEL reserve as a share of the total envelope set at spending reviews since 1998, but less than half the 2.2 per cent reserves set aside at each spending review since 2015.[54] The 2025-26 Reserve will only be available for genuinely unforeseen, unavoidable, and unabsorbable pressures as set out in Consolidated Budgeting Guidance.

4.19 In recent years, pay awards have also been funded by switching funding from capital budgets into resource budgets, reducing the amount of funds available for public investment. The government has changed the fiscal rules to remove the incentive to make these kinds of switches, and will be changing the Consolidated Budgeting Guidance to explicitly rule them out.

4.20 Departments are setting out their affordability positions in their own written evidence, taking account of the OBR's forecast for CPI inflation for 2025-26 at 2.6%. Each additional 1ppt pay increase across all PRB workforces costs an estimated £2.1 billion over a full pay year.[55] If awards are recommended above the level that departments have provisioned for within their budgets, the departments in question will need to reflect carefully on whether these additional costs can be borne either through offsetting savings on non-pay expenditure, including on frontline services, or through further productivity gains – and the justification for the recommendations will need to be carefully weighed against the impacts on other priorities. Departments would also need to consider the impact on their budgets beyond 2025-26, given that pay costs are recurring.

4.21 In general, as noted at the Budget, in the medium to long term real terms pay increases are only sustainable if they are matched by productivity gains. Departments will be able to fund pay awards above inflation over the medium term if they become more productive, whether that is through driving better value from existing programmes or cutting areas of wasteful or inefficient spending.

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[54] OBR Economic and Fiscal Outlook October 2024: Economic and fiscal outlook – CP 1169

[55] Excluding Barnett

4.22 The Covid-19 pandemic had a substantial impact on public services and public service productivity. Whilst public sector output has recovered to pre-pandemic levels according to the ONS public service productivity data, public service productivity is estimated to still be 8.5% below pre-pandemic levels, as inputs have grown at a faster rate over 2023 and the first quarters of 2024. By comparison, market sector multi-factor productivity did not see the same substantial negative impact from the pandemic.

4.23 Phase 2 of the Spending Review will therefore be technology enabled and reform driven, seeking to enhance productivity. The government will take a zero-based approach to setting budgets in phase 2 of the Spending Review, ensuring that every pound of spending is scrutinised. This will drive better value for the taxpayer while ensuring that funding is available for departments to continue to pay public sector workers fairly.

Chapter 5
Conclusion

5.1 The government inherited a challenging fiscal position. Accepting the PRBs' recommendations for 2024-25, and providing the first meaningful real terms pay increases for several years, was not a decision the government took lightly. While it was the right decision, given the falls in (relative) public sector pay and deteriorating recruitment and retention across the public sector, it required difficult trade-offs.

5.2 The 2024-25 awards for PRB workforces are above the OBR's forecast for economy-wide average earnings growth across 2024-25 and are therefore expected to support a general improvement of recruitment and retention across the public sector. Pensions remain substantially more generous, on average, in the public sector.

5.3 The government has taken further difficult decisions across tax, spending and welfare through the Budget and phase 1 of the Spending Review in order to repair the public finances and fix the foundations of the economy. This is on the back of weak economic growth since the global financial crisis of 2008. The government is restoring stability, increasing investment, and reforming the economy to drive up prosperity and living standards across the UK. Only sustained productivity growth over the medium term can deliver sustainable long-run economic growth and real-terms wage rises.

5.4 The Budget set the spending envelope across the parliament. Departmental settlements for 2025-26 and beyond will need to fund the next round of public sector pay awards and unlike recent years, there will be no additional funding for pay if recommended awards exceed what departments can afford. Departments are setting out their affordability positions in their own written evidence taking account of the OBR's forecast for CPI inflation for 2025-26, at 2.6%. If the PRBs recommend pay awards above the level departments have budgeted for, departments will have to consider the justification and whether these additional costs can be borne either through offsetting savings or through further productivity gains.

5.5 PRBs will consider wage growth across the wider economy when reaching their recommendations. Across different indicators, data across 2024 have shown a decline in earnings growth. Wage growth is forecast to moderate over the coming months, and be materially lower over 2025-26 than 2024-25, at 3.0% according to the OBR's forecast. The Government has brought forward the pay round this year, launching it three months earlier than the 2024-25 pay round. This makes it particularly important that the PRBs consider forecasts for wage growth, alongside the latest outturn data.

Annex A
HMT Public sector pay analysis

A.1 This annex provides details on the assumptions and methodology underpinning HMT's analysis of public-private sector pay differentials, referenced in chapter 3 and shown in chart 3.B and in chart 5.A below.

A.2 This analysis estimates both the 'unconditional pay differential', a measure of the raw difference in average hourly pay between the public and private sectors, and the 'conditional pay differential', which accounts for the different characteristics of public and private sector workers, and provides a more robust measure of the percentage difference in hourly pay a given worker would obtain in the public sector, compared with the private sector.

A.3 This analysis uses ONS Labour Force Survey (LFS) microdata which is available on a quarterly basis. The LFS is a household survey regarding the employment circumstances of the UK population.[56]

A.4 Analysis using outturn LFS data is conducted for each quarter between Q2 2008 and Q1 2024, and averaged across the financial year to account for seasonal variations. The analysis is based on individuals' reported 'average gross hourly pay'.[57] Throughout the analysis frequency weights are used in line with the ONS' recommendations.

A.5 It should also be noted that as LFS data is self-reported, it is typically seen as a less accurate measure of earnings than other data sources, and it has struggled to achieve the desired sample size in recent years. However, assuming that any biases are broadly consistent across the public and private sector, the comparison of public and private sector pay should still provide useful outputs.

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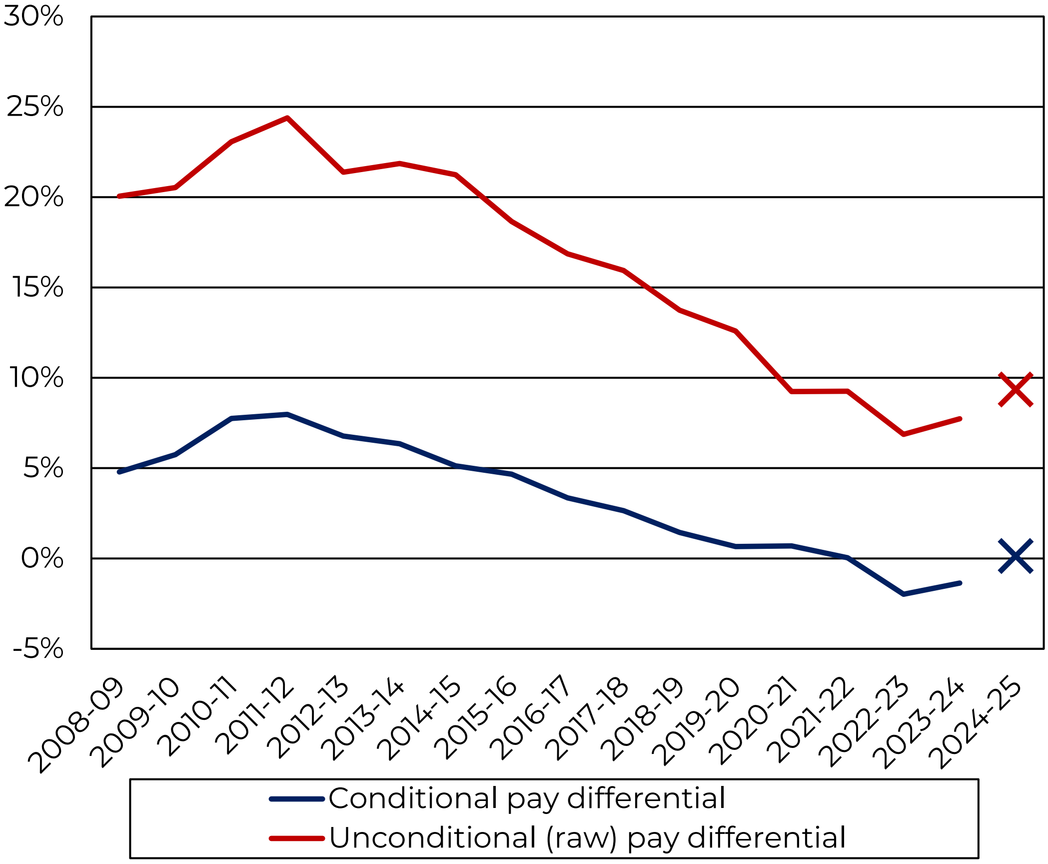
56 Labour Force Survey - Office for National Statistics

57 It is unclear whether this includes bonuses and/or overtime payments. On asking the ONS, they advised it is the respondent's discretion whether to include these payments. In order to ensure consistency, and also to avoid distortion from the impact of the one-off public sector payments in 2023, we only look at individuals who answer 'yes' to the following question: "*was your gross pay last time what you usually receive every period?*".. Doing so leads to a lower measure of the conditional pay differential in all financial years of the analysis.

Figure 5.A Estimated public and private sector hourly pay differential (%)



Source: Internal analysis using ONS LFS microdata

Unconditional pay differential

A.6 The 'unconditional pay differential' is estimated using the following Ordinary Least Squares (OLS) regression:

$$ln(Hourly\ pay_i) = \alpha + \beta_1 Public_i + \varepsilon_i$$

A.7 Where $ln(Hourly\ pay_i)$ takes the natural log (ln) of an individual i's reported average hourly pay[58] and $Public_i$ is a dummy variable indicating whether an individual works in the public sector.[59]

58 Taking the natural log of hourly pay is in line with the approach taken by the ONS in their analysis. The distribution of hourly pay is positively skewed and taking the natural log makes the distribution closer to that of a normal distribution, allowing the regression to produce more consistent estimates.

59 We drop those that are in a Public Limited Company, or a nationalised industry or state corporation.

A.8 β_1 is then converted into a percentage differential based on the formula set out in Halvorsen and Palmquist (1980)[60] which can be interpreted as the 'unconditional pay differential' between the public sector and the private sector.[61]

Conditional pay differential

A.9 The 'conditional pay differential' is estimated using the following OLS regression:

$$ln(Hourly\ pay_i) = \alpha + \beta_1 Public_i + X_i\boldsymbol{\beta} + \varepsilon_i$$

A.10 X_i is a vector of observable individual and role characteristics which include:

- Dummy variables indicating sex, highest level of education (7 options) and region (13 options);
- Age as a proxy for experience; and the square of age to account for diminishing returns to experience;
- Dummy variables to indicate if the individual is in a temporary or part-time role, and a permanent or a temporary role; and
- Interactions terms of the above variables, to capture the joint impact of some variables on earnings.[62]

A.11 These variables are conventional for this type of analysis, as they are shown to have an effect on an individual's earnings.[63] The characteristics selected are broadly in line with those used by the ONS (2020),[64] IFS (2022),[65] Resolution Foundation (2023)[66] in their analysis of the public-private sector pay differential.

A.12 β_1 is converted into a percentage differential based on Halvorsen and Palmquist (1980) which can then be interpreted as 'conditional pay differential' between the public and private sectors. It provides a more accurate estimate for the percentage

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60 Halvorsen, R. and Palmquist, R, 1980. The interpretation of dummy variables in semilogarithmic equations. American Economic Review, 70(3), 474–5, http://www.jstor.org/stable/1805237

61 A positive differential implies public sector pay is above the private sector, and vice versa for a negative differential.

62 Interactions are included between age and the square of age with each of sex and education, and between sex and education, sex and region, and education and region.

63 For example, see "Earnings Over the Lifecycle: The Mincer Earnings Function and Its Applications", Polachek, 2007, available here: Earnings Over the Lifecycle: The Mincer Earnings Function and Its Applications

64 Public and private sector earnings - Office for National Statistics

65 Public spending, pay and pensions

66 LMO-Q2-2023.pdf

difference in hourly pay a given individual can expect to get, on average, in the public sector compared with the private sector, by reducing the bias that might be introduced if the observable characteristics set out in paragraph A.10 were not accounted for.

A.13 While this analysis gives a more accurate estimate of the different earnings potential an individual may face across the public and private sectors, it does not account for differences in unobservable characteristics (such as ability and motivation) which could have an effect on differences in earnings potential between the public and private sectors.

Analysis of 2024-25

A.14 Analysis of the unconditional and conditional differential in hourly pay in 2024-25, indicated by the crosses in Chart A.1, is not conducted using outturn LFS data as this is not yet available. Instead, it takes the estimated pay differentials in 2023-24 and projects these forwards using the following assumptions:

- Average earnings growth across the private sector in 2024-25 of 4.5%, in line with the OBR's October 2024 forecast for whole economy average earnings growth. This is expected to be an upper bound given that average pay awards across the public sector for 2024-25 are expected to exceed this. The OBR have said that increases in public sector pay announced in July add around 0.5 percentage points to their whole-economy pay growth forecast in 2024.[67]
- Average earnings growth across the public sector in 2024-25 of 6.1% - this is a function of the (weighted) average public sector pay award assumed to be 5.6%,[68] and an assumption that pay drift is 0.5%.[69]
- There is no change in the average distribution of characteristics in paragraph A.10 between public and private sector workers – meaning that the modelled conditional difference in average pay increases by the same amount as the raw difference in average pay.

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67 Page 42, Economic and fiscal outlook – CP 1169

68 This is a weight average based on share of total cost of the 2024-25 pay awards for PRB workforces, the delegated Civil Service, local government, and school support staff which make-up over 80% of the UK-wide total public sector paybill.

69 This is the lower bound of the 0.5%-1.5% range that NIESR estimate that pay drift was prior to the pandemic. Page 13 National Institute UK Economic Outlook: Autumn 2021: UK-Economic-Outlook-Autumn-2021.pdf. It is in line with estimated for public sector pay drift used by the IFS, here: Options for the 2024 Spending Review and beyond | Institute for Fiscal Studies

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