



Carl Emmerson

Increasing pressures on public service spending

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Rising inflation eats into public spending settlements

- October Spending Review planned for 3.0% average real growth in departmental budgets over the next 3 years
 - day-to-day: 3.3% per year; investment: 1.9% per year
 - real-terms increases planned for all departments, with notable exception of Ministry of Defence
- Predicated on inflation forecasts that now look too low
 - cash budgets so higher inflation → lower spending power
- Public spending typically deflated by the GDP deflator; if this increases by as much as pre-invasion CPI
 - 3.3% average real growth in day-to-day budgets becomes 2.4%; higher inflation wipes out $\frac{1}{4}$ of the planned real increase
 - increases in the outlook for inflation since could eat into this further

Rising energy prices

- Public sector spends at least £3 billion a year on energy and fuel
 - Schools and hospitals alone spend £1 billion to £1½ billion on electricity and gas
 - Ministry of Defence spends about £0.6 billion on energy and fuel
- A 50% price rise would cost at least £1½ billion a year in total across the public sector
- Day-to-day Ministry of Defence budget rising by £0.9 billion between this year and next
 - in October this implied a modest (£50 million) real increase
 - easily eliminated by higher energy and fuel prices

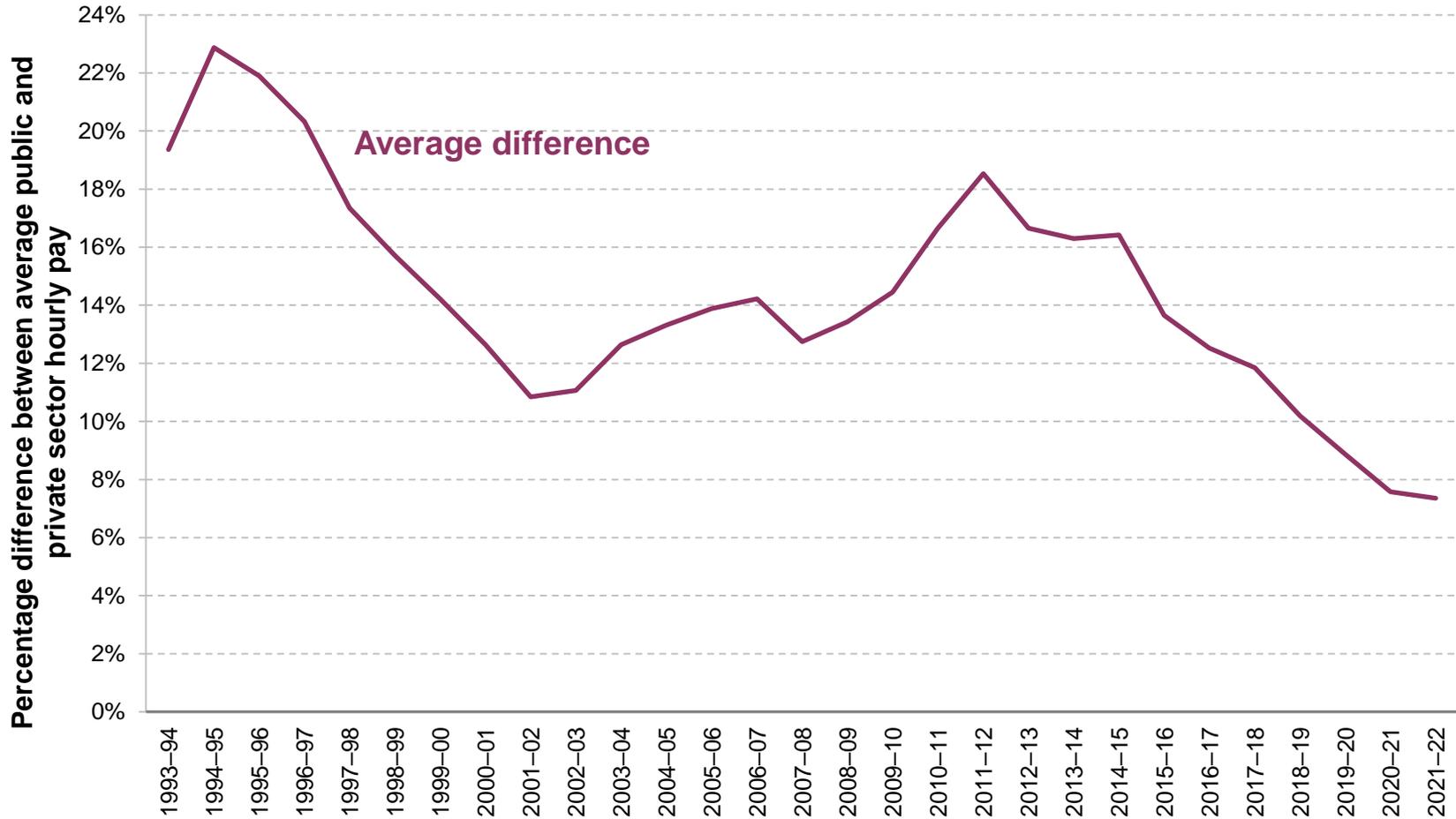
Inflation and public sector pay

- Public sector has 5.7m employees with a total wage bill \approx £240 billion
 - just over one-third of public service spending
 - each additional 1% on pay \approx £2.4 billion (about £400 per worker)
- CPI forecasts for 2022–23: NIESR = 7.3%, Citi = 8.4%, so perhaps \sim 4ppt higher than in October (OBR = 3.7%)
 - an extra 4% on the public sector pay bill \approx £10 billion, or about £1,750 per public sector employee
- What if pay awards were set at 5%?
 - NHS: would cost £4 billion, take-up over one-quarter of the NHS cash budget increase and still imply a real wage cut
 - schools: would cost £1 $\frac{3}{4}$ billion, take-up almost half of the schools cash budget increase and still imply a real wage cut
 - similar challenges in other public services
- Decisions over public sector pay not due until later in the year
 - Chancellor may set out broad pay policy in Spring Statement

The outlook for public sector pay

- Pay of most public sector workers was frozen this year
 - given spending plans and inflation cash increases inevitable
 - but below-inflation pay awards seem likely
- Any award comes on the back of squeezed pay over 2010s
 - average weekly earnings in public sector in 2021 Q4 0.2% lower in real terms than in 2010 Q1 (versus 5.6% *higher* in private sector)

Public sector pay has fallen relative to private sector pay



Note: Source: IFS calculations using Labour Force Survey.

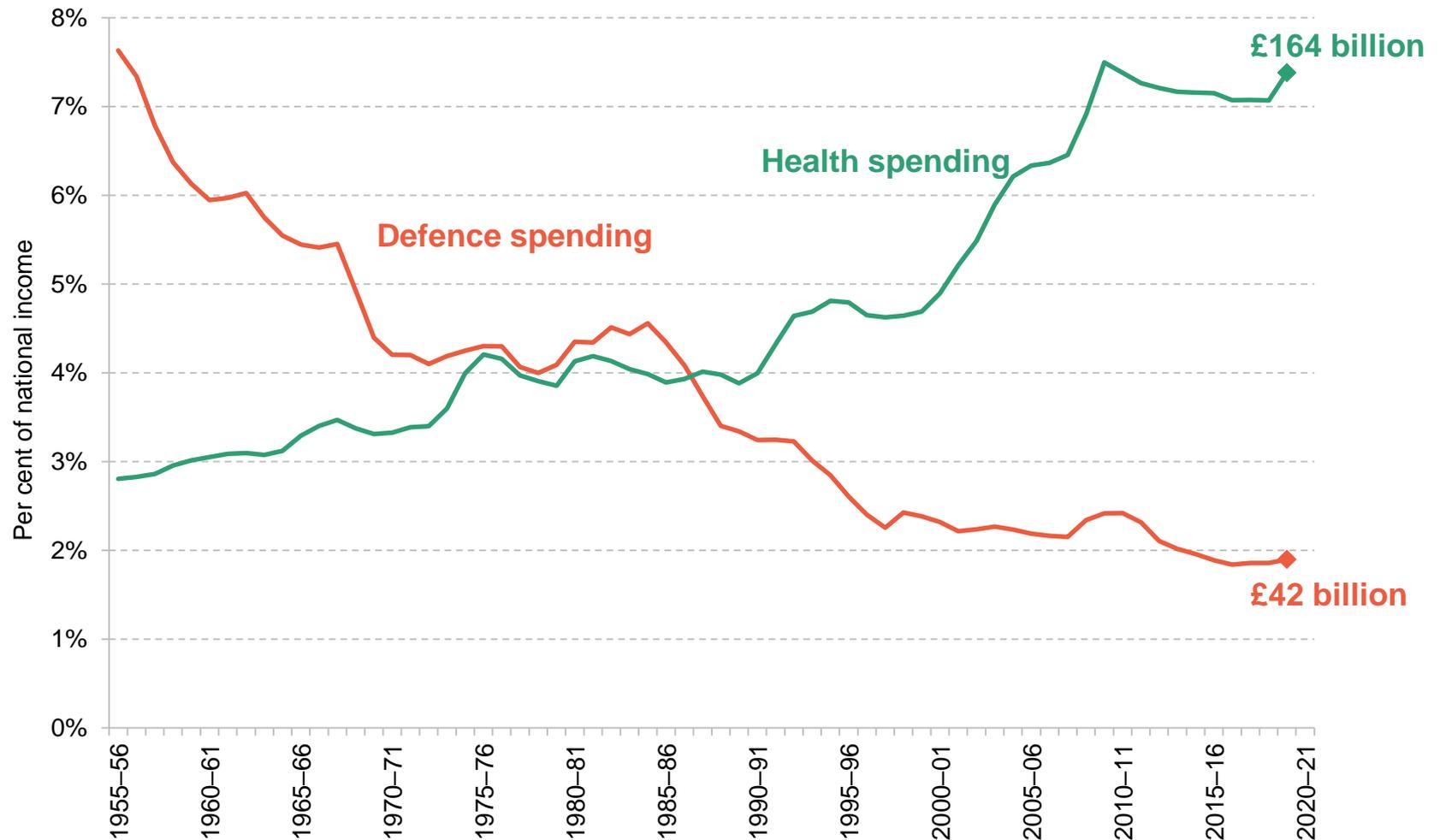
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 - more experienced and higher paid were harder hit, between 2010 and 2020:
 - experienced teachers pay down 7%
 - hospital consultants pay down 14%
 - senior civil servants pay down 11%
- Private sector pay also unlikely to keep pace with inflation
 - reported settlements over the 3 months to January of 3%, though that is the highest since 2008 and up sharply from December

Defence spending

- Cuts to defence spending over past 70 years have allowed higher spending on the NHS without growing the size of the state

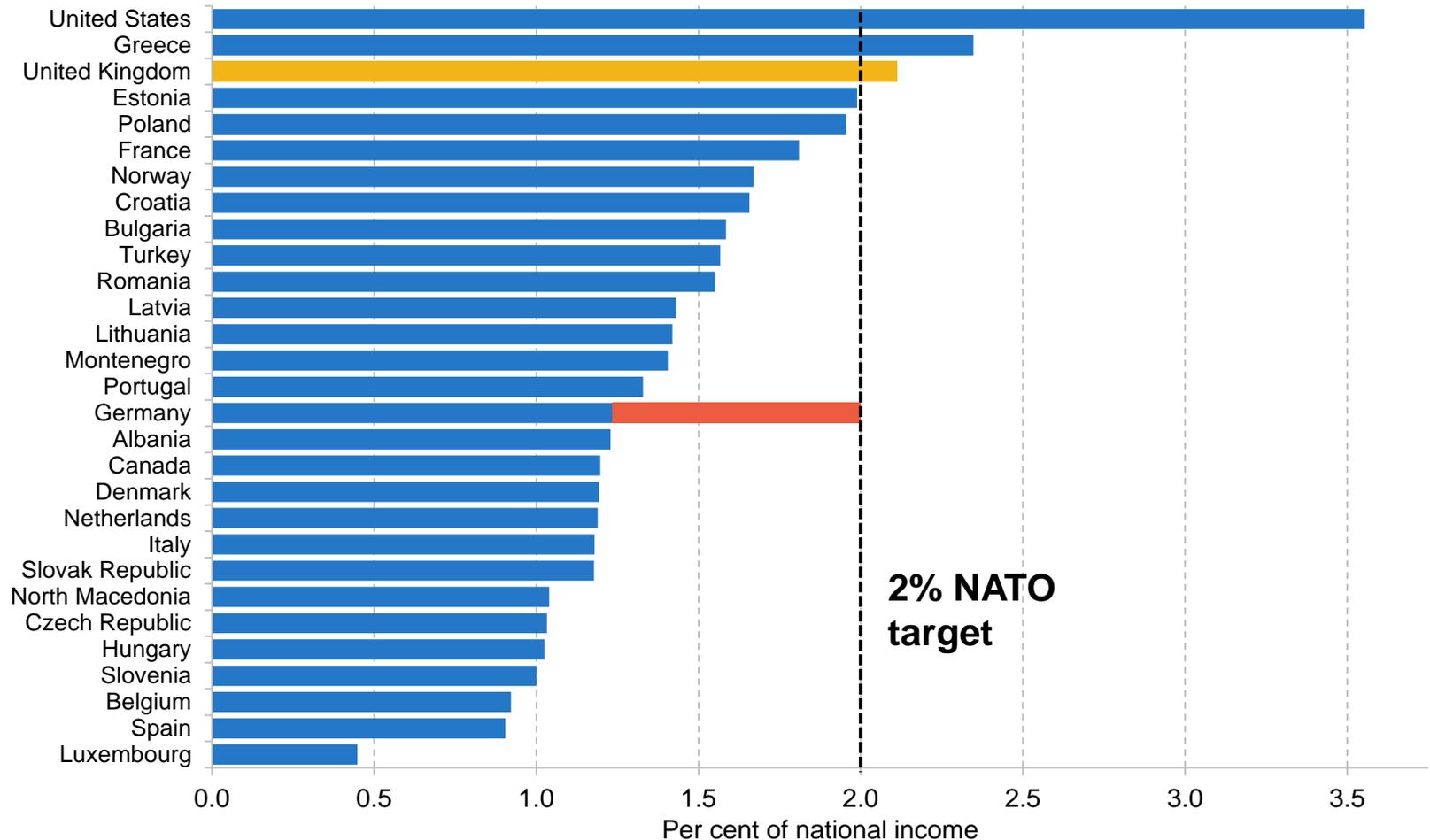
Defence spending has fallen over time, IFS offsetting rising health spending



Note: definition of defence spending here does not correspond to that used by NATO. Source: Author's calculations using HM Treasury PESA 2021, IFS spending composition spreadsheet (available to download via IFS TaxLab).

UK defence spending is high by international standards

Defence spending as % national income among NATO members (average 2013–2019)



Note: Figures shown are for NATO definition of defence expenditure, which differs to that used in other slides.
Source: NATO, Defence Expenditures of NATO Countries (2013–2020).

Conclusions

- Higher prices makes cash budgets of spending departments more challenging
 - for example: modest planned increase in next year's day-to-day MoD budget easily wiped out by higher energy prices
- Will also place upwards pressure on public sector pay awards, following a decade in which real terms pay has fallen
 - a 5% NHS pay settlement would, at £4 billion, wipe out over a quarter of its budget increase, and still leave real wages falling
 - in schools 5% would cost £1¾ billion, take-up almost half of the budget increase and again still imply a real wage cut
- Scope for falling defence spending to cover rising NHS spending had already ended
 - might defence spending now increase?