HM Treasury

# Economic Evidence to the Pay Review Bodies

## 2026-27 Pay Round

December 2025

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# Contents

# Chapter 1
# Background

1.1 The government remains firmly committed to the independent Pay Review Body (PRB) process for determining pay for the majority of frontline public sector workers. Since taking office, the government has taken clear steps to strengthen confidence in the process and support timely and fair pay awards. The government has continued to make progress on delivering more timely pay awards, having delivered both the 2025-26 pay awards and remitted the 2026-27 pay round two months earlier than the previous year.

1.2 By accepting the majority of the 2025-26 pay awards[1], the government delivered a real-terms pay increase for the overwhelming majority of PRB workforces. This represents a meaningful pay rise for public sector workers for a second year in a row. This decision reflected not only the government's commitment to fairness, but also the value the government places on the vital contribution of public sector workers.

1.3 Although accepting the majority of pay awards for 2025-26 was the right decision, it required difficult trade-offs. Where recommendations were above the figures government set out as affordable within its evidence, departments had to make challenging decisions on spending and reprioritise within their budgets. There were no top-ups from His Majesty's Treasury (HMT) for pay awards. Schools were expected to fund approximately the first 1% of pay awards by maximising value from existing budgets[2], whilst the Department of Health and Social Care took measures to eliminate waste and low-value spending to ensure funds were freed up for pay, including reducing Integrated Care Board costs by 50%.[3]

1.4 The labour market has loosened over the past year, with the public finances remaining under significant pressure. As set out in Budget 2025, the government has had to make difficult but necessary decisions to further stabilise public finances, maintain investment and lower inflation. All pay awards must continue to be funded from departmental budgets. Any recommendations above the level departments have set out as affordable will require careful consideration, particularly given the Budget 2025 commitment to make further efficiencies and savings from 2028-29 onwards. If recommendations above affordable levels are accepted, it will mean challenging trade-offs, with the potential to impact the government's wider commitments to improve public services.

1.5 This document sets out the economic, labour market and fiscal context to support the independent PRBs in reaching their recommendations for 2026-27 pay awards.

[1] The recommended award for judiciary was not accepted on affordability grounds.
[2] 'Teacher pay', Department for Education, May 2025
[3] 'NHS Pay', Department for Health and Social Care, May 2025

# Chapter 2
# Macroeconomic context

## Overview

2.1 Inflation has come down from the peak seen in 2022, with recent rises in inflation due to several factors, including one-off price rises and energy price rises falling out of the annual comparison. The government is targeting inflation at its source, and the Office for Budget Responsibility (OBR) expects CPI inflation to have peaked at 3.9% in Q3 2025 and forecasts it to fall to 2.2% in 2026-27.

2.2 Despite stronger than expected economic performance in 2025, the UK faces longstanding economic challenges. For the past two decades the UK economy has experienced low productivity growth, leading to stagnating economic growth and lower real wages. Boosting productivity is key to driving long-term sustainable growth and improving living standards, which is why growth is the government's number one mission.

## Inflation

2.3 CPI inflation peaked at over 11% in October 2022,[4] following global supply chain disruption and a sharp rise in energy prices caused by Russia's illegal invasion of Ukraine. CPI inflation rose through the second half of 2024 and first half of 2025,[5] in part due to past large falls in the energy price cap dropping out of the annual comparison, one-off price rises, and higher food price inflation. Inflation has now started to fall, coming down to 3.6% in October from 3.8% in September.[6]

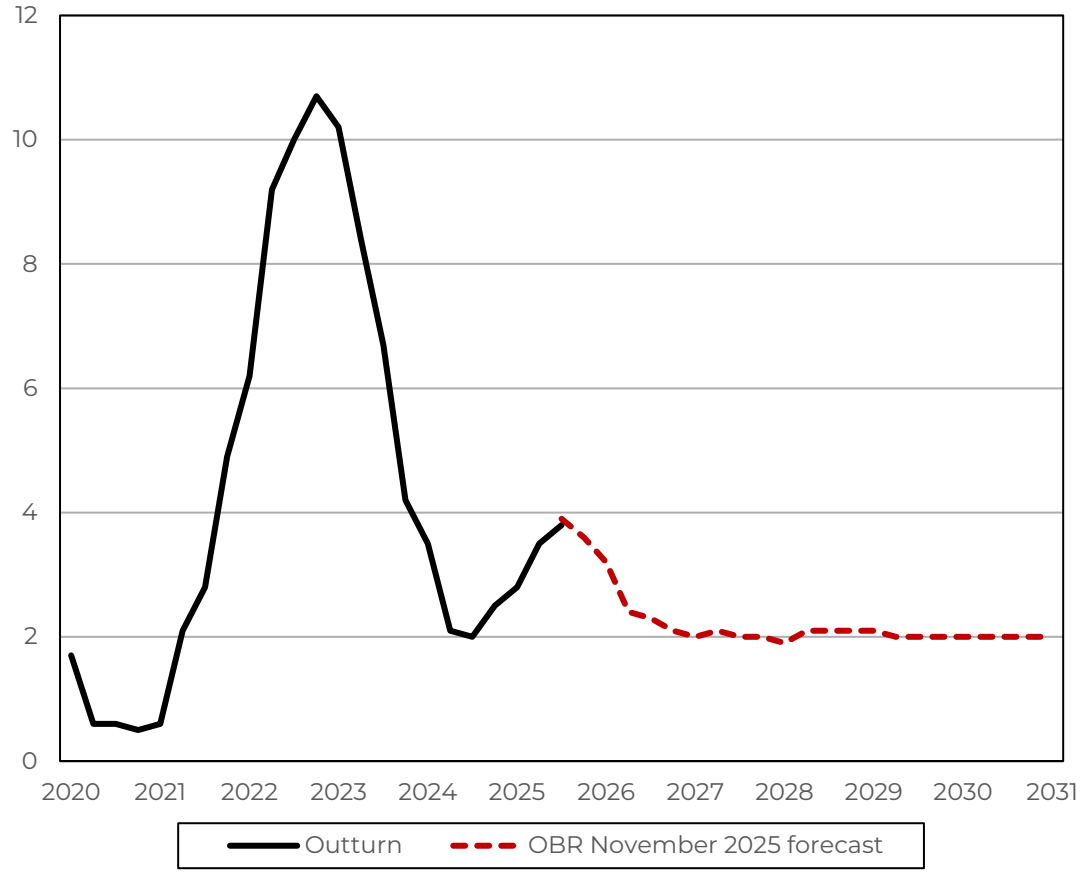
2.4 The independent Monetary Policy Committee of the Bank of England is responsible for bringing inflation to its 2% target in the UK. To support bringing inflation down to this target, the Bank Rate is currently 4.0%, up from 0.1% in December 2021.

2.5 In their November 2025 forecast, the OBR expects inflation to have peaked in Q3 2025, and that it will fall progressively to the Bank of England's 2% target in Q1 2027 – supported by a more persistent output gap reducing services inflation – where it will remain around 2% to the end of the forecast horizon.[7] The OBR forecasts CPI inflation to be 2.2% in 2026-27, 2.0% in 2027-28 and 2.1% in 2028-29.[8] The government is targeting inflation at its source by bearing down on everyday expenses such as energy bills, transport, and childcare costs. The OBR estimates the impact of government policy announced since March will reduce CPI inflation by 0.4 percentage

[4] 'Consumer price inflation tables', ONS, November 2025.
[5] 'Consumer price inflation tables', ONS, November 2025.
[6] 'Consumer price inflation tables', ONS, November 2025.
[7] 'Economic and Fiscal Outlook', OBR, November 2025.
[8] 'Economic and Fiscal Outlook', OBR, November 2025.

points in 2026-27[9] and sets out that their "CPI inflation forecast is broadly in line with the Bank of England and external forecasters – except in 2026, where policy measures announced in this Budget (which are likely not incorporated into external forecasts) reduce CPI inflation".[10] At the Treasury Select Committee, when asked about Budget 2025, Deputy Governor of the Bank of England Clare Lombardelli noted that "For us, the biggest impact is the direct impact on inflation in the relatively near term... That is a purely mechanical effect of the changes in energy prices, fuel duty and, to a lesser extent, electric vehicles and rail". The Bank of England expects the impact on inflation to be from the second quarter of 2026 and similar to that of the OBR (0.4 percentage points in 2026-27).[11]

## Figure 2.A CPI Inflation (%)




*Source: Office for National Statistics (ONS)[12], OBR November 2025 Economic & Fiscal Outlook[13]*

[9] See chart 3.4 and paragraph 3.17 of the OBR's Economic and Fiscal Outlook for further details of the measures to reduce inflation and their expected impacts in 'Economic and Fiscal Outlook', OBR, November 2025.
[10] 'Economic and Fiscal Outlook', OBR, November 2025.
[11] 'Oral evidence: Bank of England Monetary Policy Reports', Treasury Select Committee, December 2025
[12] 'Consumer price inflation tables', ONS, November 2025.
[13] 'Economic and Fiscal Outlook', OBR, November 2025.

## Productivity

2.9 Weak productivity growth has dragged on living standards and growth over the past 15 years. Prior to the COVID-19 pandemic, between 2010 and 2019, annual productivity growth averaged 0.6%, down by around 1.5 percentage points from the decade prior to the Global Financial Crisis (GFC) (1998-2007).[14] If productivity growth had continued at the pre-GFC rate, then GDP per capita could have been around £15,000 higher in 2024. Instead, productivity growth slowed significantly. While recent data has been positive – in the year to Q3 2025, productivity growth was 1.1% – at Budget 2025 the OBR downgraded its forecast for productivity growth, with potential productivity growth in 2026-27 downgraded 0.3 percentage points to 0.7%.[15] This directly impacts Gross Domestic Product (GDP) growth, which is forecast to be 1.4% in 2026.[16] Over time, lower productivity also means that workers generate less additional value per hour, reducing the scope for sustained increases in real wages without eroding UK competitiveness.

2.10 We are tackling poor productivity by investing in public infrastructure. Higher public investment increases the stock of capital in the economy, which in turn increases the level of capital per worker, productivity, and potential output. The government has also set stretching efficiency targets for the public sector. Total public service productivity in the UK fell by 0.7% in Q2 2025, compared with Q2 2024, and healthcare productivity fell by 1.5% over the same period.[17] Without improvements in efficiency, wage increases raise costs without improving outcomes.

## Risks to the outlook

2.11 There are several risks to the economic outlook. Around its central forecast, the OBR noted key risks to the economic outlook from the path of productivity growth, the Bank Rate and gilt yields, UK equity prices, and geopolitical and global trade risks.[18]

2.12 The OBR has 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.[19] Further detail on fiscal policy can be found in Chapter 4.

[14] HMT calculations based on Office for National Statistics data. Productivity flash estimate and overview, UK, ONS, November 2025
[15] 'Economic and Fiscal Outlook', OBR, November 2025.
[16] 'Economic and Fiscal Outlook', OBR, November 2025.
[17] 'Public service productivity, quarterly, UK', ONS, November 2025
[18] 'Economic and Fiscal Outlook', OBR, November 2025.
[19] 'Economic and Fiscal Outlook', OBR, November 2025.

# Chapter 3
# Labour market context

## Overview

3.1 Demand for labour has softened, reflected in falling vacancies and a slowing in private sector pay growth.[20] Wage growth is expected to continue to decline over the next year.

3.2 The government accepted the majority of the PRBs' 2025-26 pay recommendations for public sector workers. These awards followed several years in which whole-economy pay growth has been elevated, the labour market was tight, and PRB settlements broadly tracked high wage growth.

3.3 However, recent data demonstrate that public sector pay growth has outpaced private sector pay growth.[21] Whilst this is in part due to the timing of pay settlements, which have been earlier in the public sector than previous years, average PRB recommendations in 2025-26 exceeded private sector pay settlements over the same period.

3.4 When controlling for individuals' characteristics, the relative gap between public and private sector pay from the early 2010s has narrowed, and is currently estimated to be close to zero, meaning on a like-for-like basis workers on average are likely to receive similar pay in the public and private sector. This is without considering the role of pensions, which remain substantially more generous in the public sector.

## Labour Market Context

3.5 Estimates of employment growth have diverged significantly across sources. The ONS advises caution when interpreting changes in Labour Force Survey (LFS) estimates, as falling response rates and recent changes to data collection and sampling methods have affected the reliability of the data. The ONS recommends using a range of different sources to assess the labour market, including Real Time Information (RTI) and Workforce Jobs data.

3.6 Labour market conditions have loosened. His Majesty's Revenue & Customs (HMRC) RTI data, which provide a reliable and timely measure of payrolled employees, shows that employee numbers have fallen by 0.6% since October 2024.[22] This compares to an increase of 0.6% between October 2023 and October 2024.[23]

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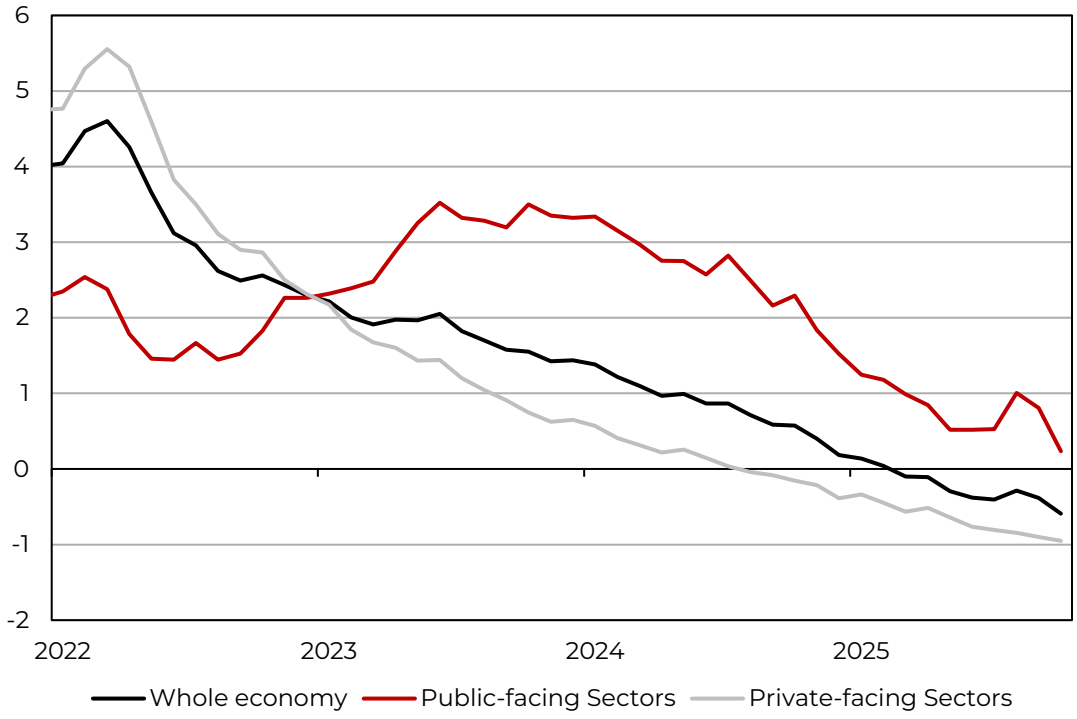
[20] 'AO1: Summary of labour market statistics', ONS, November 2025
[21] 'AO1: Summary of labour market statistics', ONS, November 2025
[22] 'Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted', ONS, November 2025
[23] 'Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted', ONS, November 2025

3.7 The decline in employees has been driven by private-facing sectors,[24] with the number of employees in these sectors declining by 0.9% in the year to October 2025. Employee growth has remained positive in public-facing sectors,[25] although the rate of growth has declined gradually (Figure 3.A). The Bank of England's measure of underlying employment, estimated using monthly survey indicators, suggests that three month on three month growth in employment was close to 0% in October 2025.[26]

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




Source: ONS[27]

3.8 According to the LFS, the unemployment rate has risen from 3.6% in the three months to August 2022 to 5.0% in the three months to September 2025.[28]

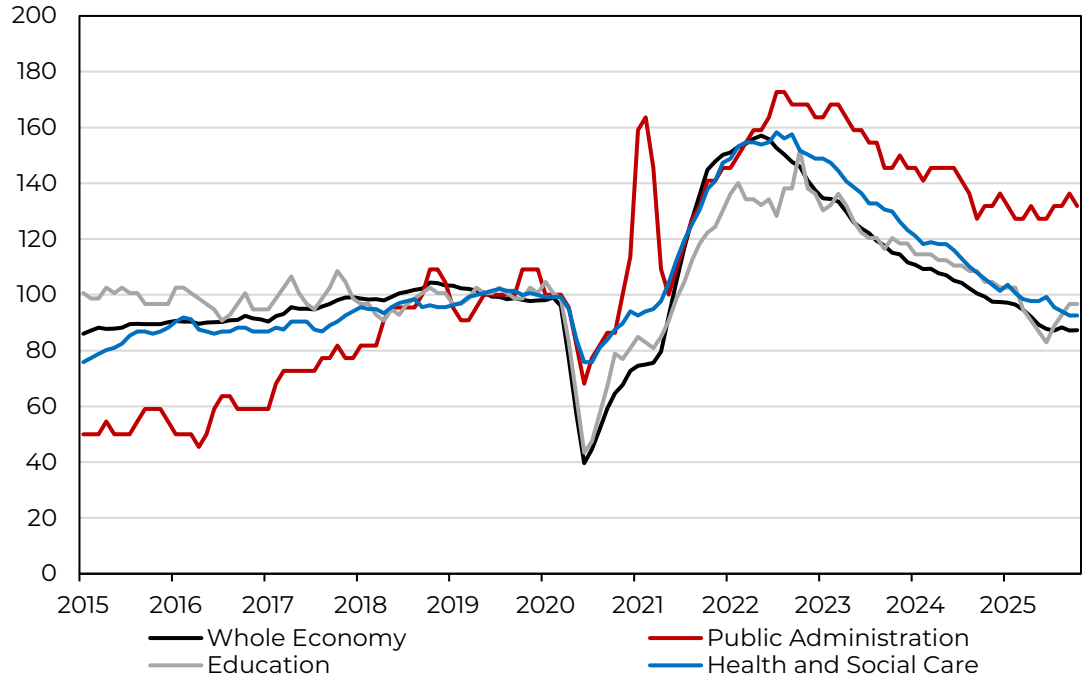
3.9 Vacancies have continued to fall over the last year,[29] indicating falling demand for labour. The total number of vacancies has fallen by 12% over the last twelve months and now stands at its lowest level, outside the pandemic period, since 2015.[30]

[24] Includes all sectors except public administration and defence, social security, education, and health and social work.
[25] Excludes all sectors except public administration and defence, social security, education, and health and social work.
[26] 'Monetary Policy Report', Bank of England, November 2025
[27] 'Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted', ONS, November 2025
[28] 'AO1: Summary of labour market statistics', ONS, November 2025,
[29] 'AO1: Summary of labour market statistics', ONS, November 2025,
[30] 'AO1: Summary of labour market statistics', ONS, November 2025,

3.10 In the public sector, vacancy levels have fallen steadily from the peaks in 2022. There remains variation within the sector: vacancies in education and health and social care sectors are now below pre-pandemic levels. However, vacancies in the public administration sector remain elevated.

3.11 Business surveys also point to falling demand for labour. The index of demand for staff from the REC/KPMG Report on Jobs has fallen for 24 successive months.[31] The ONS's Business Insights and Conditions Survey[32] and the Bank of England's Decision Maker Panel[33] data show that hiring intentions have been negative or flat throughout the year.

**Figure 3.B Vacancy levels (indexed, 2019 average =100)**




Source: ONS[34]

# Earnings Growth

3.12 There are several sources for timely estimates of earnings growth. Together, they suggest that pay growth has been easing over 2025, which is consistent with a broader loosening of labour market conditions.

## Settlement data

3.13 Settlement data are the most comparable data to PRB decisions, as they are a direct measure of consolidated pay awards and are not affected by changes in working hours or workforce composition, unlike many other measures of earnings growth. Whilst settlement data can provide an indication about the near-term up to 2026, the upcoming PRB decisions are for 2026-27.

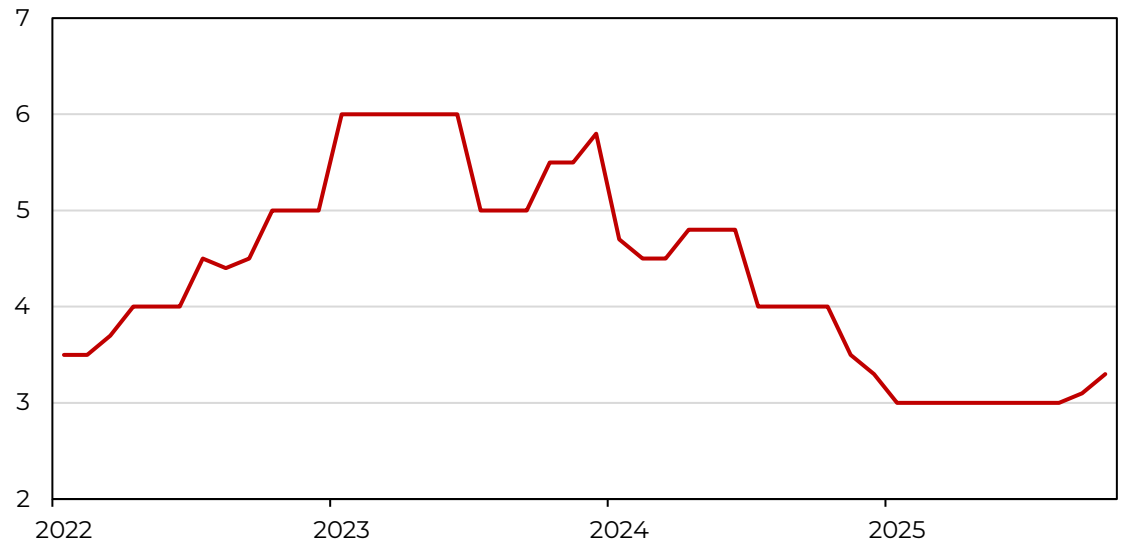
[31] 'Report on Jobs', Recruitment and Employment Confederation, November 2025
[32] 'Business insights and impact on the UK economy', ONS, December 2025
[33] 'Monetary Policy Report', Bank of England, November 2025
[34] 'A01: Summary of labour market statistics', ONS, November 2025,

3.14 Brightmine settlement data shows that pay settlements have fallen since 2023, with median pay settlements for the whole economy at 3.0% for the majority of 2025.[35] These have risen slightly over the last two releases to reach 3.3% in the three months to October 2025, although they remain below the 4.0% recorded in the three months to October 2024.[36] Private sector settlements have remained low at a median of 2.5% in the three months to October 2025.[37]

3.15 Brightmine data indicates that public sector pay settlements have been higher than private sector settlements over the past year. Private sector settlements have averaged 2.9% over 2025 so far, compared to an average of 3.6% for the public sector.[38] The average of the PRBs' 2025-26 recommendations was just under 4% in cost terms.[39]

3.16 The Bank of England Agents' Pay Survey, which excludes the public sector, shows that wage settlements for 2025 have averaged 3.9%, which is lower than the 5.3% recorded on this measure for 2024.[40] The Bank's agent contacts reported in the August 2025 MPR that settlements for 2025 were in the 3.5%-4.0% range.[41]

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




Source: Brightmine[42]

## Average Weekly Earnings (AWE)

3.17 The ONS recommends AWE data for assessing trends in near-term earnings growth. AWE offers timely splits between public and private sectors and between total and regular pay (including and excluding

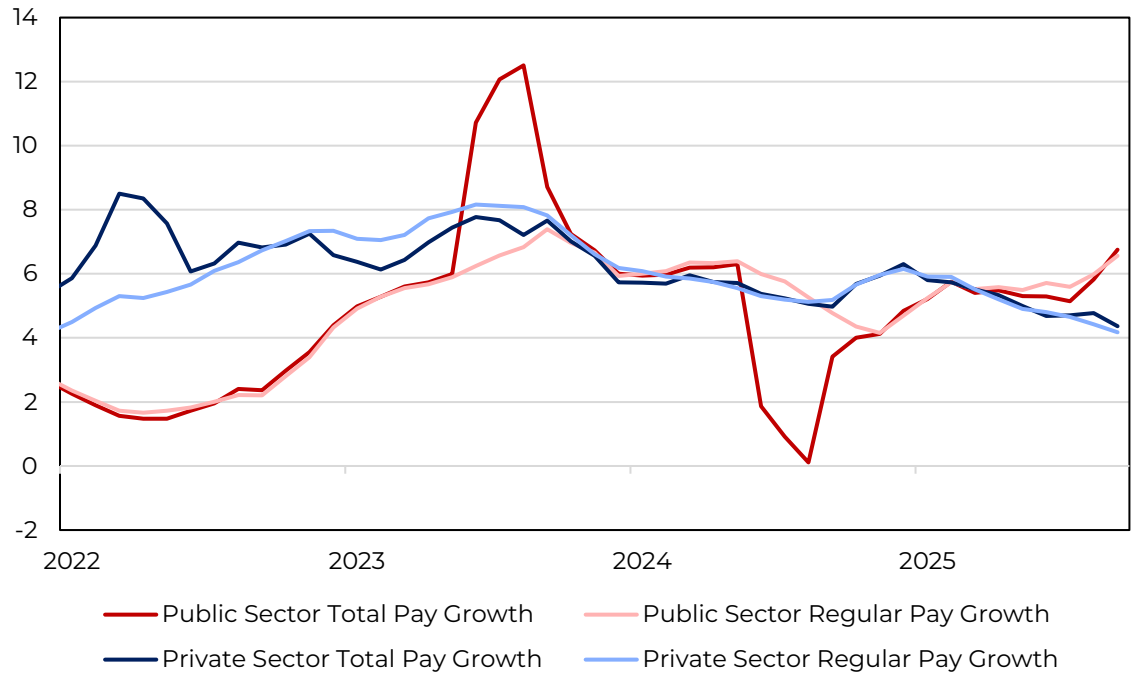
[35] 'Pay awards', Brightmine, November 2025
[36] 'Pay awards', Brightmine, November 2025
[37] 'Pay awards', Brightmine, November 2025
[38] 'Pay awards', Brightmine, November 2025
[39] HMT calculations based on taking the average public sector pay awards and weighting them by the estimated cost of the workforce.
[40] Agents' summary of business conditions, Bank of England, November 2025
[41] 'Monetary Policy Report', Bank of England, August 2025
[42] 'Pay awards', Brightmine, November 2025

bonuses, respectively). AWE is affected not only by pay awards but also by changes in working hours, overtime and workforce composition, for both public and private sectors.

3.18 Whole-economy total pay growth has, overall, fallen over the past twelve months and reached 4.8% in Q3 2025, well below the peak of 6.1% in Q4 2024.[43] Public sector total pay growth rose to 6.8% in Q3 2025, compared to 3.4% in Q3 2024, contributing to a rise in whole-economy total pay growth of 0.2 percentage points on the previous quarter.[44] This was driven by public sector pay settlements being awarded earlier this year than last year, which temporarily boosted annual growth.

3.19 Whole-economy regular pay growth, which better captures underlying trends and is unaffected by the timing of bonuses, continued to ease, falling to 4.6% in Q3 2025 from 5.1% a year earlier.[45] Private sector regular pay growth has fallen for nine consecutive releases, reaching 4.2% in Q3 2025.[46] In its November Monetary Policy Report, the Bank of England estimated that an underlying measure of AWE growth was 3.9% for the three months to August, after it adjusted for volatile movements in the data.[47]

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




*Source: ONS*[48]

[43] 'AO1: Summary of labour market statistics', ONS, November 2025,
[44] 'AO1: Summary of labour market statistics', ONS, November 2025,
[45] 'AO1: Summary of labour market statistics', ONS, November 2025,
[46] 'AO1: Summary of labour market statistics', ONS, November 2025,
[47] 'Monetary Policy Report', Bank of England, November 2025
[48] 'AO1: Summary of labour market statistics', ONS, November 2025,

### Other measures of wage growth

3.20 HMRC's Pay As You Earn (PAYE) RTI data is an administrative measure covering all payrolled employees. RTI data indicate that whole-economy mean pay growth in Q3 2025 was 5.4%, up from 4.8% in Q3 2024.[49] As with other measures, these figures reflect the effects of the timing of recent public sector pay settlements. Mean pay growth fell to 4.0% in Q2 2025.[50] The RTI estimate of whole-economy median pay growth, which is available on a timelier basis, was 5.2% in the three months to October 2025, down from 6.5% in the three months to October 2024.[51]

## Labour Market Outlook

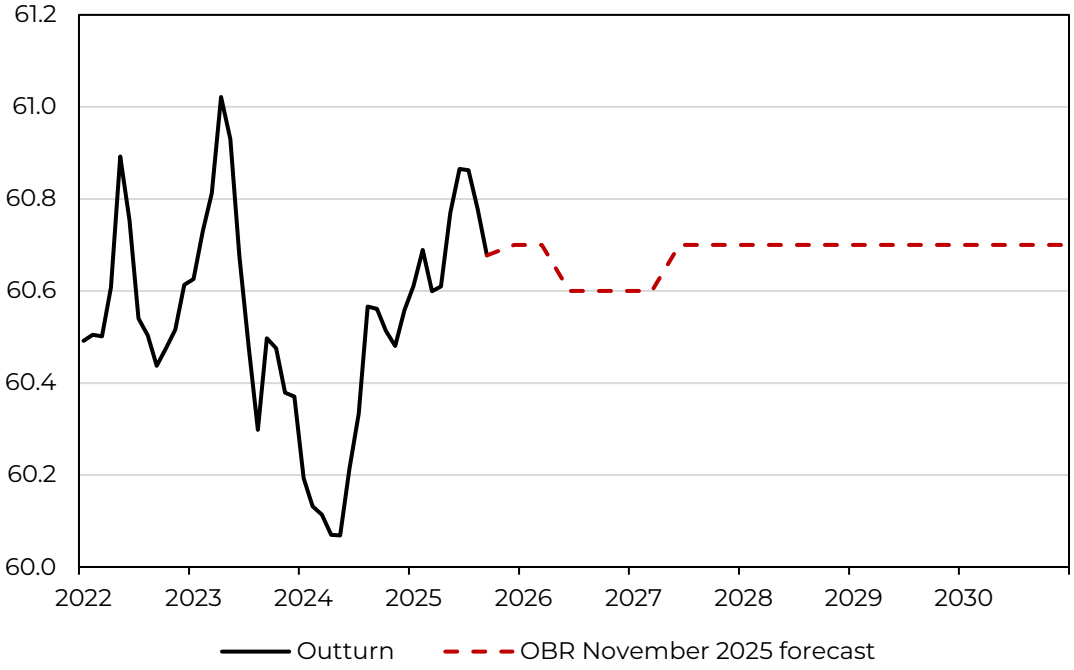
3.21 Wage growth is expected to continue to ease, consistent with the ongoing loosening of the labour market. The accelerated timing of the 2026-27 pay round, launched two months earlier than the 2025-26 round, means that forecasts of earnings growth and the wider labour market are particularly relevant for PRB deliberations.

### Employment and unemployment

3.22 The OBR forecasts that the 16+ employment rate will fall from 60.9% in Q2 2025 to 60.6% in 2026-27 and then remain roughly stable over the next five years.[52] The OBR also forecasts the unemployment rate to be 4.9% in 2026-27 and then gradually fall to 4.1% by the end of the forecast period.[53] The Bank of England forecasts that the headline unemployment rate will remain at 4.8% in the medium term.[54]

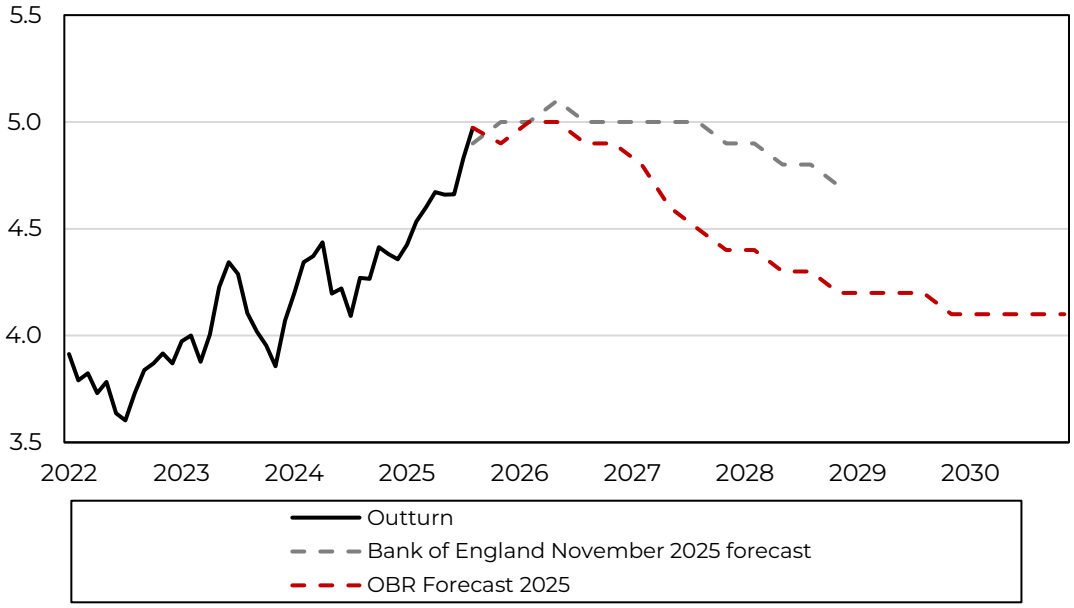
[49] 'Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted', ONS, November 2025
[50] 'Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted', ONS, November 2025
[51] 'Earnings and employment from Pay As You Earn Real Time Information, seasonally adjusted', ONS, November 2025
[52] 'Economic and Fiscal Outlook', OBR, November 2025.
[53] 'Economic and Fiscal Outlook', OBR, November 2025.
[54] 'Monetary Policy Report', Bank of England, November 2025

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




*Source: ONS[55], OBR November 2025 Economic & Fiscal Outlook[56]*

## Figure 3.F Unemployment Rate Outturn and Forecast (16+, %)




*Source: ONS[57], OBR November 2025 Economic & Fiscal Outlook[58], Bank of England November 2025 Monetary Policy Report[59]*

[55] 'AO1: Summary of labour market statistics', ONS, November 2025,
[56] 'Economic and Fiscal Outlook', OBR, November 2025.
[57] 'AO1: Summary of labour market statistics', ONS, November 2025,
[58] 'Economic and Fiscal Outlook', OBR, November 2025.
[59] 'Monetary Policy Report', Bank of England, November 2025

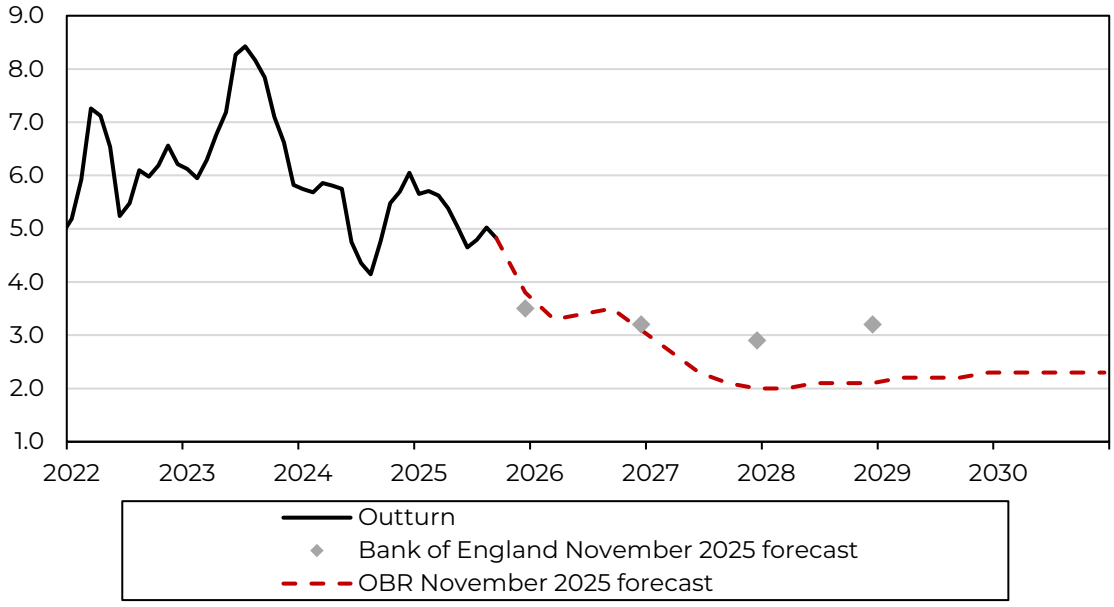
## Earnings growth

3.23 The OBR forecasts nominal average weekly earnings growth to decline to 3.2% in 2026-27 and to remain between 2.1% and 2.3% between 2027-28 and 2030-31.[60] This measure represents weekly earnings growth and is therefore affected by changes in average hours worked. The OBR forecasts average hourly earnings growth of 2.6% in 2026-27, 2.3% in 2027-28 and 2.2% in 2028-29.[61] In its November 2025 Monetary Policy Report, the Bank of England forecasts a slowing in private sector regular pay growth, reaching 3.2% in Q2 2026.[62]

3.24 Settlement data also provides an indication for the near term forward look for pay settlements. Brightmine data shows that organisations are forecasting a median 3% pay award over the next 12 months.[63] Evidence from the Bank of England's Agents suggests that pay settlements will also ease further in 2026, with the most recent Agents' report stating that early indications for 2026 could average around 3.5%.[64]

3.25 The November 2025 Comparison of Independent Forecasts also points to an expected easing of pay growth, indicating an average independent forecast for wage growth of 4.1% in 2025, falling to 3.2% in 2026.[65]

### Figure 3.G Average earnings growth (%)




*Sources: ONS[66], OBR November 2025 Economic & Fiscal Outlook[67], Bank of England November 2025 Monetary Policy Report[68]*

[60] 'Economic and Fiscal Outlook', OBR, November 2025.
[61] 'Economic and Fiscal Outlook', OBR, November 2025.
[62] 'Monetary Policy Report', Bank of England, November 2025
[63] 'Pay awards', Brightmine, November 2025
[64] 'Monetary Policy Report', Bank of England, November 2025
[65] 'Forecasts for the UK economy', HMT, November 2025
[66] 'AO1: Summary of labour market statistics', ONS, November 2025,
[67] 'Economic and Fiscal Outlook', OBR, November 2025.
[68] 'Monetary Policy Report', Bank of England, November 2025

## Public and private sector remuneration

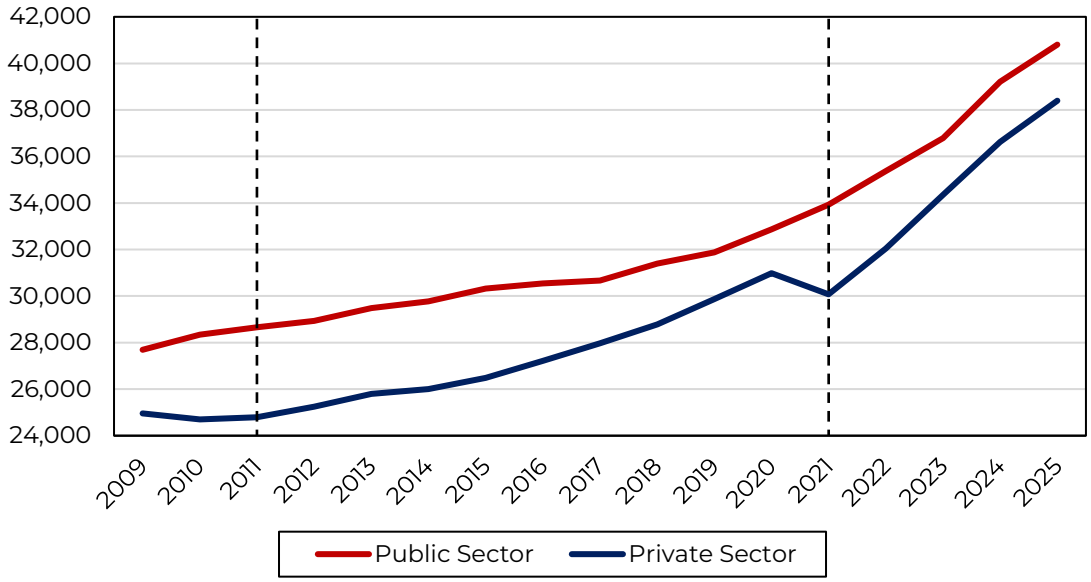
3.26 As the private sector is an alternative source of employment for public sector workers (and vice versa), comparisons between public and private sector remuneration are important for understanding recruitment and retention trends across public sector workforces.

3.27 The Annual Survey of Hours and Earnings (ASHE) continues to be the most comprehensive source of earnings information in the UK, due to its large sample size and UK wide coverage[69] [70]. This section uses ASHE data as the best source of comparisons of the level of public and private sector pay, but as this data is only released annually, it does not use it to focus on recent trends.

3.28 Annual pay was 6.3% higher in the public sector than in the private sector in 2025, with the latest estimates of £40,806 and £38,396 for median full-time annual earnings for public and private sector employees respectively in 2025.[71]

3.30 ASHE provides a snapshot of pay in April each year. The 2025 provisional release therefore reflects April 2025 pay packets. It therefore includes many private sector settlements (which are most concentrated in January and April) but excludes 2025–26 PRB awards, which did not reach pay packets until later in the year, meaning the true gap between public and private sector pay may be greater than that displayed in Figure 3.H.

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




Source: ONS Annual Survey of Hours and Earnings[72]. Dotted lines indicate breaks in the series due to changes in occupational classifications

[69] Annual Survey of Hours and Earnings (ASHE), ONS, March 2025
[70] In 2024, the ONS introduced methodological refinements, which increased average earnings estimates. These revisions continue to apply in 2025 however were not applied to the back series, creating a step-change between 2023 and 2024.
[71] Annual Survey of Hours and Earnings (ASHE), ONS, March 2025
[72] 'Earnings and hours worked, public and private sector: ASHE Table 13', ONS, October 2025

3.31 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 earnings potential individuals will experience between the public and private sectors. In particular, public sector workers are, on average, slightly older[73] (indicating greater experience in the labour market) and more educated[74] than their private sector counterparts, resulting in a higher average earnings potential[75] regardless of which sector they work in.

3.32 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 annex A.

3.33 Figure 3.I 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 conditional differential falls over time, indicating structural changes in the composition of employees between the two sectors.

3.34 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 0% in the most recent outturn data for 2024-25. The results of this analysis are broadly consistent with those from the Institute for Fiscal Studies (IFS)[76] and the Resolution Foundation[77], who also find a fall in the pay differential from the early 2010s, and that the conditional differential becomes negative in the early 2020s.

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[73] According to the LFS data in Q3 2025 the average age of those working in the public sector was 43, compared with an average age of 42 across those working in the private sector.

[74] According to LFS data, in Q3 2025 60% of individuals working in the public sector had a degree of equivalent, compared with 40% in the private sector

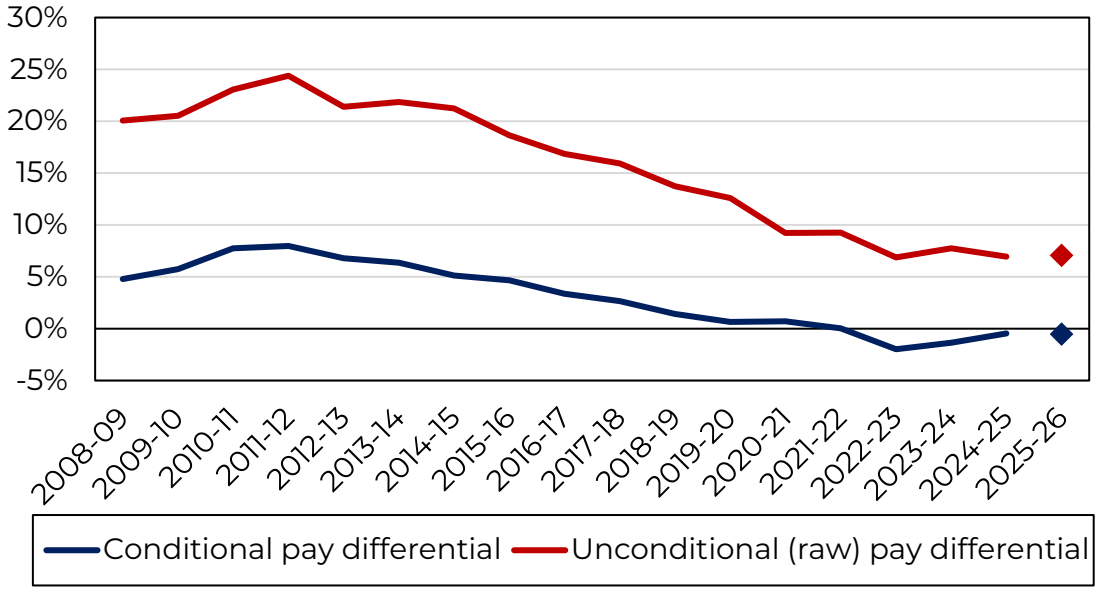
[75] Mincer's earnings function explains that earnings are a function of education and experience. Mincer, 1974 available here: c1767.pdf

[76] Green Budget, Chapter 4: Public spending, pay and pensions, IFS, October 2022

[77]The Resolution Foundation Labour Market Outlook Quarterly Briefing Q2 2023: LMO-Q2-2023.pdf 20 0.1% to one decimal place.

3.35 The diamonds in Figure 3.I update HMT's analysis of the average differential after accounting for 2025-26 average pay awards and the OBR's earnings forecast for 2025-26.[78] As set out in annex A, given the average public sector pay awards, evidence on typical pay drift in the public sector and the OBR's earnings forecast, the diamonds suggest the conditional public-private sector pay differential would remain broadly unchanged, 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 is available in annex A.

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




*Source: Internal analysis using ONS LFS microdata*

3.36 The methodology used to produce the diamonds replicates the methodology in HMT's Economic Evidence to the Pay Review Bodies for the 2025-26 pay round. That methodology, which compares public sector pay awards to earnings forecasts, suggests that there may be minimal change in the public-private sector pay differential. However, that methodology does not directly use recent labour market data on public sector pay growth relative to private sector pay growth.

3.37 Recent labour market data suggest public sector pay has been rising faster than private sector pay. Regular pay growth in the public sector (excluding financial services) in Q2 2025 was 6.1%, relative to private sector regular pay growth of 4.8%.[79] In Q3 2025, the

[78] 'Economic Evidence to the Pay Review Bodies', HMT, December 2025

[79] In the Average Weekly Earnings ONS data, between July 2009 and August 2024 Royal Bank of Scotland Group plc, known as Natwest Group plc from July 2020 was classified to the public sector; it is classified to the private sector for earlier and later time periods. Removing this group of workers from the public sector earnings statistics in August 2024 may have a compositional impact on Average Weekly Earnings statistics. We therefore use the public sector pay growth figures excluding financial services here. 'AO1: Summary of labour market statistics', ONS, November 2025.

equivalent figures were 7.1% (in the public sector, excluding financial services) and 4.2% in the private sector. However, the Q3 2025 figures (which exclude arrears and bonus payments but will reflect rises in base pay) are impacted by bringing forward the pay round. A methodology that puts greater weight on the pay growth public and private sector workers have received over the first six months of the year could predict that public sector workers will receive higher pay increases over 2025-26 than the methodology used to produce the diamonds above.

## Pensions

3.38 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.

3.39 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%) employees receiving less than 10% employer contributions.[80]

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

3.41 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 its analysis would significantly increase the conditional differential between public and private sector remuneration by around 9 percentage points.[81]

[80] Employee workplace pensions in the UK', ONS, April 2022 ; 'Public Service pensions: 2020 actuarial valuation reports' Government Actuaries Department, May 2024

[81] 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.

# Chapter 4
# Fiscal policy

## Overview

4.1 The government has set out an economic and fiscal plan underpinned by the principles of stability, investment and reform that will enable the conditions for sustainable growth and reduce the cost of living.

4.2 To deliver stability, the government has set out clear fiscal rules and is delivering a current budget surplus and a reduction in net financial debt this Parliament. This is crucial to reduce the amount spent on debt interest rather than on public services.

4.3 The government is meeting its fiscal rules and reducing borrowing as a share of GDP in every year of the forecast, but this has required choices on tax and spend.

4.4 The government has already set departmental budgets for 2026-27, 2027-28 and 2028-29. Budget 2025 announced that the government will seek to make further savings and efficiencies of £2.8bn in 2028-29, rising to £4.9bn in 2030-31.[82] This approach will require trade-offs in non-pay budgets, which would be exacerbated if pay costs were increased above what departments have outlined as affordable during this pay round.

4.5 The new savings and efficiencies target on SR25 budgets was confirmed at Budget 2025 and constitutes new information since departments' pay affordability submissions, further constraining what is affordable on pay. Continuing the approach introduced last year, departments will not be given additional funding for pay awards. Should the PRBs' recommendations exceed the affordability figures set out in written evidence, departments will have to carefully consider if further efficiencies or cuts are possible, and recommendations will have to be rejected if they prove unaffordable.

## Fiscal context

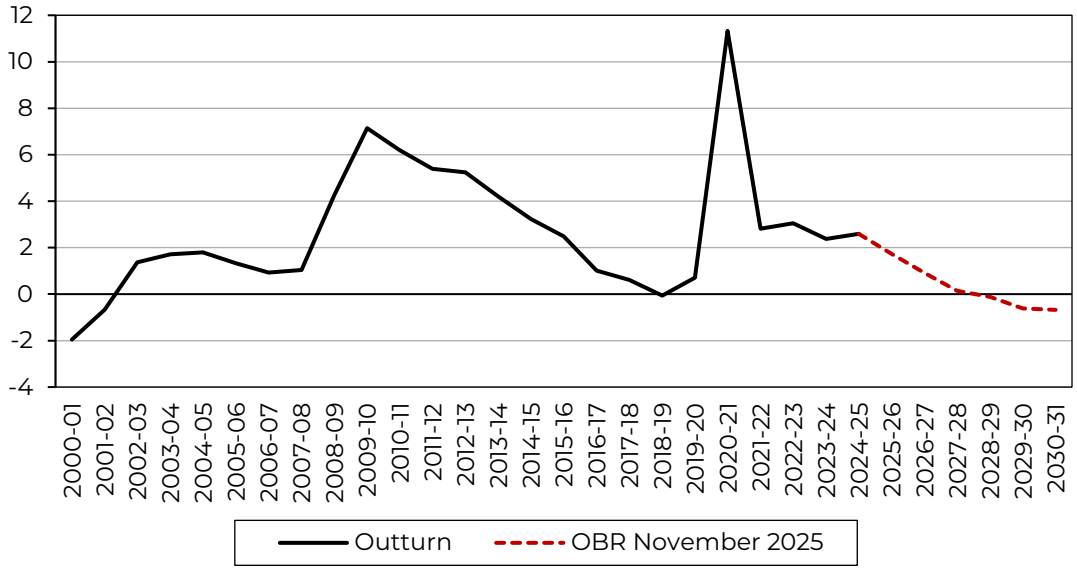
4.6 The government's fiscal strategy is to reduce borrowing and debt by meeting its fiscal rules. Debt servicing costs were over £100 billion in 2023-24 and 2024-25.[83] £1 in every £10 of public sector spending goes on servicing previously borrowed money instead of supporting public services or investment[84]. This is roughly equivalent to four

[82] 'Budget 2025', HMT, November 2025.
[83] 'Public finances databank', OBR, November 2025.
[84] 'Public sector finances', ONS, November 2025, public sector debt interest over total public sector expenditure (TME). For CDIDs: KX5Q over JW2P.

times the amount currently spent on nurses employed in the hospital and community health sector.[85]

4.7 The Budget increased the buffer against the stability rule to make the public finances more resilient. That means it is less likely that tax and spend plans will need to change in response to changes in the economy. But the public finances remain vulnerable to movements in interest rates. OBR sensitivity analysis suggests that a one percentage point increase in the Bank Rate and gilt yields would reduce the current surplus by £17 billion in 2029-30, reducing headroom to record low levels.[86]

### Figure 4.A: Current budget deficit, %GDP




*Sources: OBR November 2025 Economic & Fiscal Outlook*[87]

## Responsible decisions for stability and growth

4.8 While the government is maintaining public investment at the highest sustained level in four decades, day-to-day budgets will continue to be tight. The government is committed to living within the spending envelopes set out at Budget 2025. From 2028-29, all departments will make additional savings and efficiencies equivalent to 0.5% of their Resource Departmental Expenditure Limit (RDEL) budgets, with the NHS and the Ministry of Defence allowed to retain and reinvest savings to improve patient care and protect national security. This results in £2.8bn of savings and efficiencies in 2028-29, rising to £4.9bn by 2030-31.

4.9 The government has also made the fair and necessary decisions on tax to live within the rules. The Budget announced responsible tax decisions to raise £23.2 billion in 2029-30. As the OBR set out in its

[85] 'Public sector finances', ONS, November 2025, HMT calculations based on 'NHS Workforce Statistics – July 2025 (Including selected preliminary statistics for August 2025)', NHS England Digital and 'Pay scales for 2025/26', NHS Employers.
[86] HMT calculations based on 'Economic and Fiscal Outlook', OBR, November 2025.
[87] 'Economic and Fiscal Outlook', OBR, November 2025.

Economic and Fiscal Outlook, the tax-to-GDP ratio is forecast to increase to a post-war high of 38.3% of GDP in 2030-31[88].

4.10 In line with the government's focus on fiscal restraint, and following the inheritance of £22bn of spending pressures in 2024-25[89], the government has made a renewed effort to significantly reduce the use of the Reserve for routine departmental spending. Instead, the Reserve will return to its intended use for managing a limited number of unforeseeable, unavoidable pressures that departments cannot otherwise absorb, as set out in Consolidated Budgeting Guidance. Public sector pay awards do not meet these criteria.

4.11 As it did in 2025-26, the Treasury has also set a much smaller Reserve over Phase 2 of the Spending Review. At £4.4 billion, the RDEL Reserve for 2026-27, which forms 0.8 per cent of total RDEL, is only a third of the 2.4 per cent Reserves set aside at Spending Review 2021. Any payments made from the Reserve will also be required to be repaid in future years.

4.12 In recent years, pay awards were often 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 has explicitly ruled them out from 2025-26 in Consolidated Budgeting Guidance.[90]

4.13 These changes mean that, as was the case in 2025-26, if departments are unable to absorb 2026-27 PRB recommendations in full from within their existing budgets, they will not be able to accept them.

4.14 Departments have set out their affordability positions in their written evidence to the PRBs. Each one percentage point pay increase across all PRB workforces costs an estimated £2.1 billion over a full pay year.[91] 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 through offsetting savings on non-pay expenditure, including on frontline services. Departments will also need to consider the impact on their budgets beyond 2026-27, given that pay costs are recurring.

[88] 'Economic and Fiscal Outlook', OBR, November 2025.
[89] As set out in Fixing the foundations: public spending audit 2024-25 - GOV.UK
[90] Consolidated budgeting guidance: 2025-26 - GOV.UK
[91] Excluding Barnett, figure for 2025-26

# Chapter 5
# Conclusion

5.1 The government continues to operate in a challenging fiscal environment. Over the past two years, the government has made difficult but necessary decisions to deliver above-inflation, real terms pay increases for the vast majority of PRB workforces, reflecting the value placed on public sector workers. These decisions have required difficult trade-offs across wider public spending priorities.

5.2 At the same time, the government has taken further steps across tax, spending and welfare to strengthen public finances and lay the foundations for sustainable economic growth. The fiscal context remains tight, with departmental budgets set at the Spending Review and departments expected to manage pay within these allocations. As set out at the recent Spending Review, no additional funding will be provided for pay beyond what has already been allocated in existing settlements. Budget 2025 further announced that the government will seek to make further savings and efficiencies from 2028-29 onwards, representing 0.5% of departmental budgets set at Spending Review 2025.[92]

5.3 Departments have set out their affordability positions, taking into account the latest economic forecasts. If recommended pay awards exceed what has been budgeted for, departments will need to meet the associated costs either through offsetting savings from elsewhere or through productivity improvements. If departments are unable to absorb 2026-27 PRB recommendations in full from within their existing budgets, they will not be able to accept them. Departments will also need to consider the impact on their budgets beyond 2026-27, given that pay costs are recurring.

5.4 PRBs are asked to take full account of the latest data and forecasts for wage growth across the wider economy, which is expected to decline further in 2026-27 due to the loosening seen in the wider labour market. The OBR is forecasting average weekly earnings growth of 3.2% and hourly earnings growth of 2.6%. Inflation is also expected to fall, partly as a result of the action the government took at Budget 2025. The OBR forecasts CPI inflation to be 2.2% in 2026-27. The earlier start of this year's pay round provides an opportunity for timely and evidence-based recommendations that reflect both the economic outlook and the constraints on public spending.

[92] 'Budget 2025', HMT, November 2025.

# 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 Charts 3.I and A.1.

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.[93]

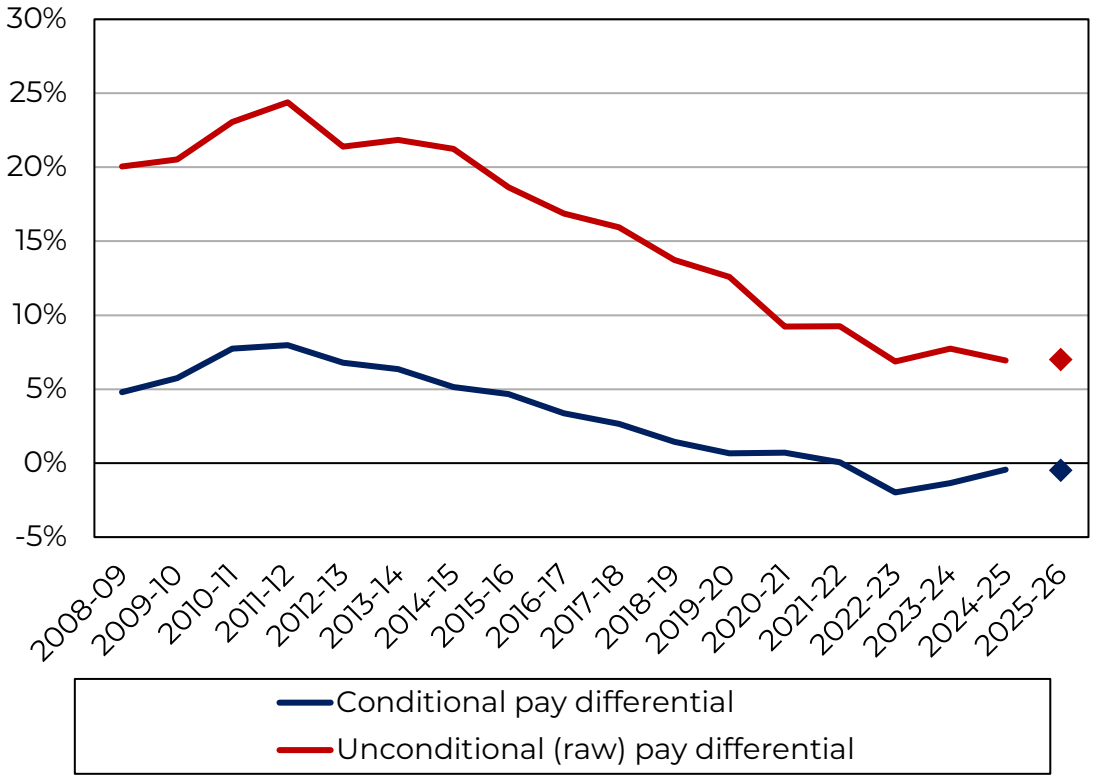
A.4 Analysis using outturn LFS data is conducted for each quarter between Q2 2008 and Q1 2025, and is averaged across the financial year to account for seasonal variations. The analysis is based on individuals' reported 'average gross hourly pay'.[94] Throughout the analysis, frequency weights are used in line with the ONS' recommendations.

A.5 It should also be noted that as LFS data are 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 sectors, the comparison of public and private sector pay should still provide useful outputs.

[93] 'Labour Force Survey', ONS

[94] 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, the analysis only looks 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 A.1 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:

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

where $ln(Hourly\ pay_i)$ takes the natural log ($ln$) of an individual $i$'s reported average hourly pay[95] and $Public_i$ is a dummy variable indicating whether an individual works in the public sector.[96]

A.7 $\beta_1$ is then converted into a percentage differential based on the formula set out in Halvorsen and Palmquist (1980)[97], which can be interpreted as the 'unconditional pay differential' between the public and private sectors.[98]

[95] 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.

[96] The analysis drops those that are in a Public Limited Company, or a nationalised industry or state corporation.

[97] 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

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

## Conditional pay differential

A.8 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.9 $X_i$ is a vector of observable individual and role characteristics that 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 full-time or part-time role, and a permanent or a temporary role; and
- Interaction terms of the above variables, to capture the joint impact of some variables on earnings.[99]

A.10 These variables are conventional for this type of analysis, as they are shown to have an effect on an individual's earnings.[100] The characteristics selected are broadly in line with those used by the ONS (2020),[101] IFS (2022),[102] and Resolution Foundation (2023)[103] in their analysis of the public-private sector pay differential.

A.11 $\beta_1$ is converted into a percentage differential based on Halvorsen and Palmquist (1980), which can then be interpreted as the 'conditional pay differential' between the public and private sectors. It provides a more accurate estimate for the percentage difference in hourly pay a given individual can expect to recieve, 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.9 were not accounted for.

A.12 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.

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[99] 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.

[100] 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

[101] 'Public and private sector earnings', ONS, September 2020

[102] 'Public spending, pay and pensions', IFS, October 2022

[103] 'Labour Market Outlook', Resolution Foundation, 2023

## Analysis of 2025-26

A.13 Analysis of the unconditional and conditional differential in hourly pay in 2025-26, indicated by the diamonds 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 2024-25 and projects these forward using the following assumptions:

- Average earnings growth across the private sector in 2025-26 of 4.4%, in line with the OBR's November 2025 forecast for whole-economy average earnings growth.
- Average earnings growth across the public sector in 2025-26 of 4.3% - this is a function of the (weighted) average public sector pay award assumed to be 3.8%,[104] and an assumption that pay drift is 0.5%.[105]
- There is no change in the average distribution of characteristics described in paragraph A.9 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.

[104] This is a weight average based on share of total cost of the 2025-26 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 pay bill.

[105] 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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