IDR

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Inflation and public sector pay

A report for the FDA

IDR

Pay Data | Intelligent Decisions

This report has been produced by Incomes Data Research for FDA. The author of this report is:

Ken Mulkearn

www.incomesdataresearch.co.uk
sales@incomesdataresearch.co.uk

Contents

Figures

Introduction

In its latest economic evidence to the Pay Review Bodies, for the 2023-24 pay round, the Treasury repeats its assertion, also made in last year's evidence, that public sector pay rises could 'exacerbate the current inflationary pressures'. Despite the current high rates of inflation having been caused by factors other than wages, this claim has been picked up and echoed by ministers in their statements to the media as a rationale for their refusing to countenance further increases as a settlement of the various disputes over 2022 pay rises.

In this report we examine this assertion in detail. We look at what has been driving inflation in the recent period and how it has affected those whose main or only income is wages. We also look at the relationship between inflation and pay, particularly the direction of the relationship, and we show how pay in the private sector has responded to rises in the cost of living. This leads us on to a consideration of whether and how we should measure the relativities between private and public sector pay.

In our view, public sector pay rises might only lead to an increase in inflation if they at least matched or were higher than current rates of inflation, and then only if private sector employers followed suit, and then only if these employers then decided to deliberately pass on this aspect of increasing costs directly to consumers in the form of price rises. It might seem like a high burden of proof, but the Treasury would need to demonstrate positive responses for this entire sequence in order for its hypothesis to have any real explanatory power. What our paper shows, by contrast, is that the thesis falls at each hurdle.

Key points

- Inflation cannot be caused directly by public sector wage rises but neither is there any evidence that this can occur indirectly, for instance by the public sector influencing private sector outcomes
- In addition, there is no evidence that private sector wage rises are leading to higher inflation. Wage rises follow inflation rather than the other way round. Indeed, inflation looks like it may have started to come down though it remains relatively high when compared to recent periods

- The current high rates of inflation are mainly due to external supply issues such as higher energy costs, rising food prices and shortages of key components
- In such a context, wages have responded but are still nowhere near inflation, however they are measured
- In the private sector, basic pay rises have been higher while bonuses have returned for better-paid staff in sectors like finance and business services, while across the economy many lower-paid staff have also received one-off cost of living payments in addition to basic percentage rises
- The difference in pay outcomes is a factor behind staffing issues in the public sector
- While inflation might be coming down employees are still feeling the effects in terms of continued price rises for food, impacts on savings and impacts on pay in real terms, affecting their purchasing power
- There is evidence that corporations have reacted to the increase in their costs presented by the inflationary factors above by raising prices to customers. As a result it may be more realistic to talk of a ‘profit-price spiral’ than a ‘wage-price’ one
- The Treasury does not appear to have an adequate theory of inflation and ignores the role that profits have played in the recent bout of increased inflation
- The Treasury also mis-characterises the relationship between public and private sector pay, in order that it can reach its desired conclusion
- Its economic evidence to the review bodies is inconsistent at points and also exhibits signs of ‘cherry-picking’ of evidence in order to suit its purpose
- As a result it tends to support criticisms about the lack of transparency surrounding review body processes and it might reconsider its approach in future years.

What is driving inflation?

Just as with its evidence to the Review Bodies for the 2022 pay round, the latest Treasury paper warns that public sector pay rises could contribute to consumer price inflation: 'It is particularly important that pay awards do not exacerbate the current inflationary pressures which are the reason behind many workers' choosing to take industrial action.'[1]

The position appears to be based on the possibility that if pay rises are set 'too high', then this will add to inflation. We deal with the question of how 'too high' might be assessed below, but since inflation is now coming down, and there is no evidence that 2022 public sector pay rises helped produce the recent spike in inflation, the question seems to be, could public sector pay rises, if they were set at a level above those most recently awarded, lead to higher inflation? Our answer is that while this is not necessarily impossible, it is highly unlikely.

This is because public services are mostly **not** traded and therefore it is usually impossible for any increase in labour costs to be passed directly on to consumers in the form of higher prices for these services. But the Treasury case is that such effects could happen indirectly, even if, as it admits, 'there is uncertainty around the magnitude of any wage-price spillovers.'

The Treasury draws on three sources in an attempt to substantiate its view. The first is a 2020 paper by Peter Dolton, Arno Hantzsche and Amit Kara for the National Institute of Economic and Social Research (NIESR).[2] Importantly, this paper only considers whether wage-setting in the public sector produces any 'spillovers' to private sector wage-setting and does **not** consider whether such wage increases consequently lead to price rises. Therefore it does **not** support the Treasury's claim that too-high public sector pay rises could raise inflation.

As it is, the NIESR paper is tentative, highlighting 'the **possibility** that pay rises in the public sector **can** lead to short-term [wage] spillovers into the rest of the economy' [emphasis added – IDR], though it argues that it provides evidence that 'suggests that public sector

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[1] HM Treasury, 'Economic Evidence to Pay Review Bodies: 2023-204 Pay Round'.
[2] The-dynamics-of-public-and-private-sector-wages-pay-settlements-and-employment-Full-Report-4.pdf (niesr.ac.uk)

spillovers are somewhat larger into sectors that are predominantly domestically-facing and characterised by low worker bargaining power, such as the hospitality, wholesale and retail services sectors.'[3]

Whether this relationship holds in every period would be worth considering, were the authors to return to the research. For instance, employers in two of the sectors mentioned – retail and wholesale – are currently conducting a bidding war for frontline staff, with large retailers 'leapfrogging' each other on the pay rates being offered, in some cases using interim awards to raise pay twice or even three times a year to do so (see below). These private sector movements are more likely to be currently influencing those making decisions on public sector pay, rather than the other way round. (For example, there is widespread anecdotal evidence of the negative effect of these developments on recruitment and retention in the NHS and in the care sector, which if not part of the public sector, is certainly allied to it and is certainly dependent on it for a large part of its funding.)

More significantly, the NIESR report's main finding is that in the long run, public sector wages adjust to wages set in the private sector, in other words the opposite of the Treasury's assertion. And the authors recognise this as important, stating that 'to retain staff of required skill levels, public sector pay should aim not to deviate for too long from private sector pay trends.' (NIESR, 2020, page 48.) We return to this point below.

The second underpinning to its argument is a paper from the Bank for International Settlements, which according to the Treasury, 'provides international evidence of spillovers from earnings growth to price growth.'[4] However, the BIS paper does **not** provide any evidence that wage rises cause inflation. Instead, it speculates that this might turn out to be the case '**if** inflation remains high', in which case 'households **may** ask for higher wages to make up for lost purchasing power and firms **may** raise prices to protect profit margins' [emphasis added – IDR].

[3] The-dynamics-of-public-and-private-sector-wages-pay-settlements-and-employment-Full-Report-4.pdf (niesr.ac.uk) See page 50

[4] The quote is from page 16 of the Treasury paper. The BIS report is here: Are major advanced economies on the verge of a wage-price spiral? (bis.org)

Finally, the Treasury paper also refers to speculation by the Bank of England's Monetary Policy Committee at its December 2022 meeting as to 'how the evidence of "inflationary pressures in domestic prices and wages" could indicate "greater persistence" in inflation, which they argue justified the increase in Bank rate by 0.5ppts.' But the MPC minutes do not provide any evidence which shows that wage rises are leading to consumer price rises. They may well believe this, and the speculative tone is demonstrated by such statements as 'there could be upside risks to services price inflation if persistently high input costs became embedded, including through higher wage growth' (page 2 of the MPC's December 2022 minutes). This correlation between service prices and wage growth is made in a number of places in the minutes, but as every statistician knows, correlation is NOT the same as causation.

In sum, the Treasury fails to provide any evidence that pay rises cause inflation. However, there is plenty of evidence that points to the contrary. In a recent paper, Joseph Stiglitz and Ira Regmi consider the possibility that, regardless of the source of current inflation (which they regard as stemming from supply issues such as higher energy and food prices and a shortage of key components such as microchips), a 'wage-price spiral' could emerge (in the US). They are open to this possibility but their conclusion, reached after examining data which shows that wage growth in the US is lagging inflation, is that this does not seem likely. This is due, in their view, to globalisation, changes in the structure of the economy and labour markets, and weaker trade unions.[5]

Much the same could be said of Britain, which is that the data on pay, whether viewed via official data on wage growth or information on pay awards (both of which we deal with in more detail below), also lags behind inflation. In other words, here too there is little sign of the Treasury's fears being realised. Inflation looks like it may have peaked, even as data on private sector wages show a rise (though still some way below inflation). This is quite different to a 'wage-price spiral'. As Stiglitz and Regmi put it, 'If wages do not increase **with prices** then there can't be a wage-price spiral, no matter the extent to which wages get reflected in prices' [emphasis added – IDR] (Stiglitz and Regmi, 2022, page 50).

[5] Roosevelt Institute - The Causes of and Responses to Today's Inflation

Price formation is a complex process and labour costs (of which wages are not the only aspect) are only one element of the picture. There is little sense of this complexity in the Treasury paper. But it is important to appreciate how it takes place in order to understand what is driving the current round of inflation and to consider whether and how wage rises could play a role in this the future.

The source of the current bout of inflation being experienced by Western economies is to a large extent geopolitical, but also climatic/environmental. The war in Ukraine led to a sharp rise in energy prices as Russia curtailed gas supplies to Europe. This is the aspect to which the Treasury paper pays the most attention, almost to the complete exclusion of any other factor. It is certainly important, especially since as energy prices have come down, so has inflation. But it is not the only factor. The conflict also affected prices for food inputs such as grain, prices which were already being shaped by climate change. And the war comes after the global coronavirus pandemic, which produced shortages of key components as the activities of the industries producing them, and also transport, were severely curtailed by efforts to limit spread of the virus. (There may be a future geopolitical aspect to this as the US and China clash over microchip production.) To the extent that the pandemic was caused by the pressure exerted by human economies on natural ecosystems, then as long as this pressure remains, such pandemics are likely to recur. And the world remains slow in dealing with the climate emergency.

(In this sense, we may have entered a period where the relatively low inflation experienced since the 1980s is over, though this does not necessarily mean that inflation will rise to levels seen in the 1970s, apart from in countries whose economies are over-exposed to pressures that have produced something like this already. A discussion of this is outside the ambit of this paper.)

So the impetus for inflation recently has been global rather than domestic. But how have these triggers found their way into prices? Is it simply, as some economists (including the Treasury) would have us believe, that because the population somehow ‘expects’ prices to be higher, firms therefore raise them? This is clearly inadequate as an explanation since it fails to explain the mechanism for price rises themselves.[6] Instead it is important to look at the reasons why firms have been raising prices recently. One is clearly that their costs, most especially in respect of energy and other input costs, have been higher. But the other reason is that at the same time they have sought to maintain or even boost their profits, especially after the pandemic dampened profit growth for many, though not all, firms.[7] In fact, rather than a 'wage-price spiral', we might reasonably talk of a 'profit-price spiral', though as we highlight below, even this is unlikely to be sufficient on its own as a complete explanation for price inflation. Nevertheless, this element (corporate profits) is entirely absent from Treasury considerations, despite it looming large as a factor in the recent round of inflation.

For instance, recent analysis from the Economic Policy Institute in the US looks at the relative contributions to growth in unit prices in the non-financial corporate sector – see Figure 1. It compares the entire period between 1979 and 2019, i.e. before the recent pandemic, with the pandemic period (Q2 2020 to Q4 2021). This shows that in the earlier period, the main contribution to growth in unit prices was unit labour costs.[8] By contrast, corporate profits and non-labour input costs played smaller roles in this period. But during the pandemic (or at its height), the position was reversed in favour of corporate profits and to a lesser extent input costs, while unit labour costs' contribution shrank significantly.[9]

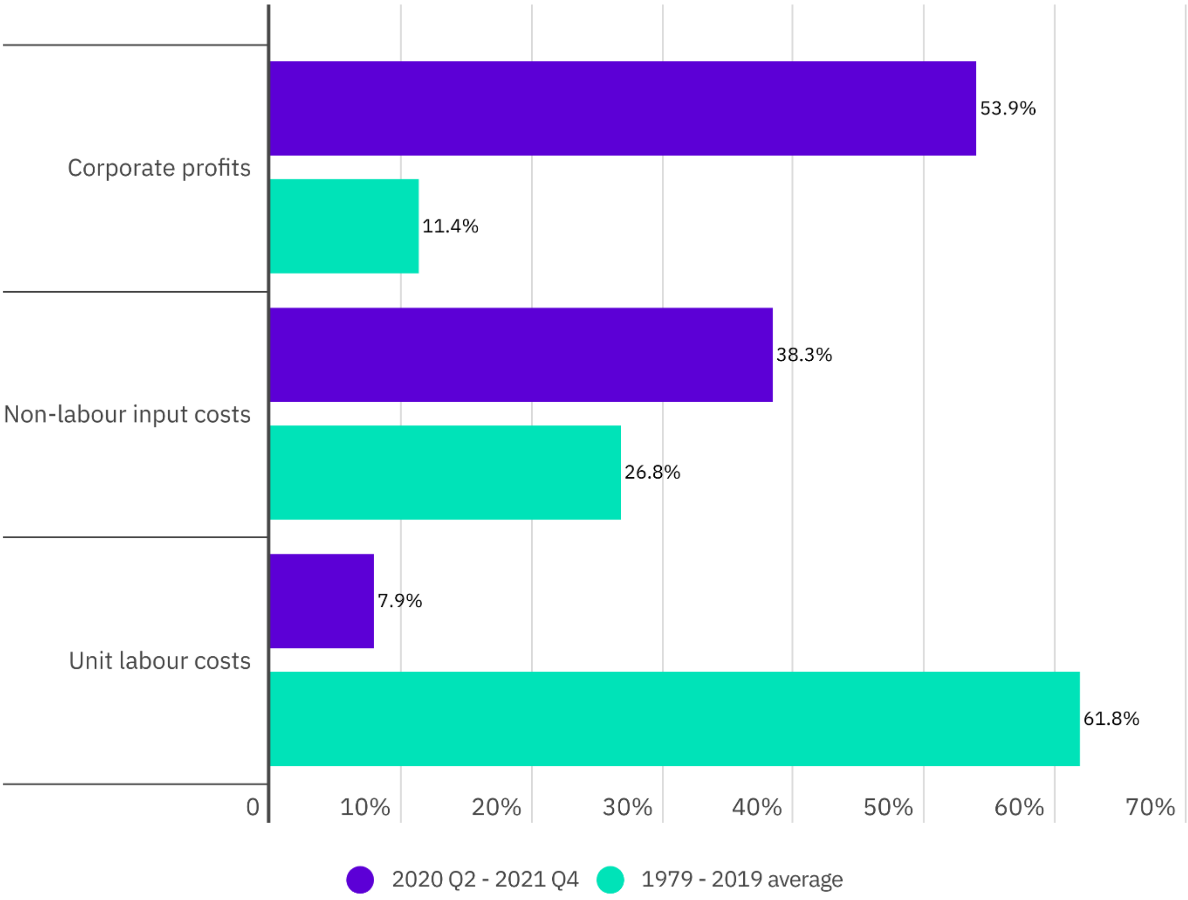
[6]The somewhat circuitous idea that people's expectations of inflation is what itself fuels inflation is popular with both monetarists and Keynesians. In the case of the former, it may be because it represents a post-hoc explanation which allows firms justify price increases without any reference to profit margins, while for the latter it could well be a popular version of the 'animal spirits' affecting investors that the master regarded as important motivators of booms and busts.

[7]Fossil fuel firms have done particularly well in this regard. And although the Government has introduced a 'windfall' tax on these firms' profits, an argument has blown up over the extent to which the firms in question have been able to avoid it by claiming exemptions provided for in the regulation itself. This is, of course, relevant to the debate over inflation and public sector pay rises since, arguably, taxation and revenue raising is one solution to the funding problems presented by public sector wage demands.

[8]Note that this is not the same thing as wages per se. Unit labour costs are usually defined as the average cost of labour per unit of output produced and are normally expressed as the ratio of total labour compensation for each hour worked (i.e. wages) to the output for each hour worked (i.e. productivity). In other words, investment – which is the main determinant of productivity – plays a major role.

[9]Corporate profits have contributed disproportionately to inflation. How should policymakers respond? | Economic Policy Institute (epi.org)

Figure 1 Normal and recent contributions to growth in unit prices in the non-financial corporate sector



National Income & Product Accounts (NIPA) of the Bureau of Economic Analysis (BEA) and Economic Policy Institute

Stiglitz and Regmi echo this. Their view is that current inflation is driven by more than companies just passing on cost increases. Instead, increased market concentration in the hands of fewer companies is leading these firms to raise their prices by more than increases in their costs (in order to boost profits). How are they doing this? One way of looking at prices is to see them as a mark-up over (marginal) costs. Stiglitz and Regmi show that in the US, oligopolistic firms have increased the amounts by which they mark up costs. Between 1960 and 1980, mark-ups averaged 26% above marginal costs and have been on a slow and consistent rise ever since. But in 2021, the average mark-up charged was 72% above the marginal cost. This coincided, in 2021, with sharply increased corporate profits, which continued to rise through the third quarter of 2022, even as inflation also increased. It is important to note that while Stiglitz and Regmi do not attribute direct causation to price/cost mark-ups, they do highlight how it aligns with research 'which concludes that an overwhelming number of corporations claimed that inflation (that is, higher prices for them) was good for business and that they didn't intend to reduce prices even as input costs came down sharply.'[10]

In Britain, work by trade union Unite has attempted to show that so-called 'price gouging', where businesses raise their prices above supply costs, is the main factor behind 'second-round' inflation.[11] In its report, Unite produces figures to show that profit margins for the UK's biggest listed companies (FTSE 350) were 73% higher in 2021 than pre-pandemic levels in 2019. Unite draws on the same US research cited by Stiglitz and Regmi to argue that this profit jump is based on 'pricing action' but extrapolate from this to argue that similar forces are operating in the UK context.

Unite goes on to claim that the profit jump is responsible for 58.7% of inflation in the past half year, as opposed to the just 8.3% that is due to labour costs. Work at around the same time by the Institute for Public Policy Research (IPPR) reaches similar conclusions, though the main focus of that paper is on how market concentration is allowing firms to make 'excess profits' via pricing, rather than the precise contribution of such practices to inflation.[12]

Interestingly, the paper from BIS cited by the Treasury in its evidence to the review bodies is also aware of firms' actions to maintain or boost profits as a factor behind recent inflation. It states: 'Firms' pricing power, as measured by the markup of prices over costs, has increased to historical highs. In the low and stable inflation environment of the pre-pandemic era, higher markups lowered wage-price pass-through. But in a high inflation environment, higher markups could fuel inflation as businesses pay more attention to aggregate price growth and incorporate it into their pricing decisions. Indeed, this could be one reason why inflationary pressures have broadened recently in sectors that were not directly hit by bottlenecks.'[13]

If the various pieces of research cited above are correct, it would appear that the Treasury's position on the relationship between wages and inflation is still to be proven empirically and

[10] Stiglitz and Regmi, 2022, page 41.
[11] 'Corporate profiteering and the cost of living crisis', Unite, June 2022.
[12] Prices and profits after the pandemic | IPPR
[13] See page 4, Are major advanced economies on the verge of a wage-price spiral? (bis.org)

remains merely a hypothesis. But could it turn out to be true in the future? The received wisdom, which the Treasury in its pre-eminent position helps promote, is that higher wages always lead to higher prices, and as such it should be possible to point to past instances of this occurring. But the evidence for this has come under scrutiny lately. The IMF recently produced a paper which examined the period from the 1960s up to the present and found only a small number of periods in which acceleration in both prices and wages was sustained. And when the researchers focussed on periods similar to the current one (of falling real wages and tighter labour markets), they found that what tended to follow was that inflation declined while nominal wage growth increased, allowing real wages to catch up to some extent.[14] The authors conclude, therefore, that an acceleration of nominal wages should not necessarily be seen as a sign that a wage-price spiral is taking hold.

This is important because it highlights how in the real world of the economy, wages follow inflation rather than the other way round. Inflation is reported monthly, but for most employees, most of the time, their wages are usually only increased once a year. Only in rare instances (such as in retail at the moment, where wages are in any case relatively low) are whole workforce wages increased by more than once a year. (Wages for some new recruits may well go higher than those under previous recruitment rounds in response to labour market conditions but these do not always represent an increase in companies' paybills since the new starters may be replacing longer-serving employees who were on higher salaries still.)

IDR and others' monitoring of the outcomes of workforce-wide pay reviews in the private sector shows that these are rising in comparison to 2022 (see below). This is because many, and possibly even most, 2022 pay reviews (or in the case of the civil service, the pay remit process) were decided against a backdrop of lower inflation, in the latter half of 2021. By contrast, 2023 pay reviews were mostly reached against a much higher inflation backdrop, in late 2022 when it may even have reached a peak. The timing of pay reviews is relevant here too, with most private sector ones taking place in January and April, while public sector reviews are either in April or late summer/early autumn (September). Meanwhile public sector pay reviews are often late and paid in arrears, when the backdrop and factors that

[14] Wage-Price Spirals: What is the Historical Evidence? (imf.org)

motivated the original decisions and the indicators on which these decisions were based, have altered, often significantly. This has been a factor in the latest round of pay disputes in the public sector.

The IMF paper also underlines the need for more empirical research to show whether firms pass on wage increases to customers in the form of price rises, or absorb them in some way, including by reducing profits. On this, research by the Chartered Institute of Personnel and Development (CIPD) for the Low Pay Commission in 2021 is relevant. It examined the extent to which firms raised prices in response to that year's increase in the National Minimum Wage. The research showed that while increasing prices was one of the reactions, it was not the most usual, with taking lower profits/absorbing the cost and improving productivity both more common responses.[15] It would be interesting to see such research repeated, or more in-depth research carried out on price formation in-situ.

One final aspect of the Treasury thesis is the implication that one of the potential mechanisms for a 'wage-price spiral' could be too-high public sector pay outcomes influencing subsequent similar outcomes in the private sector. The paper does not state this explicitly, but the idea is contained in the passage where the Treasury warns that 'public sector pay awards significantly above the private sector could… risk higher and more persistent inflation, requiring further interest rate rises to offset this effect.'[16]

This could only happen if private sector employers regard public sector wage decisions as important (and then pass on the correspondingly greater pay rises to their customers in the form of price rises). The evidence is that they do not, or at least not as importantly as a number of other stimuli. As in previous years, our most recent survey of private sector employers' pay intentions for the coming year indicated that Government policy on pay was an extremely minor influence on their decisions. The survey asked employers how important a range of factors, including Government policy on pay, were in respect of their most recent annual pay reviews (for 2022). In the latest survey, public sector pay policy was ranked just 11th out of 13. Greater influences were, in order of importance: affordability, recruitment

[15] See 5.72, [National Minimum Wage Low Pay Commission Report 2021 (publishing.service.gov.uk)]
[16] Treasury paper, page 16.

and retention, inflation, market benchmarking, the future business outlook, the going rate for pay rises, employee expectations, increases to the NLW/NMW, productivity, and the voluntary living wage. Only formal trade union pay claims and coronavirus effects were ranked lower.

When it came to forward pay plans for 2023, Government pay policy was ranked bottom, this time out of 12 since we omitted coronavirus effects. Here, the most important influences were, in order of importance: affordability, followed by – jointly – inflation and the future business outlook, employee expectations, recruitment and retention, market benchmarking, the going rate for pay rises, increases to the NLW/NMW, productivity, the voluntary living wage, and union pay claims.

The survey results also highlight that while affordability and recruitment and retention were the pre-eminently most important influences on employers' decisions for 2022, and affordability, inflation and the future business outlook the most important in respect of their forward plans for 2023, market benchmarking also looms large in their considerations. There are two aspects to this. One is that companies tend to look most closely at what other companies in the same sector have paid or are likely to pay when it comes to annual pay rises. This is reflected in the way we and other pay monitoring bodies structure our regular information on pay awards, with detailed data – usually showing outcomes at named organisations – presented according to standard industrial sectors, e.g. energy and water, financial services, retail etc. It follows therefore, that for most private sector organisations, their own sector comes first, and as a result they would not generally consider public sector developments.

The other aspect of market benchmarking that can guide companies' pay decisions is occupational pay trends, particularly where a company is a major employer of a particular type of role, e.g. customer service assistants, IT staff or engineers. Again, this is unlikely to involve examinations of outcomes for public sector occupations, since for many roles the public sector is more or less in a monopsony position, as the largest and sometimes the only substantial employer of many of the (largely professional) roles it employs. Examples include nurses and teachers. Few, if any, private sector employers are interested in pay movements for these occupations, and much the same could be said for less specialised public sector jobs. Even for so-called generic roles it is the private sector that sets the pace on pay, rather than the other way round. (Of course, as a result the opposite is true for the public sector, since the better pay on offer in the private sector often means that the former is forced to compete with the latter. This is truer for some parts of the public sector than others. The increased importance of digital roles in the wake of the coronavirus pandemic has presented particular problems for the public sector, in addition to specialised areas such as project management.) The Treasury paper does not exhibit much appreciation of these realities.

The other difficulty facing the Treasury is that it appears to be operating without a viable theory of inflation, in the sense of one that can explain what is actually happening.[17] Theories of 'cost-push' and 'demand-pull' inflation, both of which refer to wages, have been discredited, as too has the monetary theory of inflation, in each case by reality disproving their predictions. As a result, the Treasury's hypothetical assertions, even if they have the apparent force of policy, are at best partial and tend to favour one side of the employment relationship over the other, and at worst do not take proper appreciation of the various economic mechanisms involved in the recent upturn in the rate of increase in prices.

The version of cost-push theory on which the Treasury seems to be relying is the Keynesian one in which inflation is caused by workers receiving too-high wage rises. The model here is the relationship between unemployment and inflation or the so-called 'Phillips curve' in which low unemployment should lead to high inflation (and vice versa). However, following the crash of 2009, unemployment fell to record lows but inflation remained moderate as did wage rises, at least until recently when supply shocks provided the initial trigger for rises in the former.

The demand-pull theory forecasts that prices rise or fall in line with increased or decreased demand for goods and services. In relation to wages, it holds that if wages grow faster than production of goods or services, then 'excess demand' will result, leading to a rise in

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[17] Though the Treasury is not alone in this. For more details see [We have no theory of inflation - by Duncan Weldon (substack.com)]

inflation.[18] As well as the fact that current inflation has patently not been caused by an excess of demand, but rather by deficiencies in supply, there are two further things wrong with this idea. The first is that is that (excess) wage rises do not simply happen, especially not in an economy where profits are just as, if not more, important than wages. And this relates to the second issue, which is that profits as well as labour costs exert pressure on prices (most especially for inputs to production and capital goods, which have knock-on effects on the prices of consumer items). This understanding points to the realisation that the arrow of causation points the other way, that is from increases in prices as firms try to maintain or raise profits, to claims for higher wages as labour tries to maintain its purchasing power.

Finally, there is the monetary theory of inflation, taken from Milton Friedman, who argued: ‘Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.’[19] This theory met its apotheosis in the fact that since the crash of 2009 and even into the Covid pandemic, the cash injections of central banks and Governments, via ‘quantitative easing’ and other measures, failed to have any significant effect on consumer price inflation.

We would note that it is also difficult to see how monopoly pricing is the main cause of inflation since greater concentration of market power has been a growing trend in the US and other economies since around 1980 but has not produced increased inflation. In the current context, rather than inflation being a factor of monopoly power per se, mark-ups have risen because it has been possible to raise them in an environment of supply blockages.

In our view, therefore, it would be better to adopt a more holistic theory of inflation that attempts to look at the purchasing power of profits as well as wages in the context of overall value creation, and that also takes account of the money supply.[20] But this is not the space in which to develop these ideas. For now we would highlight that existing theories are at best

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[18]This seems to be what is guiding the Bank of England in raising interest rates, on the basis that it wants to squeeze domestic demand. But this is not what is driving inflation at the moment and as a result the ‘cure’, in the form of recession, could be worse than the disease.

[19]Friedman, M. 1970, ‘The Counter-Revolution in Economic Theory’, IEA Occasional Paper No. 33, Institute of Economic Affairs (page 6)

[20]On value, see ‘The Value of Everything: Making and Taking in the Global Economy’ by Mariana Mazzucato, 2018.

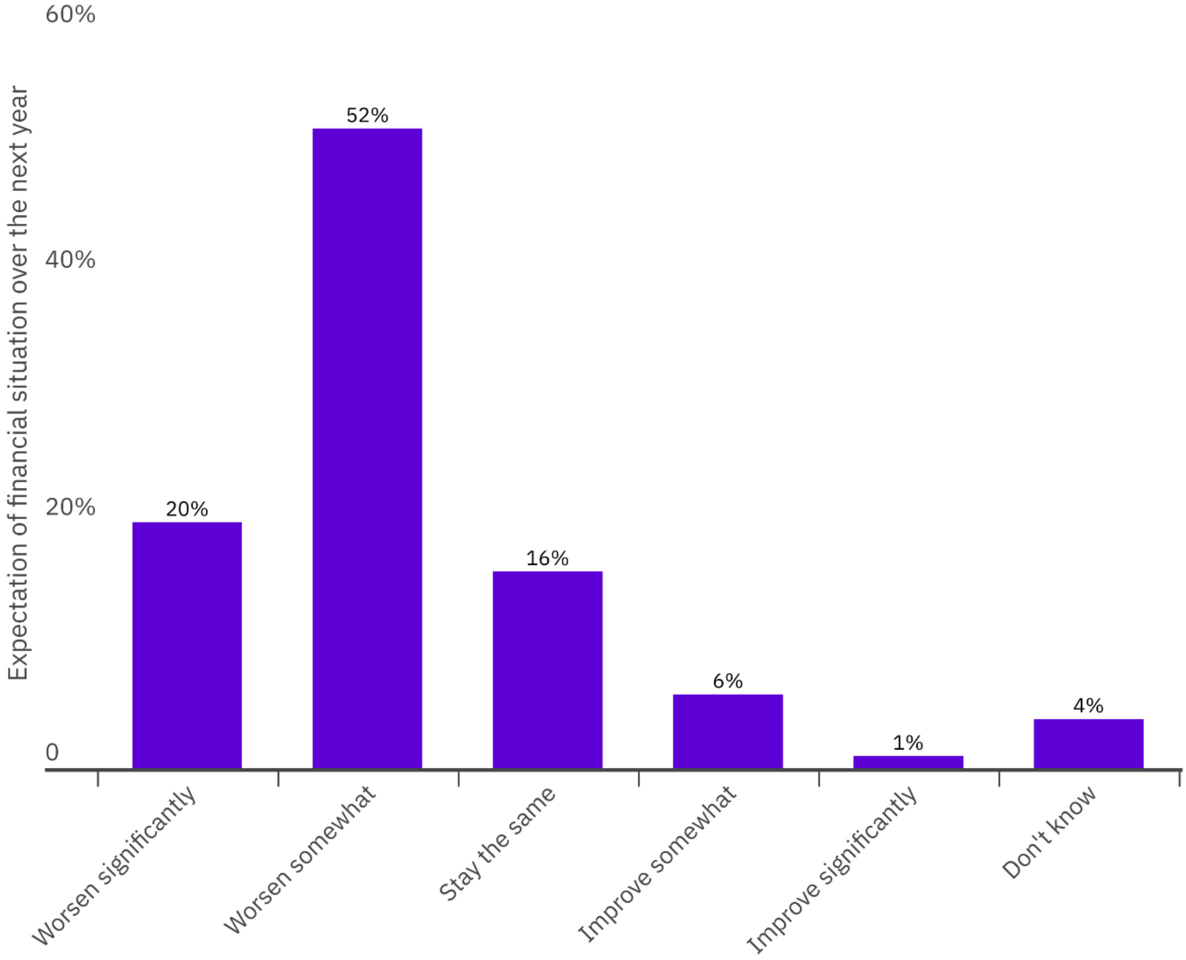
partial explanations for inflation, at worst plain wrong, and by relying on them the Treasury cannot guide decision-making. In particular, it is clear that recent inflation has **not** been caused by wage increases and is unlikely to be so in the future. Rather, inflation is more closely connected to what is happening within the global economy as a whole, and how large corporations have reacted to this. This allows us to understand that, by taking industrial action, public sector workers are merely trying to maintain the purchasing power of their pay. In other words, they are simply responding to economic facts.

How has inflation impacted workers?

The Treasury paper does not detail the impact of inflation on employees, which given that the remit of the review bodies – which it receives from the Government – is to have regard for not just recruitment and retention, but also morale, is perhaps a more serious omission than it first appears. In a cost of living crisis, it is reasonable that employers should be concerned with the possibility that staff might sometimes be more worried about paying for necessities than their responsibilities at work. (And public sector roles are positions affecting the whole of society, not just the bottom lines of their immediate employers. They are also often defined by the fact that the motivation for taking them up is often intrinsic, unlike many private sector roles where the main incentive is extrinsic. In the past, this was one reason why a certain measure of pay restraint was tolerated by public sector workers, but Treasury insistence that funding for pay rises must be found from existing budgets, with the consequent effects on the wider working context, has negatively impacted the intrinsic as well as extrinsic aspects of many public sector roles.) Figure 2, from the CIPD's latest labour market outlook, summarises the position from employers' point of view.[21]

[21] Labour Market Outlook | Surveys | CIPD

Figure 2 Overall, thinking about your employees' financial situation over the next 12 months*



Source: Labour Market Outlook, CIPD.

*Do you expect this to improve, stay the same or worsen in comparison with now? (%)

It is worth remembering that the different estimates for inflation attempt to measure the rate of increase in prices, and just because that rate of increase may be starting to slacken (because of base effects and lower wholesale energy prices), it does not mean that all prices themselves will fall. Food prices are a particular concern in this regard. Indeed, even as the rate of inflation has begun to come down, prices for food have continued to rise. In its latest release on inflation, the Office for National Statistics highlights how, even though the rate of inflation dropped slightly, food prices continued to place upward pressure on the index.[22] In addition, the market research organisation Kantar found recently that grocery prices in the

[22] Consumer price inflation, UK - Office for National Statistics

UK had risen by record amounts.[23] And the lower-paid that employees are, then the greater the proportion of their income they are likely to spend on necessities like food.[24] The rise in prices for necessities is partly what is driving the response of private sector employers to inflation (more on which below).

The other impact of the sharp rise in inflation recently has been on savings. While the coronavirus lockdowns led households to build up their savings, since the pandemic started to abate, households have been drawing down their savings to maintain consumption in the face of the cost-of-living crisis. The National Institute of Economic and Social Research (NIESR) has forecast the net savings rate to continue falling to a low of 1.1 per cent in the first quarter of 2023 before returning gradually towards its pre-referendum level of 6 per cent.[25] NIESR also highlights that although the household sector can draw down on its savings in aggregate, a large and growing number of households have no savings and so will struggle in the absence of further government support. The institute forecasts that, by 2024, the number of people with no savings will double to slightly above 5 million or 20 per cent of households.[26]

Finally, there is the impact of inflation on pay in real terms which, added to the earlier effects of austerity and Government pay restraint, has in some cases been significant. A number of key public sector occupations have seen their pay fall in real terms over the period since the last great recession. For example, the Institute for Fiscal Studies (IFS) has shown that salaries for experienced and senior teachers have fallen by 13% in real terms since 2010.[27] In other words, in spite of salary increases over the same period, inflation has acted to devalue teachers' pay in relation to increases in the cost of living. The same is most likely true for other groups as well. For example, recent analysis by the Institute for Government shows that civil servants' median salaries at each grade have reduced in real terms by between 12% and 23% since 2010. And more pertinently for this report, the senior civil service has faced the biggest real-terms pay cuts of any grade since 2010.[28]

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[23] Grocery price inflation rises to record 16.7% (kantar.com)
[24] Family spending in the UK - Office for National Statistics (ons.gov.uk)
[25] NIESR-UK-Economic-Outlook-Autumn-2022-final-1.pdf See page 21
[26] NIESR-UK-Economic-Outlook-Autumn-2022-final-1.pdf See page 27
[27] What has happened to teacher pay in England? | Institute for Fiscal Studies (ifs.org.uk)
[28] whitehall-monitor-2023.pdf (instituteforgovernment.org.uk)

What is the relationship between inflation and pay?

It is worth noting, as mentioned in passing above, that employers' ranking of inflation in order of importance as an influence on their remuneration deliberations rose from third out of 13 – high enough in itself – in respect of 2022 outcomes, to joint second in respect of forward plans for 2023. This indicates the heightened importance of inflation to pay-setting currently (it had been ranked lower in previous years, at fourth and fifth respectively in the previous survey for example) and hints at the pre-eminent relationship in employers' minds: when inflation is high, they must have greater regard to it when it comes to setting pay.[29] Alongside this, employee expectations also rose up the rankings, from near the bottom in our 2021 survey, to near the middle for 2022 pay decisions and nearer the top in respect of forward plans for 2023. This is likely to be linked to the increase in the cost of living, even if formal trade union claims rank lower.

In other words, pay responds to inflation and is retrospective to it. And not only is there a time lag between the two, but pay rises are, on average, generally lower than inflation, apart from during those brief periods – generally in recessions – when inflation falls sharply. The chart below shows this clearly, with three main periods in evidence. The first is that prior to the 'great recession' of 2009, when the median pay settlement moved up and down more or less as inflation rose and fell but was always below it.[30] And there is no evidence for this period that higher pay settlements fuelled increases in measures of the cost of living.

The second period is the 10 years or so between the crash and the pandemic. During this long period, the association between inflation and pay settlements weakened significantly, in large measure due to the post-recession climate, though inflation did not rise as high as recently either. For most of the period since the economic crisis of 2009, the median basic pay award has been more or less stuck at between 2 and 2½%. When inflation rose, the median settlement failed to follow it upwards, though nor did it follow inflation down when the latter fell.

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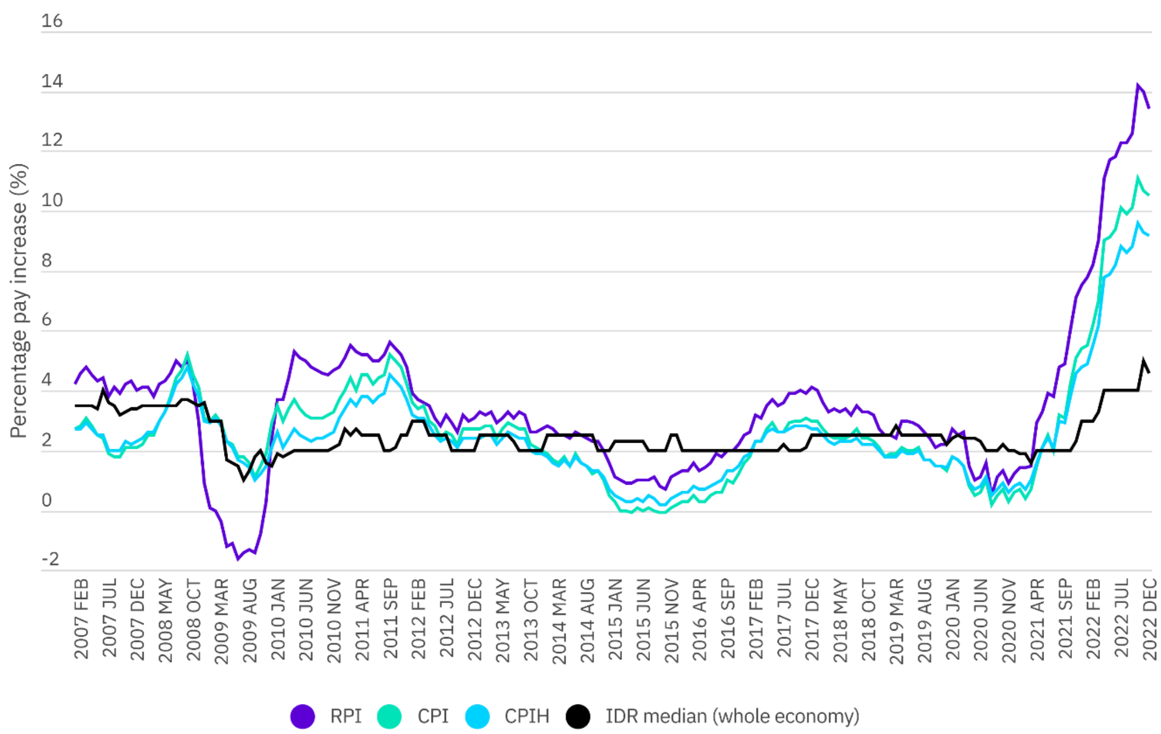
[29]At the same time it is worth remembering that inflation, as well as other factors, are always trumped by 'affordability', which takes into account both costs and profits.

[30]Just as 2% seems to be something of a floor for pay increases in the private sector, so when they are higher, they nevertheless tend to show below inflation, as we have commented in the past, 'like washing hanging from a line.'

The final period is the most recent one, in which inflation has risen and pay settlements have responded, raising the possibility that the pre-crash relationship between the two could be restored to some extent.

Figure 3 Inflation versus IDR median pay award, January 2007 to December 2022



Sources: ONS. IDR Pay Benchmarker

How has pay responded to higher inflation?

Figure 3 shows pay review outcomes for the whole economy on the basis of the median pay award for each rolling three-month period until the end of 2022, which is also the end of the period for which we have inflation data at the time of writing, i.e. December 2022. Since then, pay settlements have moved a little higher, with our whole-economy median award for the first quarter of 2023 showing at 5%. Since most awards at the moment are in the private sector, the median in the private sector is also 5%, though some four-fifths of awards are worth 5% or above, and the upper quartile is now 6% (Meanwhile XpertHR's median is now 6%, continuing in the direction of travel established by its earlier figures.) As we have said already this is because these pay decisions were made against a higher inflation backdrop than in 2022, and as a result are higher. But still basic pay rises are nowhere near inflation.

But basic consolidated pay rises are not the only way in which employers have tried to meet their employees' expectations. As we show in the box below, one-off 'cost of living' payments are an important part of the current picture in many parts of the private sector, with these being made in addition to below-inflation percentage rises to basic pay in recognition of the difficulties many employees are facing as a result of high energy and food bills.

BOX: Percentage rises to basic pay are only one element of current climate

Employers are adopting a variety of remuneration responses to tackle recruitment and retention pressures and support their staff with the cost of living, against the continuing backdrop of high inflation and tight labour markets. Awarding high-end pay rises worth 5% or more became commonplace in 2022 with 35% of awards at the level, compared to just 6% in 2021. Such large uplifts are set to continue this year as we have observed over half (53%) of employers doing so in 2023 (based on a sample of 85 outcomes monitored so far).

During this time we have observed other pay approaches grow in popularity across the economy. The main ones are one-off payments, additional or interim pay rises and consolidated flat-rate amounts. Instances of planned pay rises being implemented early have also occurred, although to a lesser extent than some of the other approaches. We explore examples of each approach in the tables below, alongside a brief explanation of each.

One-off payments

We observed an increase in the propensity of employers to make one-off payments to their staff in 2022. In some cases these have been paid to all workers, usually in addition to, and either at the same time or subsequent to, the rise in basic pay under the annual pay review, while in some instances they have been made to the lowest-paid staff, particularly where these make up a large proportion of the workforce. These sums are not consolidated into basic pay and have been commonly termed 'cost-of-living' payments by employers. Our survey of 121 UK organisations found that around one-in-five employers took this step and in nearly all cases these payments were made on top of – either in addition or subsequent to – any consolidated salary increases awarded under usual pay reviews.[31] Several other reasons were cited by participants for making the payments, including recruitment or retention.

Our analysis of a sample of 44 one-off payments that were part of annual pay reviews effective between January 2022 and January 2024 found that 78% of employers decided on additional cash lump sums with the value of such payments ranging between £100 and £3,000. At the median, such payments were typically worth £500 and on average £800. The remaining proportion of employers (22%) paid a one-off sum as a percentage of salary, typically worth 1.5% at the median. Instances of these payments occur across the economy with no discernible trend by sector, however very few in our sample were in the public sector. In around one-in-five cases, the one-off payments were specifically negotiated with trade unions as part of annual pay reviews and in these cases accompanied percentage pay increases.

[31] See the IDR research report, 'Pay planning for 2023'.

Examples of one-off payments that accompanied pay reviews

Organisation	Date	Comments
BMW	01/01/2022	A lump sum payment of £1,500 agreed as part of a long-term pay deal that provides annual salary uplifts. Payments were worth £1,000 in April and £500 in July. In the second and third year of the pay deal (2023 and 2024) workers will receive a £1,000 cash payment in April and, if RPI is above 3% in June, they will receive a further £500 in July. Accompanies a pay rise of 5.5%
Caterers Offshore Traders Association	01/12/2022	A one-off payment of around £1,000 paid to lower grades. Agreed as part of pay rise of 10% effective 1 Sept 2022
Financial Conduct Authority	01/04/2022	A one-off payment worth 4% of salary as at 1 April 2021 paid to most staff. Accompanies an average pay rise of 5%
Lloyds Banking Group	01/04/2022	A lump-sum payment of £500 for lower-paid staff. Accompanies a 5% pay rise (that was subject to maximum of £5,000)

Elsewhere, some employers have awarded one-off payments outside of the annual pay review. We have observed this across the economy but particularly among high-street banks. The value of such payments are typically £1,000 – around double the value of such payments that were agreed as part of annual pay reviews, as detailed above. In around half of cases (45%) we have observed, such one-off payments are given to the lowest-paid staff only and in a quarter of cases the payment was paid to all staff regardless of salary.

Examples of one-off payments (separate to basic pay reviews)

Organisation	Date	Comments
Galliford Try	Autumn 2022	One-off payment of up to £750 paid to around half of workforce (1,800 employees) as cost of living boost
HSBC	01/08/2022	£1,500 cost-of-living pay payment for 18,000 lowest-paid staff
NatWest	01/01/2023	A one-off cash payment of £1,000 paid to 59,000 colleagues
Skanska	01/11/2022	A one-off payment of £750 for the lowest-paid employees (circa 1,300 staff)
Taylor Wimpey	01/09/2022	£1,000 cost of living bonus. To be paid in monthly instalments between 1 September 2022 and 1 February 2023
University of Manchester	01/11/2022	£1,000 cost-of-living payment for all employees earning less than £71,000 pa. Paid in two instalments (the second in January 2023). Pro-rata for part-time staff but with a minimum of £250 per payment
University of Sheffield	01/10/2022	An additional payment of £1,000 to all colleagues in 10 instalments between October 2022 and June 2023
Virgin Money	01/08/2022	£1,000 cost-of-living payment
Yorkshire Building Society	01/09/2022	A one-off payment of £1,200 for the majority of employees to help with the rising cost of living

Additional/interim pay awards

These are additional increases to basic salary that take effect within the same 12-month period as the usual pay rise anniversary for employees, which in most cases also involved an increase to basic pay. Interim increases are most commonly percentage rises but some employers have implemented flat-rate uplifts (see below). Interim awards differ in intent and principle from pre-planned, staged increases where dates and increases have already been decided on in advance. Instead they represent relatively short-term reactions to the current context of labour market pressures and higher inflation.

Examples of additional/interim awards

Organisation	Date	Comments
Aldi	01/01/2023	A 5% uplift to the minimum hourly-rate of pay (nationally). This takes effect outside of the usual February pay anniversary and is the third increase in an 11-month period. Follows uplifts 5.8% and 4% in February and September 2022 respectively
Curry's	31/10/2022	A 3.5% pay increase for hourly-paid staff. This follows two other increases in the same 13-month period (9% in October 2021 and 5.2% in August 2022)
Lidl	01/10/2022	A 7.9% uplift to the minimum hourly-rate of pay (nationally). This is in addition to a 6.3% increase that took place on the usual pay anniversary in March 2022
NatWest Group	01/09/2022	A 4% pay rise awarded to 17,300 lowest-paid employees. This is in outside of the usual pay anniversary in April
Santander	01/08/2022	Cost-of-living pay award of 4% for 11,000 employees earning under £35,000pa. The starter rate will also increase to £19,500. This is in addition to the usual March pay review
Tesco	13/11/2022	2% uplift to the minimum hourly pay rate. This is in addition to a 5.8% increase that took effect on 24 July 2022

Early pay rises

These are when an agreed pay rise is brought forward to take effect on a date that is ahead of the usual pay anniversary.

Examples of early pay rises

Organisation	Date	Comments
Asda	01/07/2022	A 5% uplift for hourly-paid workers that was originally planned for April 2023
Audley Travel	01/10/2022	Bringing forward the January 2023 pay increase of 5%
Sainsbury's	07/02/2023	A 7.3% increase for hourly-paid Argos and Sainsbury's staff. This takes effect a month ahead of the usual March pay anniversary for these workers. Follows increases of 5.3% and 2.5% in March and October 2022 respectively

Flat-rate payments

Flat-rate payments are fixed amounts that are applied to all salaries across an organisation, and as such are worth more in percentage terms to lower-paid staff, though some employers have awarded lower amounts to higher-paid employees. Such payments involve a permanent increase to pay. And most examples over the last 18 months are typically in addition to, and paid outside of, percentage increases to basic pay under the usual annual pay review. As such they (may) overlap to an extent with interim awards. NHS staff received flat-rate payments as part of their latest, review body-recommended award.

Examples of flat-rate payments

Organisation	Date	Comments
Barclays	01/08/2022	£1,200 interim salary uplift for 35,000 staff. This is outside of the usual March pay anniversary
Royal London	01/10/2022	Permanent pay increase for lower-paid staff of £1,000pa. This is in addition to earlier pay award in 2022
NatWest	01/01/2023	Minimum salary increase of £2,000 paid to 39,000 staff on lower pay bands. A one-off sum of £1,000 will also be paid
BT Group	01/01/2023	£1,500 consolidated award outside of the usual January and April pay reviews. Affects 85% of workforce
Tesco Bank	08/01/2023	£1,250 uplift to salaries ahead of usually pay review in May 2023. Affects 90% of the workforce

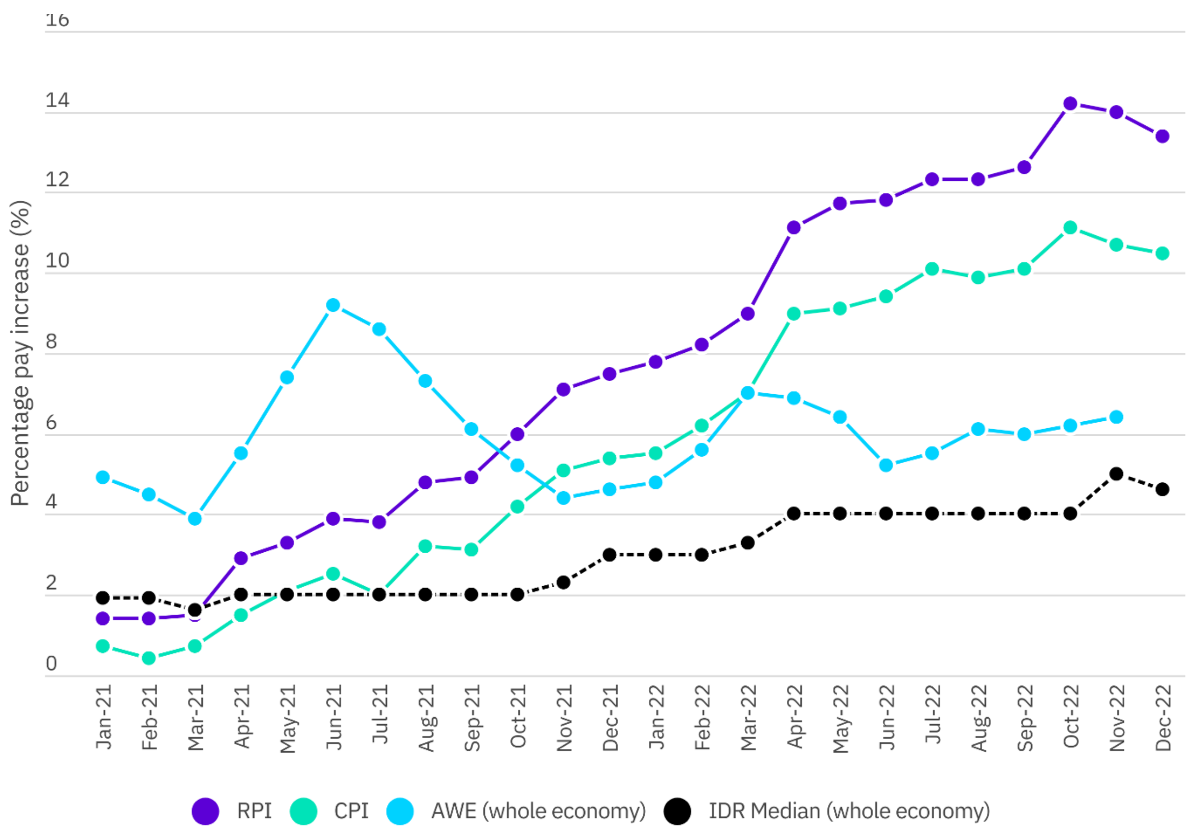
Other measures

Among the other measures we have monitored is the payment by Barrett Developments of a temporary salary supplement of £1,000 to all employees below senior management, phased over the six months to 31 December 2022.

Such developments mean that when it comes to assessing the impact of inflation on pay trends in the private sector, basic pay awards are only one part of the picture, even if they are the most important aspect. It is important to note that one-off payments are generally <u>not</u> reflected in our data on pay awards since it is not always possible to obtain a figure for the paybill effect, i.e. the percentage rise on the paybill represented by such additions. Some companies will supply this information but many or even most do not. Therefore in certain important respects pay settlements may be underestimating the effect of inflation on pay setting behaviour in the private sector.

A consequence of this is that it is important to look at other measures of pay movements to gain a fuller appreciation of current trends in private sector pay-setting. One way of doing so, and perhaps the main way, is by examining the Government's own average weekly earnings series or AWE. This has many positive features but first it is important to be clear on what it does not represent as well as what it does. Too many media outlets, including at times the BBC, often refer to it as a measure of 'average pay rises'. It most definitely is not. Instead, it is a measure of the change (most usually the growth) in average earnings, which is quite different to our and others' data on pay reviews, which could reasonably be described as 'average pay rises', even if we generally spotlight the median. But its strength is that unlike pay settlement data, it attempts to measure the effect of all elements of pay on average earnings, including bonuses – which have been much stronger in finance and business services recently – and also one-off cost-of-living payments of the type described above. As a result, it shows stronger growth than pay settlements recently, as seen in the chart below. But as with settlements, it also remains some way below inflation.

Figure 4 Inflation versus AWE and IDR median pay ward, January 2021 to December 2022



Sources: ONS. IDR Pay Benchmarker

It is important to note here that as well as inflation, the other influence on private sector pay-setting is the labour market, which remains tight in comparison to the pre-pandemic period, something that has been caused in large measure by a rise in economic inactivity since the virus first spread. In practice it is very difficult to separate the two influences, since both form the backcloth against which employers are making decisions that in turn affect their employees' living standards.

On this, the Treasury paper relies on a certain amount of wishful thinking about the recruitment and retention situation facing the public services when it states: 'It remains the case that the most significant R&R challenges are found in specific roles, with pay not always being stated as the primary cause.' But some of these specific roles are amongst the most-populated and important in the entire public sector.

And the paper is also inconsistent on this point when it admits in section 3.11: 'There are recruitment challenges across the whole economy, in both the public and private sectors. In the Bank of England's Decision Maker Panel survey for December 2022, 71% of firms reported that they were finding it harder to recruit new employees compared to normal. Furthermore, vacancies in the three months to November were 44% above pre-pandemic levels and elevated in every sector of the economy.'

The labour market should arguably be of greater concern to the Treasury. Other European countries are facing similar problems and the UK labour market may not loosen as the Treasury seems to think it will, or at the very least issues in key areas, including the public sector, could persist. In these circumstances, the fact that public services are delivered by people in roles that the Government and public bodies are finding it increasingly difficult to recruit, retain and motivate should be enough to prompt a focus on investing in these people, which must include pay.

Even at the level of the senior civil service, challenges have emerged, and these are likely to be linked to pay. As the Institute for Government put it in its recent 'Whitehall Monitor' report: 'At the highest levels of the civil service… pay restraint has led to a decrease in the attractiveness of working as a civil servant, particularly for specialist roles – substantiating the Senior Salaries Review Body's concern that "the government's focus on keeping the annual pay increase low is eroding the attractiveness of the SCS proposition, which in turn will impact on the quality of those joining and remaining".'[32]

In respect of the wider civil service, the Institute for Government report highlights that the service needs 'to get better at external recruitment', including of specialist staff. It points out that the recruitment and retention of digital leader roles is proving particularly challenging.

[32]See page 45, [whitehall-monitor-2023.pdf (instituteforgovernment.org.uk)](whitehall-monitor-2023.pdf)

The report argues that some of these problems are due to pay, and in particular the gap with private sector salaries, which is often in favour of the latter. The report states:

> 'Civil service salaries are unlikely to ever be able to compete directly with the private sector, especially at the top levels. But the size of the pay gap is a problem. Ministers need to be aware that continuing to hold down civil service pay in an attempt to save on administration budgets will worsen existing difficulties with the external recruitment and retention of the best talent – particularly of people with in-demand skills who could command much higher salaries outside the civil service. This runs contrary to their stated aim to make the civil service more 'porous' and "encourage entrants with specific, high demand skills", and will have a negative impact on the efficiency and effectiveness of government.'[33]

Private and public sector pay compared

The Treasury hypothesis (on inflation and pay) posits a situation where public sector pay rises could be a causative factor in the level of pay rises in the private sector (with these in turn leading to inflation). Now there is certainly a relationship between the two, but the causal link points generally, and perhaps even always, in the opposite direction. Indeed the association between private and public sector pay awards can be characterised by the idea of a 'cycle', with private sector pay rises generally ahead in those periods when the economy is growing or at least not shrinking, that is, most of the time, followed by (usually briefer) periods when public sector pay awards narrow the gap or, even less often, catch up with those in the private sector.[34] Crucially, it is this notion of 'catching up' that provides the clue to the motive force in the nexus.

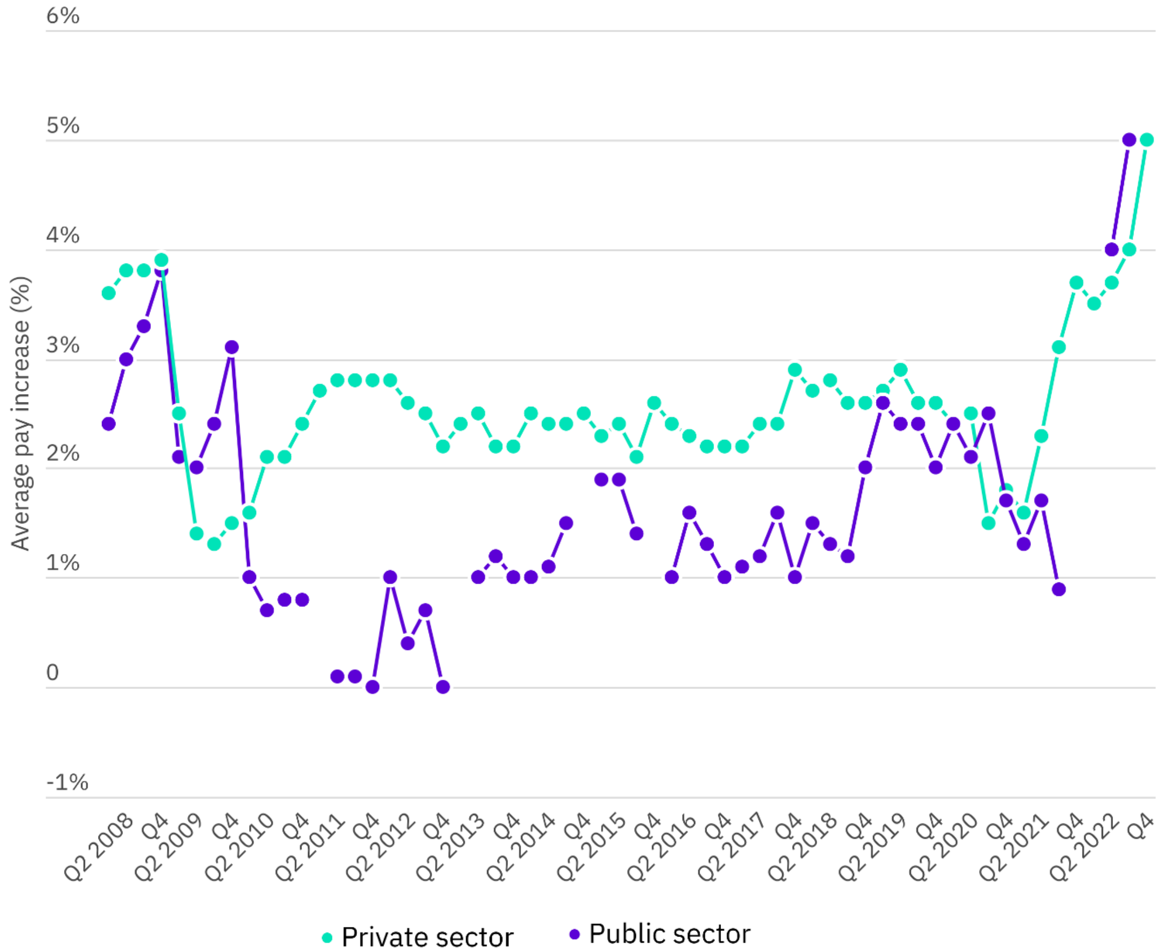
A time-series of IDR's pay award monitoring illustrates the point even more clearly. In the figure below, which shows the period from 2008, just before the major financial crisis, we can see that private sector pay awards were higher than those in the public sector in the period immediately before the crash. Public sector awards went ahead for a short time, mostly because they were made under long-term deals reached before the recession hit.

[33]See page 46, [whitehall-monitor-2023.pdf (instituteforgovernment.org.uk)](https://www.instituteforgovernment.org.uk)
[34]Employment levels in the public sector also rise and fall according to a cycle, one that is closely associated with the cycle of pay movements and relativities.

From 2010 to 2021 however, the previous relationship was re-established, albeit with pay awards in both sectors at lower levels than before.[35] In the latest period, 2022, private sector deals initially forged ahead, but public sector awards have recently caught up. This is in large measure because the Government felt duty-bound to accept recommended pay increases following pay freezes for most review body remit groups in 2021, especially in the post-pandemic context of challenges around recruitment, retention and morale.

[35]Some commentators have argued that austerity and pay restraint in the public sector over most of the last decade may have played an additional though largely unspecified role in keeping average pay increases in the private sector lower than they might otherwise have been. But even if this was a minor element, the central factor in keeping pay rises comparatively low (and holding back earnings growth in real terms) was the post-recession context and historically weak economic growth. In other words, it is highly unlikely that private sector pay awards would have been higher, even in the absence of public sector pay restraint. And in any case, as the chart shows, private sector pay awards were still mostly ahead of those in the public sector.

Figure 5 Private versus public sector* average pay awards, 2008 to 2022



Source: IDR

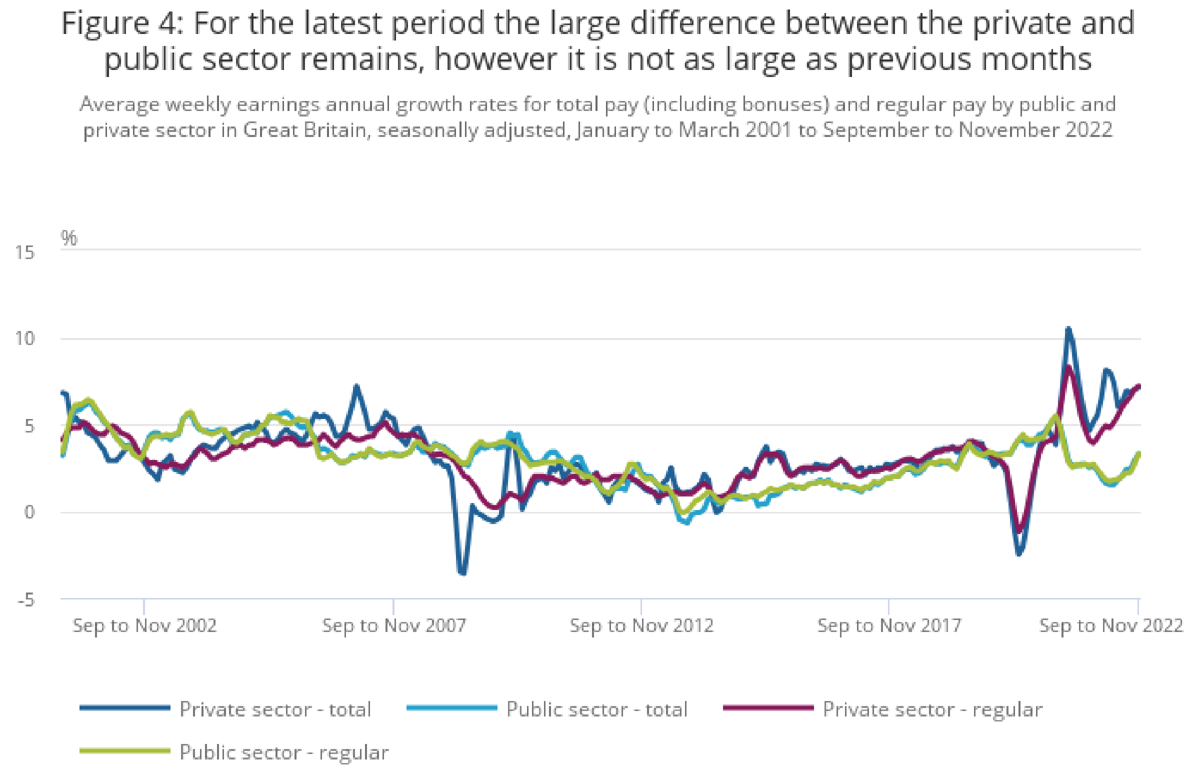
*In some periods of the year there are no public sector awards.

The official average weekly earnings series shows a slightly different picture, especially for the most recent period. Average regular earnings growth (excluding bonuses and one-off payments) in the private sector was 7.2% in September to November 2022, while in the public sector it was just 3.3%. The corresponding figures for total earnings (including bonuses and one-off payments) were 7.1% and 3.4%. The ONS commented that the figure for regular earnings represents the largest growth rate it has seen for the private sector outside the coronavirus pandemic period.[36] It also said that while the large difference

[36]The Treasury seems to think that these figures still reflect a measure of 'bounce-back' or base effects in comparison with the period when many staff were furloughed and therefore earning less than they would have been normally. Since the furlough scheme ended in September 2021, and the latest figures are for September to November 2022, this is likely to be, in the words of the ONS, 'minimal'.

between the private and public sectors remains, it is not as large as in previous months. This is mainly to do with the fact that 2022 public sector pay deals finally started to reach pay packets during the period in focus in the latest release. But despite this, the gap remains.[37]

Figure 6: average weekly earnings growth in the private and public sectors compared



Source: Office for National Statistics – Monthly Wages and Salaries Survey

Our interpretation is that in broad terms, the gap reflects the greater scope enjoyed by the private sector to use pay to deal with recruitment and retention issues as well as the cost of living crisis. The regular earnings figures are ahead of the total earnings figures because the period in question, September to November, is just ahead of the usual bonus season, which normally runs from December to March, and just because we have monitored one-off

[37]Whenever we have engaged with the ONS on the impact of pay settlements on the AWE series, the reply has always been to say that the effect is negligible. This makes sense in the light of a monthly series, when pay settlements generally only take place once a year and at different times for different workforces. But settlements covering relatively large numbers of workers, as in the public sector, can show up in the figures, and indeed the single-month figures for the public sector in each of the latest and preceding months (November and October 2022) are greater than the respective headline three-month figures, by 0.6 percentage points in each case. This is most likely to do with review body awards reaching pay packets at that point.

payments in some parts of the economy during 2022, this does not mean that many were paid in the period covered by the latest AWE figures or perhaps were not picked up by the monthly survey which forms the basis of the series. In any case, September to November is a generally quieter time for pay setting than earlier in the year.

The Treasury paper also relies on one other source of data to make comparisons between private and public sector pay outcomes – the Government's own Annual Survey of Hours and Earnings (ASHE). The Treasury's interpretation of the latest ASHE data allows it to write that 'median pay… remained 11% greater in the public sector than private sector in 2022, broadly in line with and slightly greater than the average gap between the two sectors since 2009.' This is based on the Treasury's own analysis of ASHE data for annual median gross pay for all employees in each sector, which shows a figure of around £30,000 for the public sector and just below £27,000 for the private sector.

The main problem with such an approach is that it does not represent a like-for-like comparison. Pay in the private sector ranges much more widely than in the public sector since the former contains a much greater proportion of lower-paid roles, especially in such sectors as retail, wholesale, hotels and restaurants. And how effective ASHE is in providing data on pay for those who earn most in our society remains an open question. By contrast, a large proportion of public sector roles are professional ones, generally more highly-qualified and therefore more highly-paid than in the private sector. Producing a simple whole-sector average or a median in the way that the Treasury has done merely obscures these important differences. And as a result most serious studies of the issue have attempted to take these differences into account.

Indeed, previous studies which did so showed much smaller gaps between private and public sector earnings. For example, the ONS itself has previously carried out analysis – it last did so in 2020, using data from ASHE 2019 – which controlled for worker, job and firm characteristics such as age, sex, skill level, organisation size and working patterns.[38] It did so using regression analysis and found that in relation to gross pay including overtime and bonuses, the average for the public sector was some 3% **lower** than the average for the

[38] Public and private sector earnings - Office for National Statistics (ons.gov.uk)

private sector. If bonuses are excluded then the public sector is 3% ahead. But bonuses are a key part of remuneration in some parts of the private sector, notably finance and business services, whereas in the public sector they are virtually unknown. (The differential is greater if pensions are factored in, since public sector pensions are generally better than those in the private sector, but since the Treasury has focussed on gross pay we have followed suit.)

A repeat analysis might reach similar conclusions. At the very least, we would suggest that it is unlikely to find that, as long as the differences between the sectors are accounted for, average public sector pay would be greater than average private sector by a factor of 11%.

The IFS has also carried out similar analyses and the latest one features in its 'Green Budget' for 2022, published on 8 October last year. The IFS version of the Treasury figure is the 'raw difference between public and private sector hourly pay levels, which does not take account of the different characteristics of employees in the two sectors'. According to the IFS, this fell from 13% in 2007–08 to 7% in 2021–22. Then, in the IFS version of the ONS analysis, the 'conditional public–private pay differential, which controls for the fact that public sector workers tend to be more educated, older and more experienced, has fallen steadily from around 3% in 2007–08 to slightly below zero in 2021–22.' The IFS additionally points out that this public–private pay differential is now less favourable to the public sector than at any point in the past 30 years.[39]

Therefore when the Treasury claims that 'the public sector remuneration package remains competitive', this is not necessarily borne out by studies which attempt to control for the differences between the two sectors. Indeed, if this is so, why are public sector employers experiencing recruitment/retention issues and why have a number of trade unions taken industrial action over pay and staffing issues?

One of the difficulties with the Treasury report, as highlighted by its choice of figures to illustrate the differential between average earnings in the public and private sectors, is that it tends to cherry-pick statistics to support its view, rather than examining the broad overall picture presented by all the relevant data. It is also inconsistent in some key places. For

[39]See page 3, [Public spending, pay and pensions | Institute for Fiscal Studies (ifs.org.uk)]

example, on page 14 it states: 'Data on average private sector pay settlements... provides the most comparable measure of pay growth to public sector pay settlements.' As we have highlighted, pay settlement data are useful but do not reflect bonuses or one-off payments which have become more important recently, and therefore they need to be supplemented with an assessment of the official AWE series.

But the Treasury report later opts for another 'indicator', the forecasts produced by the Office for Budgetary Responsibility (OBR) for average earnings growth (see Treasury paper, section 3.16). Presumably it does so because it better suits its purpose, which is to direct the review bodies to have greater regard for 'affordability' (see below) than tackling recruitment and retention or compensating employees for the effect of inflation on their pay. The OBR's record in forecasting average earnings growth is less than perfect and we would suggest that rather than cherry-picking an indicator which is likely to provide an outcome that is acceptable to one party, in this case the Government, we would suggest that all parties to the review bodies would be best guided by accepting the complexity of the picture and examine actual data on both pay settlements and average earnings growth, cross-referencing each against the other in order to obtain as accurate an assessment of the current pay landscape as possible.

A further potential difficulty is that although the Treasury exhorts the review bodies to have regard to affordability, it fails to define this. This may be deliberate. On the one hand it is trying to avoid being prescriptive, since the review bodies are intended to be independent, but on the other it is trying to adopt as austere a position as it can in the circumstances in the hope that review body members will respond in kind. But in the context of criticism of a lack of transparency around the review body process, it might be better to attempt to provide some indication, for example a range of acceptable rises or at least a ceiling or a way of assessing a ceiling.[40]

The Treasury states: 'There is therefore a direct trade-off between recruiting more staff, investing in public services, and giving higher pay rises.' We would argue to the contrary that

[40]For one set of recommendations on how review body processes could be improved, see: Basis of negotiation: recommendations to improve the NHS pay review process | The Nuffield Trust

since public services are delivered by people, a pay rise represents investment in public services. Even without pay rises, public sector employers would still have to recruit and if they do not retain sufficient existing staff they will have to recruit more staff to replace leavers than was originally planned. Therefore such alleged ‘trade-offs’ really represent false economies in labour market terms.

IDR

Incomes Data Research
71-75 Shelton Street
London
WC2H 9JQ

e: sales@incomesdataresearch.co.uk
w: www.incomesdataresearch.co.uk
t: +44 (0) 1702 669549