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UNCAPPED POTENTIAL

THE FISCAL AND
ECONOMIC IMPACT
OF LIFTING THE
PUBLIC SECTOR
PAY CAP

**Alfie Stirling and
Joe Dromey**

November 2017

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IPPR
4th Floor
14 Buckingham Street
London WC2N 6DF
T: +44 (0)20 7470 6100
E: info@ippr.org
www.ippr.org
Registered charity no: 800065 (England and Wales),
SC046557 (Scotland).

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ABOUT THE AUTHOR

Alfie Stirling is a senior economic analyst at IPPR.

Joe Dromey is a senior research fellow at IPPR.

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SUMMARY

The UK needs a pay rise. Real median (average) household incomes are today only five per cent higher than they were in 2007 and the country is in the worst period of pay growth in 150 years, exposing serious weaknesses in the UK's economic model. The focus of government economic policy must now be to raise pay and productivity across the entire economy, and it is critical that the public sector is not left behind.

The public sector has faced seven years of consecutive pay squeezes, with real terms cuts in salary at every level. Both public sector organisations covered by pay review bodies and the majority of those where wages are set by collective bargaining have been subjected to the squeeze. Raising public sector pay stands alongside welfare reform and boosting private sector productivity and earnings through industrial strategy as a key part of the response to the country's crisis in living standards.

Following the 2017 General Election, there has been a growing cross-party consensus that the public sector pay cap must be lifted. Recent polling has also shown that a significant majority of voters support rising pay for most public sector occupations. The one per cent pay cap was due to continue until 2019/20, but following the General Election, the government signalled a change in direction. Prison officers have been offered a pay rise of 1.7 per cent for 2017/18, while police officers have been offered two per cent and the Secretary of State for Health has said that the NHS pay cap has been scrapped. However, with inflation close to three per cent, all of these settlements could yet see pay fall still further in real terms and employers have been asked to fund both of these pay rises from existing budgets with no additional funding.

This briefing sets out the fiscal and economic impacts of lifting the public sector pay cap for the final two years of the pay squeeze up to 2019/20. Compared with a baseline scenario of pay rises continuing to be capped at one per cent a year, we model two further illustrative scenarios for public sector pay increases up to 2019/20. The first scenario increases pay in line with the Consumer Price Index (CPI); the second 'catch-up' scenario increases public sector pay in line with private sector earnings plus an additional percentage point of growth.

We find that the headline cost of increasing public sector pay in line with CPI is £5.8 billion in 2019/20 while the cost of our 'catch-up' scenario is £12.7 billion. However, a significant portion of these costs would be returned to the Treasury almost immediately in the form of higher taxes and lower spending on means-tested benefits. After taking these receipts and savings into account, the immediate net cost of increasing public sector pay in line with CPI falls to £3.55 billion, while the cost of our 'catch-up' scenario is £7.75 billion.

We also model the economic impact of increasing public sector pay on Gross Domestic Product (GDP). We find that increasing public sector pay in line with CPI would, at a conservative estimate, generate additional economic growth of £800 million by 2019/20, of which £250 million would be additional taxes. Under our 'catch-up' scenario, GDP would be at least £1.75 billion, with additional taxes worth £550 million. **Taking this into account, this brings the final cost to government of increasing public sector pay in line with CPI to £3.3 billion per annum in 2019/20. The final cost to government of our catch-up scenario would be £7.2 billion.**

We argue that government should revise its policy on public sector pay as part of a wider strategic intervention to raise earnings across the economy, in both the public and the private sectors. The public goods created by services such as health and education have both intrinsic value in themselves as well as broad economic benefits that are fundamental to a high-performing economy. In a world where the focus of government must shift to raising pay across the economy as a whole, it is critical for the quality of future service delivery that the public sector is not left behind.

We set out three principles to guide government and pay review bodies in lifting the public sector pay cap:

- 1. Over a medium-term horizon, government should budget to restore pay to its real terms level of 2010/11, the year prior to the formal pay freeze coming into effect. This process should be gradual, and responsive to the macro trends in the economy. As a minimum, government should commit to supporting a new 'double lock' for public sector pay. This would guarantee funds for public sector pay to rise by either CPI or private sector earnings, whichever is highest. The double lock should remain in place until public sector earnings return to 2010/11 levels. During the lifetime of the double lock, this will ensure that pay will never fall in real terms, and in most years it would be expected to 'catch up' relative to 2010/11 levels. Once real terms pay has returned to 2010/11 levels, future increases above inflation should be linked to improved quality of services for the public.**
- 2. Until 2010/11 pay levels are restored, pay review bodies, public sector employers and trade unions should consider recommending additional uplifts in pay on top of the double lock.** This could be delivered through pay settlements that include higher percentage pay rises for workers on the lowest salaries bands, such as through a cash element to increasing pay. Faster increases in pay should also be delivered through a public sector-wide commitment to the Living Wage.
- 3. All increases in public sector pay for years in the current Spending Review period should be paid for with additional funding outside current public service budgets.** These funds should be raised through additional taxation on the highest income households in society. This would help to make sure that the overall package is as progressive as possible, while also maximising the benefits to GDP growth as in effect money will be redistributed to those more likely to boost consumption in the economy.

1. THE ECONOMIC CONTEXT: A FAILING MODEL

The UK is in the worst period of pay growth for more than 150 years. Real terms earnings for the period 2007 to 2016 have seen the biggest average contraction since the period 1851 to 1862 (IPPR analysis using Bank of England 2017) and the latest forecasts from the Office for Budget Responsibility (OBR) show that wages are not expected to reach 2007 levels until after 2022/23 (OBR 2017a). This period has also seen an unprecedented ‘de-coupling’ between general economic growth and average wage returns to labour (see figure 1.1). Real GDP per person in work rose by 3.5 per cent between 2010 and 2016, but real average weekly earnings for the same period contracted by 1.1 per cent (Stirling 2017) – a combination that is unique, both on the UK historical record (Stirling 2017) and among advanced economies since the start of the financial crisis.¹

Stagnant productivity growth has been to blame for the lacklustre performance of both GDP and earnings since the financial crisis began, while all three have been affected by internationally low rates of public and private investment in the UK, excessive short-termism in corporate governance and a financial sector that has failed to sufficiently support the real economy (for further analysis on the UK’s structural economic weaknesses, see IPPR 2017).

However, these factors do not alone explain the UK’s ‘de-coupling’ between GDP and earnings. The collapse in real earnings relative to GDP has been driven primarily by a marked rise in the cost of consumption (for further analysis of this, see Stirling 2017), driven by the rising price of imports due to the weak exchange rate of the pound. Since the financial crash, the trend in real earnings has more or less followed that of the effective exchange rate for sterling, albeit with a lag of around 12 months (see figure 1.1).

Together, the macro picture has demonstrated a serious yet under-discussed weakness in the UK’s economic model. Falling confidence from international investors has caused significant collapse in the value of the pound twice in the past 10 years – once following the financial crash and once since the vote to leave the European Union – bringing with it rising prices for consumers and lower standards of living if left unaccompanied by nominal growth in pay.

While a falling exchange rate reduces real earnings by increasing the cost of imported consumer goods, in theory it should also make UK exporting firms more competitive, and therefore able to lift their output and domestic wages.² The fact that a depreciating pound has twice led to consumer prices rising faster than average nominal wages (the definition of a contraction in real wages) is symptomatic of an economy in acutely poor health and one that is structurally unable to compete internationally.

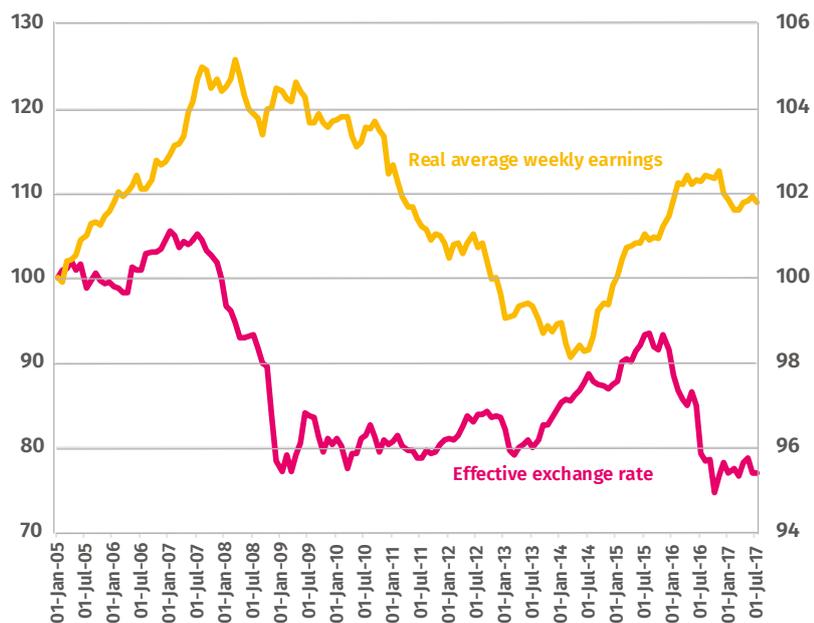
Key to this has been a lack of investment, with UK firms now net savers at aggregate in the economy (Tomorrow’s Company 2016). Low nominal wage growth

¹ See: <https://www.ft.com/content/83e7e87e-fe64-11e6-96f8-3700c5664d30>.

² The latest wage data from the UK’s manufacturing sectors suggest that any increase in export profits as a result of a currency devaluation has not fed through into wages.

is both a cause and an effect of this phenomenon. Cheap labour has led to firms raising output by increasing the number of hours worked rather than improving the stock of working capital, such as machinery, software and management strategies. This erosion of the UK's capital base in turn reduces worker productivity and the economic potential for a pay rise. Consequently, the combination of absent business investment and low wages has meant that GDP growth since 2014 has come almost entirely from household consumption paid for by borrowing (Whittaker 2017), much of which is unsustainable over the long term.

FIGURE 1.1



Real average weekly earnings (three-month average) and the effective exchange rate for sterling (monthly average), 100 = January 2005

Source: IPPR calculations using ONS 2017a and Bank of England 2017.

Such a failing economic model requires radical and wholesale reform beyond the scope of this briefing – however, it is being taken on by IPPR's two-year research programme for the Commission on Economic Justice.

Nonetheless, the government can make a meaningful intervention by helping pay to rise now. Part of the solution to break the UK's low pay-low productivity cycle is to make labour more expensive than capital: therefore, increasing incentives for firms to invest in raising productivity (Dolphin and Hatfield 2015). The UK's great economic 'muddle' (IPPR 2017) has seen no real increase in average wages in at least a decade. Government needs to play its part to help turn things around.

While much of the heavy lifting must come through a renewed partnership between government and business in the private sector (see IPPR 2017) – and through a new industrial strategy in particular (see Jacobs et al 2017) – the public sector must also play its part. Unlike in the private sector, the capacity for a pay rise in the public sector cannot be driven by traditional economic measures of productivity. The public goods created by services such as health and education have both intrinsic value in themselves as well as broad economic benefits that are fundamental to a high-performing economy. In a world where the focus of government must shift to raising pay across the economy as a whole, it is critical for the quality of future service delivery that the public sector is not left behind.

2. THE PUBLIC SECTOR PAY CAP

Public sector pay is set either through negotiation between employers and public sector trade unions, or else following evidence-based advice to government from specialist pay review bodies. There are eight pay review bodies, covering 45 per cent of the public sector workforce (OME 2017), but government is not bound to follow the recommendations of these institutions.

As part of their efforts to reduce public spending, the Coalition Government introduced a two-year public sector pay freeze from 2011/12. This was followed by five years of pay rises being effectively capped at one per cent across the vast majority of the public sector. This policy has affected both areas of the public sector where pay is set by collective bargaining and areas covered by pay review bodies. The government had planned to continue the public sector pay cap for another two years, up to the end of 2019/20 (HMT 2015). This would have represented an unprecedented nine-year pay squeeze – and a decade of real terms pay cuts in local government where pay was frozen in 2010/11.

However, following the 2017 General Election, and following sustained pressure from public sector trade unions, concerns expressed by pay review bodies and growing recognition of the impact of the pay cap on the workforce and on public services themselves, the government has started to change course. Prison officers have been offered a pay rise of 1.7 per cent for 2017/18, and police officers have been offered two per cent, one per cent of which was non-consolidated. Most recently, the Secretary of State for Health has said that the NHS pay cap has been scrapped.

While the government has abandoned the one per cent cap, the pay rises offered so far to police officers and prison officers remain well below inflation, so these pay deals would represent another year of real terms pay cuts. In the case of police and prison officers, the pay rises also do not come with additional funding; the cost of the rise over and above the one per cent planned for will have to come from existing budgets that have already borne the strain of seven years of austerity.

While public sector pay is mostly a devolved issue, the Westminster government's approach has led to pay being capped in devolved authorities too. The funding cuts associated with the pay cap have led to reductions in Barnett consequential for devolved nations, and this has led to the Welsh and Scottish administrations saying that public sector pay rises would be dependent on an increased settlement in Westminster (GMB 2017). While the Scottish Government has recently announced its intention to lift the pay cap, it has warned that 'if austerity is not lifted, our ability to offer the kind of deal we might want to will remain constrained, no matter what powers we use' (MacKay 2017). In Northern Ireland, the collapse of the Executive has delayed the implementation of even a one per cent pay award in 2017/18.

3.

REAL TERMS PAY CUTS FOR SALARY GRADES

The long public sector pay squeeze has led to a significant decline in the value of public sector pay (TUC 2016).

Table 3.1 shows the impact of the pay squeeze on real terms pay between 2010/11 and 2017/18. It also shows the projected loss of real terms earnings by 2019/20 were the pay cap to continue.

TABLE 3.1
Pay points for illustrative public sector workers, 2010/11, 2017/18 and 2019/20 (£, 2017/18 prices)

	2010/11	2017/18	2019/20 (Cap)
Refuse collector (SCP 15)	18,634	-1,562	-2,064
NHS Estates officer (band 3)	21,540	-1,688	-2,271
School teacher (outside London, M6)	36,624	-2,800	-3,794
Nurse (band 5)	31,960	-3,214	-4,059
Police Sergeant (pay point 1)	39,684	-4,107	-5,153

Source: IPPR analysis of NHS Employers 2017, NHS Employers 2010, Met IBB 2010, NASUWT 2016, NJCLGS 2009, NJCLGS 2016, Police Federation 2017 and OBR 2017.

TRENDS IN PUBLIC SECTOR PAY

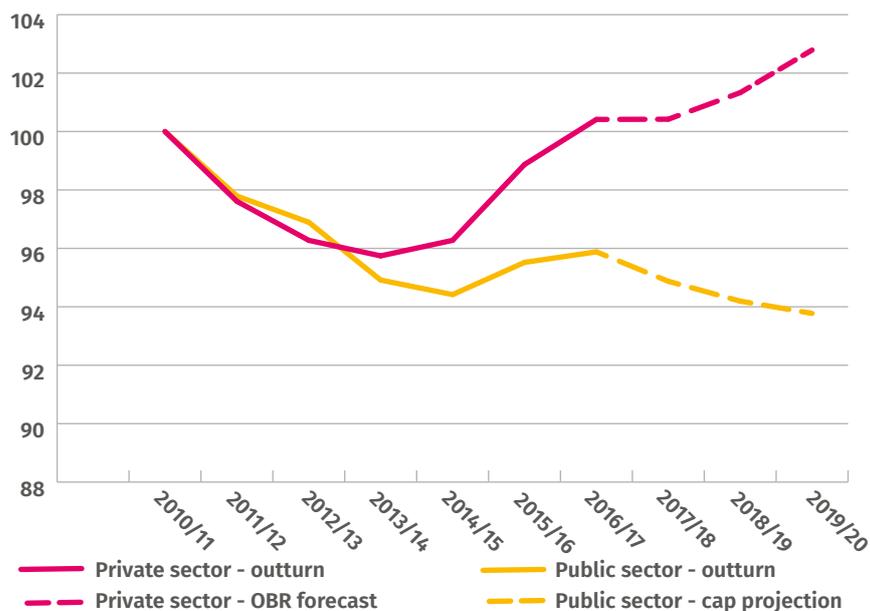
Since the start of the public sector pay squeeze in 2011/12, the rate of real growth in public sector pay has fallen significantly behind private earnings (see figure 3.1).³ Real earnings in both the private sector and the public sector fell significantly between 2010/11 and 2013/14, partly as a result of high inflation driven by a weak pound. Private earnings fell fastest, largely due to compositional effects such as low-skilled workers starting to come back into the jobs market on below average salaries.

Since 2013/14, however, private sector earnings have grown consistently and this trend is forecast to continue for the next few years, with pay rising in real terms up to 2019/20 (IPPR analysis of OBR 2017a). However, in the public sector, the pay cap has stifled average wage growth since 2013/14. While a one per cent increase in pay scales was enough to deliver a small real terms increase during

³ This report uses the CPI index for inflation from the ONS, and forecasts for CPI from the OBR, to measure all 'real terms' effects across time. Other inflation metrics are available, such as the consumer price index including owner occupiers' housing costs (CPIH),– and the retail price index (RPI), which uses a different methodology to calculate the average rate of price change across consumer items. While the direction of trend in real pay is similar for all metrics of inflation for the period in question, our findings will not be exactly the same as those estimated using alternative inflation indices.

years of low inflation, much of the gains since 2014/15 are likely to be lost this year. This will deteriorate further if pay scales continue to rise by just one per cent and inflation stays above the Bank of England's two per cent target, as is currently expected.

FIGURE 3.1
Trend growth in real average weekly earnings for the private and public sectors respectively, outturn and forecasts



Source: Authors' calculation based on ONS 2017a, OBR 2017a and OBR 2017b.

Note: Rates of change in average weekly pay will not be exactly the same as the rate of change of pay scales due to compositional effects in the workforce.

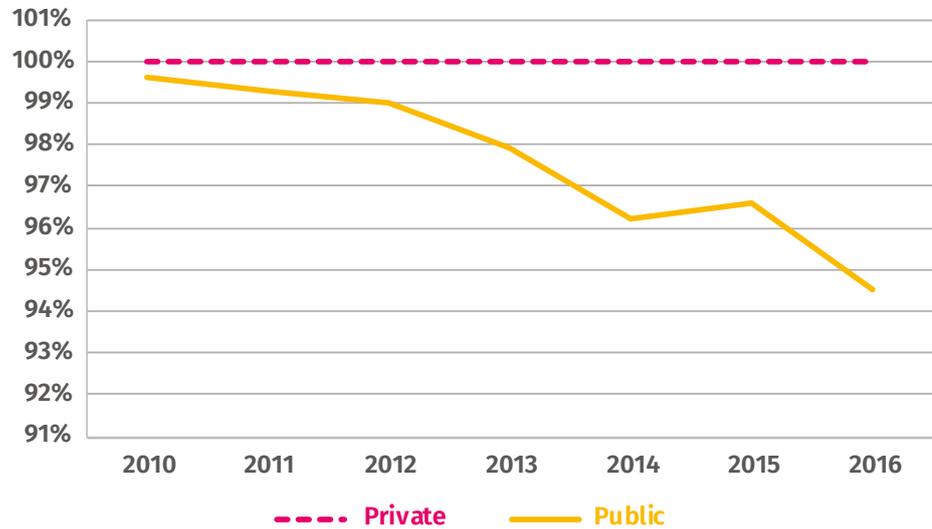
The effect of these trends has been to push the level of public sector earnings below the private sector (see figure 3.2), compounding issues of recruitment and retention. Although the levels of raw earnings are higher in the public sector compared to the private – due to the higher proportion of professional occupations in the former – comparing otherwise equal workers in each sector suggests that public sector employees are in fact paid less than their private sector counterparts. A recent freedom of information request by the GMB union showed that the government's own analysis of the pay differential between public and private sector workers estimated lower pay in the public sector across like-for-like employees in 2016. Detailed econometric modelling from the ONS (2016) also showed that pay in the public sector was 5.5 per cent lower compared with otherwise similar employees in the private sector.⁴ Furthermore, this gap has grown considerably since the government's pay squeeze first came into force in 2011/12.⁵

4 Results from both the IFS (Cribb 2017) and the ONS (2017a) show that if a smaller number of control variables are included, public sector pay remains higher than private sector pay. In particular, comparing like-for-like across the size of employer organisations (in terms of number of employees) has been shown to be particularly important.

5 ONS estimates do not take account of either employer or employee pension contributions, both of which are higher in the public sector compared with the private.

FIGURE 3.2

Average public sector earnings as a proportion of average private earnings, comparing hourly pay on a like-for-like basis, 2010 to 2016



Source: ONS 2016

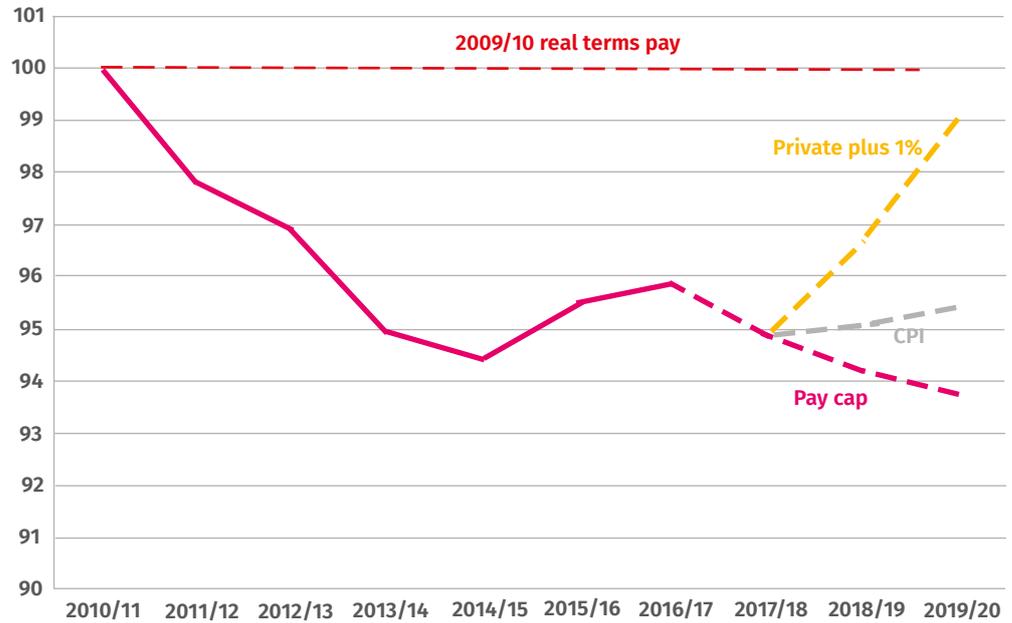
Note: The data represents results from ONS modelling using the Annual Survey of Hours and Earnings. The model compares average rates of hourly pay (excluding overtime pay), comparing like-for-like workers across the public and private sectors in terms of age, gender, occupation, geography, hours worked, weekly hours, length of employment and size of employer.

In this paper, we set out three projected scenarios for public sector pay up to 2019/20 (see figure 3.3). In 2016/17 – the final year for which outturn data is available – weekly earnings were on average 4.1 per cent below their level in 2010/11, the year before the cap came into effect. This is expected to fall to 5.1 per cent below 2010/11 levels in 2017/18. In our forecast baseline scenario, which provides an estimate for weekly earnings if the pay cap is not lifted, by 2019/20 real terms public sector pay will have fallen to a level 6.2 per cent below that of 2010/11.

Our first counterfactual scenario sees public sector pay rising in line with CPI inflation. In this scenario, weekly earnings in 2019/20 are likely to be 1.7 per cent higher than they would otherwise be if the cap were not lifted. But pay would remain 4.6 per cent below 2010/11 levels. Our final counterfactual represents an illustrative ‘catch-up’ scenario. Here, average weekly pay rises in line with private sector earnings, plus an additional percentage point of growth each year. In this scenario, levels of average pay in 2019/20 would be 5.6 per cent higher compared with if the cap remained in place, and only one per cent lower than average pay in 2010/11.

FIGURE 3.3

Trend growth in real average weekly earnings for the public sector, outturn and counterfactual scenarios



Source: Authors' calculation based on ONS 2017a, OBR 2017a and OBR 2017b.

Note: The projection for CPI shows a small real terms increase because we assume that pay is uprated at the beginning of a given financial year in line with the average for the previous September. Because inflation is forecast to fall over the period, this means that pay is uprated slightly faster than the average rate expected for the forthcoming year. Our uprating scenarios are illustrative only. They assume that all workers see pay increase in line with the uprating policy and do not take account of compositional effects in the workforce.

4.

THE ECONOMIC AND FISCAL IMPACTS OF LIFTING THE PUBLIC SECTOR PAY CAP

For this briefing, IPPR has modelled the three scenarios set out earlier in order to compare and assess their impacts on both the public purse and the economy as a whole. The analysis was conducted using IPPR's microsimulation tax-benefit model based on the latest sample of 19,000 from the 2015/16 Family Resources Survey (for further information, see DWP 2017).⁶ The model is capable of projecting forward different rates of earnings for individuals in the economy, estimating the interactive effects on personal tax and benefits, and rebuilding an aggregate picture from the bottom up. By analysing the new data created, we are then able to present estimates of the fiscal and distributional effects of different rates of pay increase in the public sector.

In the first instance, we model the static – before behavioural or multiplier effects – impact of an increase in pay on the government's fiscal position (see Table 4.1).⁷ Our findings show that a significant portion of funding required to lift the public sector pay cap is in fact returned to the Treasury almost immediately in the form of higher tax receipts and lower welfare payments. The initial cost per year in 2019/20 of uprating public sector pay in line with CPI for two years from 2018/19 is £5.8 billion, compared with the cost had the cap remained in place. However, this drops to £3.55 billion once higher receipts from Income Tax and National Insurance and lower welfare payments from means-tested benefits are taken into account. Uprating pay scales in line with public sector earnings plus one per cent a year has an initial annual cost of £12.7 billion in 2019/20, which falls to £7.75 billion after higher taxes and lower welfare payments are taken into account.

6 For the purposes of our modelling, we strip out all compositional effects from a changing labour market across time and assume that changes in average earnings are exactly equal to the change in each individual's pay.

7 Because these results are static, they do not take account of any feedback effects on costs, such as through the number of people recruited or retained on the public sector pay bill, which might occur as a consequence of uprating pay bands at different rates.

TABLE 4.1

Annual fiscal effects of lifting the pay cap, relative to keeping the cap in place, £ million, 2019/20

	CPI	Private sector plus one percentage point
Change in total pay bill	5,800	12,700
<i>of which:</i>		
Employer pension contributions	850	1,900
Tax receipts generated	2,100	4,600
<i>of which</i>		
Income tax	1,100	2,450
Employee NICs	400	850
Employer NICs	600	1,300
Net pay	2,850	6,200
Savings from means-tested benefits	150	350
Change in net income	2,700	5,850
Immediate net cost	3,550	7,750

Source: Authors' analysis using the IPPR tax-benefit model based on data from the Family Resources Survey 2015/16, OBR 2017a, OBR 2017b, ONS 2017a, ONS 2017b and Cribb 2017.

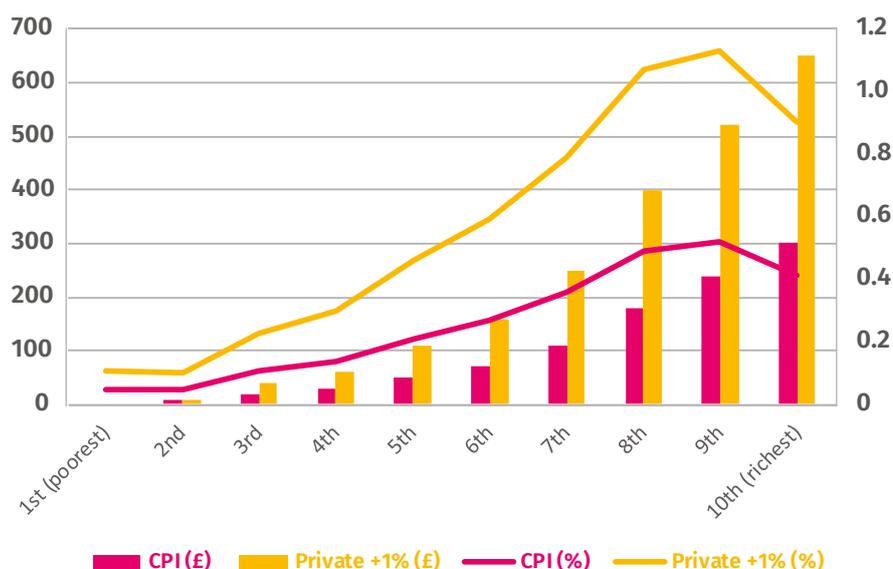
Note: Counterfactual scenarios assume that the cap is lifted from 2018/19 onwards and pay scales are uprated by either CPI or private sector earnings plus one per cent (respectively) for two years to 2019/20. All effects are compared with a baseline scenario where public sector pay goes up with the OBR's forecasts for 2018/19 and 2019/20. Columns may not sum due to rounding.

5. THE DISTRIBUTIONAL IMPACT OF INCREASING PUBLIC SECTOR PAY

Our analysis also provides an estimate for the distributional effects in 2019/20 of raising the public sector pay bill above the cap in respect to our two counterfactual scenarios. Figure 5.1 places families into 10 equally sized buckets or deciles, from poorest to richest, in terms of their combined equivalised income. From this type of analysis, we can see that the effect of lifting the pay cap in the public sector is likely to disproportionately benefit higher-income families. However, this does not provide a full picture of the distributional impact.

The benefits in kind accrued by securing and maintaining high-quality public services disproportionately benefit lower-income households (Reed 2016). The results presented largely reflect the fact that levels of pay in the public sector are higher than the UK average, and that the proportion of public sector workers within deciles is likely to be higher at the top of the distribution compared with the bottom. However, as shown in Chapter 3, public sector workers are in fact paid less than otherwise similar private sector workers when compared on a like-for-like basis.

FIGURE 5.1
Average change in disposable family incomes by equivalised disposable income decile, total public sector, 2019/20

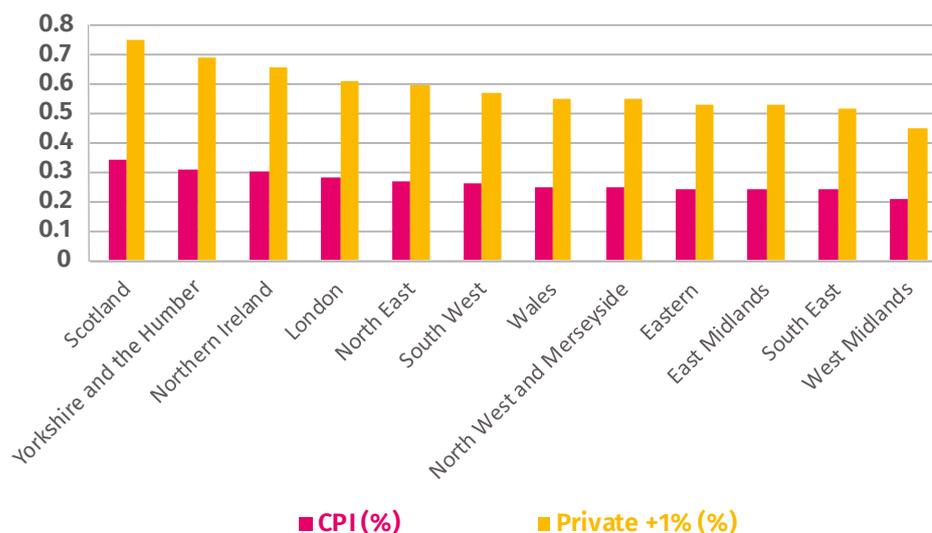


Source: Authors' analysis using the IPPR tax-benefit model based on data from the Family Resources Survey 2015/16, OBR 2017a, OBR 2017b, ONS 2017a and ONS 2017b. See source for Table 4.1 for further information.

Note: Averages taken across all households in the economy, including the majority who do not work in the public sector and whose pay remains constant across all scenarios. The average change for public sector workers only would be significantly higher.

In terms of the impact on regional imbalances in pay, the effects of lifting the cap are mixed. The largest percentage increases in average disposable income are likely to be seen in Scotland, Northern Ireland and Yorkshire, with lower percentage increases in the South East where pay across the whole economy is higher and the proportion of public sector workers is lower. However, London is likely to see the fourth largest percentage boost, partly as a result of improved incomes for the central government administrators.

FIGURE 5.2
Average percentage change in disposable family incomes by region of residence, 2019/20



Source: Authors' analysis using the IPPR tax-benefit model based on data from the Family Resources Survey 2015/16, OBR 2017a, OBR 2017b, ONS 2017a and ONS 2017b. See source for Table 4.1 for further information.

Note: Averages taken across all households in the economy, including the majority who do not work in the public sector and whose pay remains constant across all scenarios. The average change for public sector workers only would be significantly higher.

6. THE ECONOMIC IMPACT OF INCREASING PUBLIC SECTOR PAY

In addition to the static analysis presented above, there is also likely to be a positive stimulus in the economy through increased household consumer spending. This is likely to increase GDP and tax receipts, reducing the overall cost to government still further. We estimate these effects using the methodology set out by the economist Howard Reed (2014).

Using the IPPR tax-benefit model, Reed (2014) has shown that the distributional effect of increased public sector pay is similar to that of a decrease in Income Tax. This means that the Office for Budget Responsibility's estimated multiplier effect on GDP of 0.3, following a change in Income Tax, provides an approximate estimate of the likely effect on GDP following a change in public sector pay. The additional GDP generated from higher spending will also include new tax revenue from VAT, as well as further labour tax receipts due to the jobs created to meet new demand in the economy. We estimate that uprating all public sector pay in line with CPI will result in additional GDP growth worth £800 million⁸ (including additional tax receipts worth just under £250 million) in 2019/20, compared to a baseline where the cap remains in effect. Uprating in line with private sector earnings plus one per cent a year would see GDP £1.75 billion higher and tax receipts up £550 million.

It should be noted, however, that OBR multipliers are currently lower than those estimated by other economists. For example, the International Monetary Fund (IMF) estimates average multipliers of between 0.54 and 1.02 on a comparable basis to the OBR estimate of 0.3 for income tax (Howard 2014). Under our CPI scenario, these estimates would imply additional growth in GDP of between £1.4 billion and £2.7 billion – compared with our more conservative, core estimate of £0.8 billion using OBR estimates – including additional tax receipts worth between £400 and £750 million (see note under Table 6.1 for more details). The upper bound estimate would suggest that as much as £4 billion could be returned to the exchequer of the original £5.8 billion cost of lifting public sector pay scales with CPI.

⁸ Our calculations of additional GDP in 2018/19 are likely to represent an underestimate since they exclude the cumulative and compound effects of higher GDP in 2018/19, as well as any multiplier effects from higher investment in the economy as a result of increased employer pension contributions. They also exclude any upward pressure that may come to bear on private sector earnings as a result of higher pay settlements in the public sector, which could also boost tax receipts and economic activity.

TABLE 6.1**Annual effect on GDP and final fiscal cost, £ million, 2019/20**

	CPI	Private sector plus one percentage point
Change in net income	2,700	5,850
Additional GDP	800	1750
<i>of which:</i>		
Consumption and labour taxes	250	550
Non-tax components of GDP	550	1200
Final cost to government	3300	7200

Source: 'Change in take home pay' taken from Table 5.1. Additional GDP estimated using the OBR 2015 multiplier for Income Tax (see Reed 2014). Additional receipts from consumption taxes were estimated by applying an estimate for the marginal propensity for additional consumption following a positive income shock (Bunn et al 2017) and an estimate for the value of consumption taxes in additional consumer spending (Reed 2014). Additional receipts from increased labour in the economy are estimated using ONS 2017c and OBR 2017a projections for the share of labour costs in GDP and an estimate for the proportion of wages recouped in taxes (Reed 2014). The final cost to government is estimated by subtracting additional tax receipts from the immediate net cost in Table 4.1.

Note: Counterfactual scenarios assume that the cap is lifted from 2018/19 onwards and pay scales are updated by either CPI or private sector earnings plus one percentage point (respectively) for two years up to 2019/20. All effects are compared with a baseline scenario where public sector pay goes up with the OBR's (2017a) forecasts for 2018/19 and 2019/20. Columns may not sum due to rounding.

7. POLICY RECOMMENDATIONS: LIFTING THE CAP

The UK needs a pay rise. Real median (average) household incomes are today only five per cent higher than they were in 2007. This is 10-15 per cent lower than would have been expected had incomes continued on their pre-economic crisis growth rates – the equivalent of almost £4,000 per year ‘lost income’ for the average household (Hood and Waters 2016). This trend is set to continue. The OBR forecasts no real growth in median income over the next two years, and only modest growth thereafter (OBR 2017a). This would leave the incomes of half of the population in 2021/22 more than 15 per cent below where they might have been expected before the financial crisis hit – equivalent to over £5,000 per household per year on average (Hood and Waters 2016). For the poorest fifth of the population, incomes are in fact expected to fall over the next five years.

Raising public sector pay is not a silver bullet to the UK’s crisis of low incomes. However, it stands alongside welfare reform and boosting private sector productivity and earnings through industrial strategy as a key part of the response to the country’s economic ‘muddle’ (IPPR 2017). Recent polling has also shown that a significant majority of voters support rising pay for most public sector occupations (Ashcroft 2017). Crucially, the public sector workforce also delivers value beyond its economic contribution in terms of consumption power in the economy: public goods such as policing, health and education are the foundations upon which private commerce is built. Recruiting and retaining a highly skilled and motivated workforce to deliver public services is therefore an important goal in and of itself.

The government’s pay cap policy, and their refusal to fund the cost of any pay rise of above one per cent, has effectively constrained both the operation of pay review bodies and the collective bargaining process between employers and unions in recent years. The government should scrap the public sector pay cap and restore the independence and credibility of the public sector pay-setting process. It should review its guidance to pay review bodies and to public sector employers, making clear that it will not arbitrarily limit the funding available for any pay rise.

We set out three principles to guide government and pay review bodies in lifting the public sector pay cap:

- 1. Over a medium-term horizon, government should budget to restore pay to its real terms level of 2010/11, the year prior to the formal pay freeze coming into effect. This process should be gradual, and responsive to the macro trends in the economy. As a minimum, government should commit to supporting a new ‘double lock’ for public sector pay. This would guarantee funds for the public sector pay to rise by either CPI or private sector earnings, whichever is highest. The double lock should remain in place until public sector earnings return to the levels of 2010/11. During the lifetime of the double lock, this will ensure that pay will never fall in real terms, and in most years it would be expected to ‘catch up’ relative to**

2010/11 levels. Once real terms pay has returned to 2010/11 levels, future increases above inflation should be linked to improved quality of services for the public.

2. **Until 2010/11 pay levels are restored, pay review bodies, public sector employers and trade unions should consider recommending additional uplifts in pay on top of the double lock.** This could be delivered through pay settlements that include higher percentage pay rises for workers on the lowest salaries bands, such as through a cash element to increasing pay. Faster increases in pay should also be delivered through a public sector-wide commitment to the Living Wage.
3. **All increases in public sector pay for years in the current Spending Review period should be paid for with additional funding outside current public service budgets.** These funds should be raised through additional taxation on the highest income households in society. This would help to make sure that the overall package is as progressive as possible, while also maximising the benefits to GDP growth as in effect money will be redistributed to those more likely to boost consumption in the economy.

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