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IDS

The current public sector pay policy in the NHS

**Report for the NHS trade unions
by
Incomes Data Services**

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This report was researched and written by Incomes Data Services (IDS) on behalf of the NHS trade unions.

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Key findings

1. The Government's public sector pay policy is for pay rises to be consistent with its inflation target of 2 per cent based on the CPI. The policy was developed when inflation was lower, and economic growth was stronger.
2. The underpinning assumption of this policy is that public sector pay rises are inflationary. However this assumption has been shown by economists and others to be false.
3. The implementation of the policy has produced disputes – during 2007 in particular, with rows over Government interventions into the outcomes of pay reviews for NHS staff, police and prison officers.
4. The process which produced the current long-term deal in the NHS was highly unusual with only the first-year increase the result of a Review Body recommendation.
5. In many ways this situation has been produced by successive Government interventions into the Review Body process in order to bear down strongly on the level of recommended rises.
6. In these circumstances, the adequacy of safeguards against future changes in 'recruitment and retention and wider economic and labour market conditions' will come sharply into focus.
7. The Review Body's role will be crucial here but the key question will be whether the Government is willing to allow it to play its role.
8. In 2007, the award for the NHS in England was staged in order to 'ensure consistency with the Government's inflation target'. The devolved administrations in Scotland, Wales and Northern Ireland paid the full increase from 1 April 2007.
9. The 2008 increases awarded to the NHS have shown that some limited 'wiggle room' is available, with increases higher than what might have been expected in the context of the formal policy.

10. However, by agreeing a long-term deal with lower increases in subsequent years and no formal link to inflation, the Government is attempting to ‘lock in’ its restrictive policy over the coming period.
11. High inflation means that arrangements for reopening talks on 2009 pay rises will be sharply in focus. Inflation may come down as predicted but the planned increase is still likely to be below inflation.
12. Inflation, on the CPI measure, has risen to 5.2 per cent, above that for the RPI which is 5 per cent. This follows a long period in which the CPI, cornerstone of the Government’s public sector pay policy, was below the RPI.
13. The Review Body has challenged the DoH’s view that progression should be combined with annual revalorisation of pay scales in assessing the value of the annual award.
14. The gap between public and private sector pay rises persists and private sector settlement levels are likely to remain higher than public sector settlement levels into 2009. Currently, the median basic pay rise for the whole economy is 3.8 per cent (in the three months to the end of September 2008). This is largely based on private sector settlements, and is driven partly by awards in the retail and not-for-profit sectors, the median for which is 3.8 per cent, which happens to be the same as the latest increase in the National Minimum Wage.
15. In 2009, IDS is expecting a wider range of pay rises under the impact of the economic downturn.
16. The labour market looks like it is weakening but skills shortages will remain in particular areas.

1. Introduction

The Government's formal policy on public sector pay is that pay rises should be consistent with its CPI inflation target of 2 per cent. This position strongly influenced the outcome of the 2007 pay review in the NHS, when the Government staged the Review Body-recommended pay award for nurses and other professional staff, reducing the overall value of the award to below 2 per cent.

The formal policy has been in place since the early years of the new century, but the way in which it has been implemented in practice has shifted over time. The Government's broad approach with respect to public sector pay can be characterised as having three phases. The first, from 1997 to 1999, was one in which the new administration generally followed its predecessor's restrictions on spending, with little new money made available to deal with the serious recruitment and retention problems that had built up during the 1990s. During this time, under-funding of the public sector had led to shortfalls in recruitment, failure to retain staff in many cases, and generally poor morale.

The following period could be regarded as an attempt to address these shortfalls, and to 'modernise' public sector pay systems, to deal with equal pay in particular but also to provide flexibility and permit some focus on productivity. This period, more or less from 2000 to 2004, saw increased spending on 'catch-up' increases, pay structure reforms and specific initiatives on recruitment and retention. The approach here was based on the evidence around staffing issues. As a result, the public sector workforce expanded in a number of key areas.

This has since been curtailed by a much tougher policy from the Treasury. From around 2004, as public sector funding has come under pressure from other sources, negotiators had been forced to set their sights lower in successive years. The low point, perhaps, was reached last year, when the Government staged a number of major awards to reduce their annual value to around 2 per cent, in line with the macroeconomic target for CPI inflation (see below). In addition, job losses across the civil service, and financial restructuring and recruitment freezes in the NHS, mean that overall public sector workforce numbers were falling, in contrast to the growth shown between 1999 and 2005. This may impact on services. To the extent that there is a cycle to public sector

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pay negotiations, the policy of restraint appears to be building up pressure for a ‘catching-up’ phase once more by 2010 or 2011.

1.1 Outcomes in 2007

In the NHS last year, the Review Body had awarded a relatively modest rise of 2.5 per cent, partly under the pressure of the Department of Health’s arguments about the affordability framework and the additional costs arising from planned progression payments (see below). However the Government came back ‘for a second bite of the cherry’, and staged this recommendation, causing a dispute that was only settled by additional increases for the lowest-paid staff who, although not covered by the Review Body arrangements, were on the same ‘Agenda for Change’ pay scales, and had been offered an identical pay deal.

The staging of the review, which should have been paid in full from 1 April 2007, resulted in increases of 1.5 per cent from 1 April and the balance (1 per cent) from 1 November, in order to ‘ensure consistency with the Government’s inflation target, in line with other parts of the public sector’ (The Secretary of State for Health Ms Patricia Hewitt, Written Ministerial Statements for 2 March 2007). Interestingly, the award was only staged in England, with the devolved administrations in Scotland, Wales and Northern Ireland paying the full increase from 1 April 2007.

Other groups such as police and prison officers also had their 2007 awards staged to bring them into line with the policy. In each case, the implementation of the policy caused disputes. In the NHS, the dispute was resolved by an enhanced pay offer of a flat-rate £400 for staff on the lowest two bands of the Agenda for Change scales (staff on the next two highest bands – 3 and 4 – got an additional £38), though the Government still insisted on staging the increases in England. This meant that the increases for the lowest paid were worth 2.3 per cent over the year. However we estimate that the overall annualised value of the whole pay award was still around 2 per cent, due to staging.

One by-product of the 2007 dispute was that the Review Body’s remit was extended to cover lower-paid staff such as catering employees and porters. These had had their pay set by collective bargaining, under the NHS Staff Council, and this body had rejected an original and identical staged offer. With both groups on the same pay scales under Agenda for Change, a

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single pay setting mechanism was deemed necessary to maintain the integrity of the pay structure. The Review Body's name was changed to reflect the move, from the 'Nursing and Other Health Professions Review Body' to the 'NHS Pay Review Body'.

In the case of the police, the 2007 review was referred to binding arbitration at the Police Arbitration Tribunal (PAT), an established part of the pay setting mechanism for this group. The arbitration process eventually resulted in an award of 2.5 per cent, which should have been backdated to 1 September 2007. However, the Government deferred the increase until 1 December, again reducing its annualised value to 1.9 per cent. The Police Federation campaigned against the move, staging a march in Westminster, and the organisation was subsequently granted permission to mount a High Court challenge over what it argued was the Home Secretary's failure to honour the PAT's ruling. However, the resulting judicial review argued that the Government had not acted unlawfully, and the Police Federation decided not to appeal.

Meanwhile, prison officers staged an unofficial walkout in response to the Government's decision to stage the 2007 award of 2.5 cent as recommended by their review body. As with the police, this resulted in a reduction in the annualised value of the award to 1.9 per cent.

1.2 Inflation and pay rises

The Government's interventions in the pay setting process during 2007 were characterised by an underlying assumption that public sector pay rises were somehow 'inflationary'. After an intervening period in which the focus switched to seeking agreement on long-term pay arrangements (see below), some of that rhetoric has returned recently, albeit in a slightly more sophisticated way which accepts that current inflation has been driven by external factors, but goes on to warn about wage increases feeding into future inflation rises. In other words, the causal relationship posited in these statements is from wage increases to inflation.

For example, in a letter to the Governor of the Bank of England on 12 September 2008, the Chancellor wrote the following: 'it would be damaging for us to allow inflation to become entrenched as it did in the past. That is why...pay rises must be consistent with the inflation target. Otherwise, every penny in pay rises will be swallowed up by higher prices'.

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However, wage negotiations are normally retrospective in respect of indicators such as inflation. In other words, the parties examine what has already happened on the inflation front, or to average earnings growth, as well as other indicators, and react (or choose not to react) accordingly. In other words, the causal relationship is usually not from wage increases to inflation, but rather the other way round.

And in the private sector, it is not pay rises per se which may lead to increased prices for the products produced, but a rise in labour costs per head. It is typical for private sector employers to maintain (or reduce) their labour costs, notwithstanding annual rises in basic pay, by a variety of strategies. One of these is ‘productivity bargaining’, a process in which pay rises are traded for changes in working practices or patterns which raises productivity and therefore keeps unit labour costs in check. (Interestingly, there is a sense in which Agenda for Change can be seen as a giant productivity deal – we return to this point in more detail below.) Further from this, in the public sector, pay rises for employees who neither produce commodities for sale, nor whose services are traded on open markets, are unlikely to have much impact on prices for consumer goods and services.

Recent rises in inflation have been driven by external factors, mainly food and fuel costs. As a result, what economists call ‘real wages’ (average earnings growth, adjusted by RPI inflation) have been squeezed since inflation – as measured on the all-items RPI – rose sharply at the end of 2006.

The problem is that the Government’s policy focuses on inflation and seeks to control pay rises as a means of keeping the former low. But as we have shown, this gets the relationship between inflation and pay rises the wrong way round. If inflation remains high, public sector workers’ finances will strain under the impact of a policy which reduces the spending power of their salaries. In these circumstances, the climate for pay negotiations in 2009 may be tougher than ever.

But even if inflation comes down, as some economists believe it will, under the influence of falling oil prices and the deflationary effects of the financial crisis, the Government is unlikely to get off the hook quickly. Inflation will have to fall significantly before pay rises are once more in line with the cost of living. And even then, the economic situation presents a new set of

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pressures. With prospects for the economy gloomier than ever, too-harsh wage restraint may impact on demand for goods and services, and worsen the economic outlook further. However concerns about the public finances will be an offsetting factor here.

In his September 2008 speech to the TUC, the Chancellor said: '*public and private sector* [our emphasis] pay rises must be consistent with our inflation target because otherwise every penny in pay rises will be quickly swallowed up in higher prices.' The mention of both the public and private sectors in the same breath is probably an attempt to appear even-handed, rather than an indication of a serious effort to extend the Government's policy on pay to the private sector. It's not clear what levers the Government possesses to influence practice in the private sector, as recent attempts in the financial services sector show. In any case, the gap between private and public sector pay awards has been persistent over the last couple of years. And while the gap might narrow if inflation falls significantly, it still remains the case that private sector employers must (and do) take a range of factors – besides the key one of affordability – into consideration when it comes to awarding pay rises. These include market factors, competitor benchmarking and the 'going rate' for settlements in their sector, among other criteria.

2. 2008: subtle shifts in policy

The Government's tough stance in 2007, and the disputes it caused, produced something of a backlash, not only from the unions, but also from MPs and public sector managers who were concerned that the policy was too tight in a period of higher inflation than hitherto. The TUC also conducted a campaign against the policy under the 'Speak Up For Public Services' banner.

Interestingly, while the objections of ordinary public servants and their union representatives to the policy and its outcomes are well known, some managers are also dissatisfied with the approach. This is because of their wish to pursue a reform agenda with respect to pay and conditions, with items like Total Reward on the wish lists of some departments. However the operation of the pay policy makes it difficult to follow any of this through in practice since, in crude terms, there is little incentive for the unions to discuss reform when the basic pay awards on offer are so low.

The Government's response to the criticism was to rein in its pronouncements about 'inflationary' public sector pay rises and instead call for long-term deals (though as we have noted, following the signing of a multi-year settlement for the NHS and other groups, some of this rhetoric has returned).

In addition, 2008 increases have shown that some limited 'wriggle room' is available. In particular, the NHS award of 2.75 per cent for 2008 was higher than might have been expected in the context of the formal policy. This wriggle room arises in the context of the backlash mentioned above, and may well indicate some acceptance by the Government that it had dug itself into something of a hole with the manner of its implementation of the policy during 2007.

2.1 Long-term agreements

Long-term deals represent a key shift in the Government's policy, and these are aimed at ensuring a lengthy period of industrial peace, probably until after the next general election. This has been achieved, in the case of the NHS, by a small element of front-loading, with a slightly higher increase in the first year of the deal than subsequently. However because the subsequent

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increases on offer are comparatively low, this and other long-term deals also represent an attempt by the Government to lock in what remains a fairly restrictive policy over the coming period.

The new three-year deal for the police, reached in October 2008 as arbitration proceedings were due to begin, is a case in point. The pay increases are modest, but agreement appears to have hinged on promises not to bring forward plans to replace the current negotiated arrangements with a review body, the prospect of which the Police Federation had strongly opposed. In the first year of this deal, police officers will receive pay increases of 2.65 per cent, backdated to 1 September 2008. Next year, pay will increase by 2.6 per cent from 1 September 2009 and by a further 2.55 per cent in the third year of the deal, effective from 1 September 2010.

It is worth pointing out that the number of long-term deals in the public sector has fallen over the last few years, from the high point of their popularity in the sector during 2005/06, when IDS monitored some 43 separate long-term deals across the public sector, covering around 3.6 million employees. Currently, IDS has monitored just nine long-term deals in the public sector with increases due to take effect in 2009. These include two ‘deals’ in the civil service, which were imposed in 2008, despite union objections. IDS has dubbed these ‘long-term disagreements’.

The reduction in the number of multi-year arrangements is linked to the tightening of the Government’s pay policy, with lower increases on offer since the earlier period, when most rises under long-term deals in the public sector were centred on around 3 per cent. In the private sector, by contrast, front-loading of deals and inflation-linking of subsequent increases are usually regarded by employers as a price worth paying for a period of industrial relations stability, and this normally achieves buy-in from employees who are effectively relinquishing their bargaining rights for the same period. Hence there has been no similar fluctuation in the popularity of long-term deals in the private sector.

That said, the current crop of multi-year deals in the public sector cover a large number of employees, some 2.2 million in total. The desire by the Government to negotiate long-term arrangements for key groups as a way of ensuring its broad policy remains in place over the next few years is a key driver here.

2.2 Planned increases in 2009 and 2010

Given the relatively modest level of the subsequent increases under the long-term deals for the NHS, police and teachers, the Government has conceded the possibility that negotiations on subsequent increases may be re-opened in each case. However the Government has avoided the sorts of specific links to inflation (RPI or otherwise) that are a key feature of most long-term deals in the private sector. Instead, the clauses mostly contain some sort of reference to the wider economic backdrop, and to recruitment and retention. However, notwithstanding this, the lower increases on offer subsequently mean that these arrangements are likely to be in sharp focus, particularly if inflation remains above the level of the rises on offer.

In the NHS, the re-opener clause reads as follows: ‘In the event that the NHSPRB receive and identify new evidence of a significant and material change in recruitment and wider economic and labour market conditions, they may request a remit from the Secretary of State to review the increases set out in this agreement for 2009/10 and/or 2010/11.’

The 2009 and 2010 increases under the long-term deal for teachers in England and Wales are ‘indicative’. These will be reviewed and will be the subject of a report from the School Teachers’ Review Body (STRB) in June 2009. The STRB has said that this mid-term review should be programmed and the Review Body remitted to carry it out as a matter of course, without reference to a ‘trigger’ (eg one based on inflation) or to the Secretary of State’s discretion.

For teachers in Scotland, who are also subject to a three-year deal, with increases of 2.5 and 2.4 per cent due in 2009 and 2010 respectively, there is no specific link to inflation. However the joint Scottish Negotiating Committee (SNC) will monitor movements in prices and wages generally over the period and consider the evidence on recruitment and retention. Early in 2010, the SNC will consider the findings and their implications for teachers’ pay.

For the police, the mechanism is that ‘if at 31 August 2009, or 31 August 2010, either side of the Police Negotiating Board produces new evidence of a substantial change in wider economic and labour market conditions and a significant material change to police officer recruitment and retention over the previous twelve month period, then both sides will enter into discussions relating to the pay award due the 1 September immediately following.’

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Importantly however, the arrangements surrounding the likelihood of re-opening discussions are different in each case (see below). In the case of the police, if the staff side (ie the Police Federation) consider that the criteria for reopening discussions have been met, but they have been unsuccessful in reopening negotiations with the official side, then they (ie the staff side) can register a ‘failure to agree’ and make an application to the Police Arbitration Tribunal (PAT). If the PAT then agrees that the criteria have been met, and it decides to order a re-opening of negotiations, this decision (to reopen talks) will be binding on the Home Secretary.

For teachers in England and Wales, there is scope for the STRB to carry out a review of the subsequent rises, and the STRB has said that this review must be programmed as a matter of course. With the long-term deal for NHS staff, the Review Body must seek permission from the Government to carry out a review, which on the surface at least, differs from the approach with the STRB award. However in both cases there is no guarantee that the minister concerned will abide by any resulting recommendations. These arrangements were probably a key factor in the smaller NHS unions’ rejection of the three-year deal.

2.3 Progression in focus

If there is a review of the subsequent pay increases on offer in the NHS, figures on incremental progression and the position of staff on the NHS pay bands may play a role. The Department of Health’s evidence to the Review Body for the 2007 pay review placed great emphasis on what it termed ‘pay drift’. It argued that this should be taken into account when determining an appropriate level of basic pay uplift.

In essence, the Department wanted the basic uplift to be offset by the increases that would come from planned progression, which it sees as a cost. It concluded that ‘an affordable level of pay uplift for the remit group for 2007/08 was 1.5 per cent’. Once progression increments and other payments had been taken into account, the Department estimated a basic increase of 1.5 per cent would lead to ‘an increase in average earnings of 4.0 per cent’. This reduced significantly the Review Body’s room for manoeuvre when it came to recommending a level for the 2007 increase, notwithstanding the fact that the Review Body had repudiated the Government’s arguments and pointed out that progression and the basic rise were distinct elements of the pay system, aimed at achieving very different objectives, and should not be conflated in the way that

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was being proposed. (Some critics of the Review Body system have argued that it is susceptible to this sort of pressure, in a way that is greater than normal, ‘unmediated’ collective bargaining.)

The NOHPRB pointed out that increases arising from incremental progression should not be taken into account in determining the basic pay uplift since those payments are ‘designed to reflect the extra knowledge and skills that staff gained with service’. The Review Body said: ‘It is not clear to us why...the additional pay that accrues to employees in recognition of their experience and knowledge should influence pay recommendations aimed at positioning the pay structure as a whole at an appropriate level in relation to the wider labour market. This confuses two totally different features of the NHS pay system.’

The DoH repeated these arguments in its evidence for the 2008 review. However it now appears that relatively large proportions of NHS staff are at the tops of their scales, and therefore not in receipt of incremental progression. This meant that the arguments over progression worked out slightly differently with the 2008 pay award for NHS staff, and the position of staff on the pay bands appears to have been a factor behind the level of the review body’s recommendation.

The 2008 increase appears not to have been offset by progression costs, though it remains modest and subsequent increases are very low indeed. One of the key justifications advanced by the NHSPRB for the slightly higher increase was the proportion of staff at the top of their pay bands who would not receive any progression increase.

In its evidence to the review body, the Department for Health made the case that a basic pay uplift of 2 per cent would be sufficient to recruit, retain and motivate the staff needed by the NHS, as a majority of staff would also be eligible for progression increases. The Department produced evidence that estimated around 80 per cent of staff would receive incremental rises, but admitted that ‘these data needed to be treated with some caution’.

The review body estimated that ‘some 24 per cent of staff (around 300,000 people) are at the top of their pay bands and will not benefit from increments. They will, therefore, receive only the basic pay award and an award below the current rate of inflation, even as measured by the CPI, would further erode the morale of this important, experienced group’. The review body also recommended higher increases for pay band 5, the main band for qualified nurses and midwives.

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It is estimated that a quarter of nurses are at the top of their pay band, and following calls for improved career progression, the review body proposed that some of the band 5 and 6 pay points should be restructured, providing for additional increases ranging from 1.22 per cent at point 19 to 0.33 per cent at point 25. It was also recommended that the length of band 5 should be reduced from nine to eight points and the eight points redistributed across the band in the third year of the deal.

However industrial relations was a key factor as well, with the Government's desire to avoid a re-run of the 2007 dispute, and buy itself a lengthy period of industrial peace beyond the next general election, weighing heavily on an unusual process which also produced an unusual outcome – a three-year award, but with only the first-year rise resulting from the recommendation of the review body. The subsequent increases resulted from negotiations involving the staff side, represented by the RCN and Unison, and the Department of Health.

AfC, progression and productivity

A key question in the debate over the Government's desire to include progression in the overall value of each award is whether planned increments really do represent a form of 'pay drift', as the Government argues. With this view, the Government is confusing two distinct aspects of the pay system: the basic pay rise, or 'revalorisation', which is mainly aimed at bringing pay scales back into line with previous rises in the cost-of-living; and incremental progression, which rewards staff for the acquisition and use of additional skills and knowledge.

In the NHS, those elements of the AfC pay system that the Government regards as producing 'drift' might more properly be regarded as 'drive', since far from being accidental, they are intended both to reward employees for applying extra knowledge and skills, and deal with equal pay problems.

Many NHS trusts also regard the new system as providing them with additional flexibility, by permitting the development of lower-paid staff to perform frontline roles and be rewarded for doing so. In other words, while there have been initial assimilation costs, there are likely to be savings later on. In some ways therefore, AfC can be viewed as a major productivity deal, with a trade-off between extra pay and progression for employees on the one hand, and flexibility and savings for NHS trusts on the other hand, with the latter delivered by the workforce remodelling accompanied by the deal. This is likely to give trusts the ability to move lower-paid staff into more frontline roles.

The difficulty is that, in focussing on the costs of progression, the Government may be failing to see the benefits for it as an employer associated with a new pay system which was nearly a decade in the making, and has still not been implemented in its entirety.

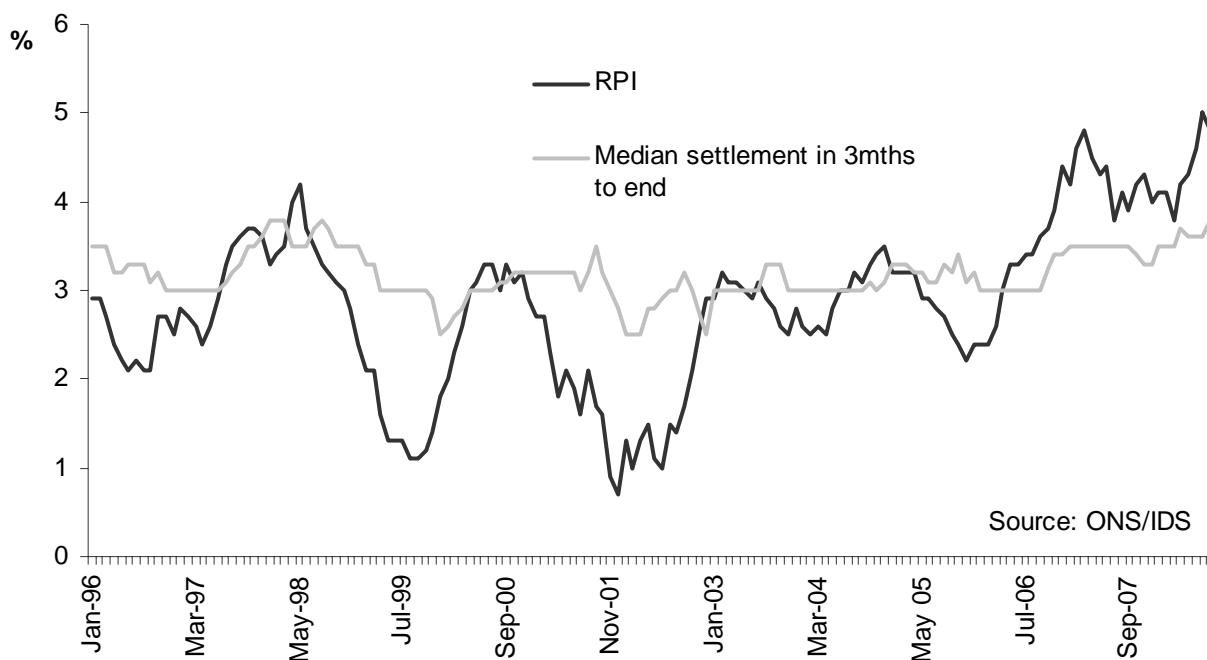
2.4 Inflation backdrop and outlook

When the NHS three-year deal was agreed, the economic outlook had not deteriorated to the extent it has recently. Most commentators now agree that a recession is likely, with the only question remaining that of its depth and duration. It is extremely difficult to make predictions in this regard.

However, the pay policy was developed at a time when the economy was stronger and inflation lower than it is currently. Since then the rise in inflation – on all measures – has placed the policy under considerable pressure. This means that ‘real wages’ have been falling over the period.

Another way of looking at this can be seen in the graph below. This shows that the median level for basic pay rises across the whole economy has been lower than RPI inflation for over the last two years. To the extent that public sector pay deals have been lower on average, this gap is even more marked for workers in this part of the economy. (We cannot produce a single series for median increases in public sector pay since awards are overwhelmingly concentrated in April, with a smaller number of mainly civil service deals in the autumn, mostly effective in August.)

Pay settlements compared with inflation



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In addition, the CPI is now higher than the RPI, at 5.2 and 5 per cent respectively. This is largely because, while food and fuel prices have kept both measures high in relative terms, house prices have been falling. Housing costs are included in the RPI, but not in the CPI, so while falls in these represented a downward pressure on the RPI – offsetting rises in food and fuel costs – this has not been the case with the CPI.

The sharp rise in the CPI, and its outstripping recent increases in the RPI, may well be something of an embarrassment for the Government, which had made the CPI the cornerstone of its pay policy in the public sector. Again, this is in contrast to private sector practice, where the RPI, because it covers all items of expenditure, is the main indicator for inflation when it comes to pay reviews, as evidenced by the fact that most long-term deals in the private sector with an inflation link for subsequent rises reference the RPI, or occasionally the RPIX. The CPI is rarely, if ever, used in the private sector.

In autumn 2006 the Governor of the Bank of England, Mervyn King, criticised the CPI measure on the basis that it does not include housing costs. He said: ‘For some time we’ve been hoping that housing costs will come into the CPI. I think the latest date for progress on this front has been pushed out until 2010, but frankly, I don’t think that will be in my lifetime. That’s one of the downsides of the CPI – it’s very hard to see now when housing costs will come back into the index.’

He repeated these criticisms on a recent issue of the BBC Radio 4 programme, Inside Money, broadcast on 21 July 2007. He said that the omission of housing costs from the CPI had caused ‘particular difficulty’ for the Bank of England. He went on to say: ‘[The] CPI is meant to be an index which is constructed in the same manner in all European countries, and so far the European statisticians have not worked out a way of how they can calculate the cost of housing in a way that can be done uniformly across Europe. And for that reason it’s not in this harmonised European index. I wish it did include housing, but it doesn’t, at least at present. Maybe one day it will.’

2.5 Outlook for inflation

Whether inflation will constitute a significant upward pressure on pay into 2009 depends on the outlook for this key indicator. For the remainder of 2008, inflation is set to remain relatively high, and this will form a key backdrop to January 2009 pay reviews. On the all-items RPI measure, most commonly used for pay bargaining, inflation is currently running at 4.8 per cent in the year to August 2008. It is forecast to remain at around this level until March next year (see inflation forecasts below). Thereafter, forecasters think it will come down, mainly as a result of falling oil prices. In addition, the financial crisis may have a deflationary impact as the supply of money throughout the economy is reduced.

Predicting the path of inflation over the medium and longer-term is notoriously difficult, since so many different factors play a role. The medium and longer-term projections need to be treated with caution, especially since the forecasts failed to predict that the RPI would remain as high as it did throughout 2007, when it averaged 4.3 per cent.

One possibility is that the models for forecasts are based on pricing behaviour during a relatively lengthy period in which, although house prices were high, food and fuel prices were low. This period may now be coming to an end, which makes predicting the outturn on inflation trickier still. While falling economic growth may 'return inflation to the target', as Mervyn King put it in his letter to the Chancellor, oil prices in particular represent a 'wild card' for forecasters, and Mr. King also noted that higher prices for imports (as sterling falls) are another potential offsetting factor.

Inflation forecasts

In the year to September 2008 the all-items Retail Prices Index (RPI) rose by 5 per cent. City analysts expect this to be a peak and although it is then forecast to come down, it may stay around 5 per cent for the remainder of 2008 and into early 2009. CPI inflation is similarly expected to remain at high levels, staying above its 2 per cent target well into 2009. GDP growth is likely to remain very subdued and the slowdown in the economy is expected to put a brake on rising inflation in the longer term. The forecasts for 2009 take into account the recent fall in oil prices which may be significant for the longer term since it is higher oil prices, which peaked near \$150 a barrel in July, which contributed to stubbornly high inflation over the past 12 months. But as the outlook for oil and other commodity prices remains uncertain it may be necessary to monitor and perhaps revise these figures in due course.

CPI inflation

In the year to September 2008, the Consumer Prices Index (CPI) rose by 5.2 per cent, up from 4.7 per cent in August. This is the first time since early 2002 that the CPI has risen above the RPI annual rate, and the fifth consecutive month that it exceeds the Government's target for the CPI by more than one per cent. As the CPI reached 4.7 per cent in the year to August, Mervyn King, Governor of the Bank of England, was forced to write another letter to the Chancellor explaining the reasons why the Bank had again missed its 2 per cent target for CPI inflation by more than one percentage point. Mr. King highlights the sharp slowdown in the economy and the weakness in overall activity in his open letter to the Chancellor and says this will act as a significant brake on rising inflation. Mr. King also outlines his views that the CPI will soon peak at 5 per cent but remain above its target well into 2009 and he therefore expects to write further open letters. Mr. King goes on to express the views of the Monetary Policy Committee, that 'a period of muted economic growth is necessary to dampen pressures and return inflation to the target in the medium term. But it is also aware that the slowdown in activity that is already in train could, if severe, result in inflation falling below the target in the medium term'.

GDP growth

The outlook for GDP growth remains weak and most of the City analysts expect the economy to grow by around 1 per cent in 2008, though these predictions may be revised possibly downwards in light of the recent financial crisis. Barclays points out that 'the shortfall in actual output over potential production should act as a significant drag on inflation two or three years down the line'. And HSBC adds: 'the UK economy is slowing sharply, and UK prices tend to be fairly responsive to slowing demand, despite cost pressures. As such we expect inflation to fall back sharply over the course of next year and RPI inflation should reach 1.9 per cent by the end of 2009'.

Interest rate cuts

Recent rising inflation has meant that the Bank of England has been unable to offset the economic downturn by cutting interest rates. Barclays points out that once short-term inflation is under control, this will allow the Bank of England to focus on longer-term inflation by cutting interest rates. Nearly all of the City analysts are expecting interest rates to be cut over the course of the next 12 months. Both Barclays and HSBC are expecting the first cut to come in November this year, taking the rate to 4.75 per cent and most of the economists expect further cuts throughout 2009.

All-items retail price inflation forecasts, September 2008									
	ABN Inc%	BC Inc%	C Inc%	DB Inc%	GS Inc%	HSBC Inc%	OEF Inc%	RBS Inc%	Rounded average Inc%
September 2008	5.6	4.9	5.1	5.4	5.0	5.2	5.4	5.1	5.2
October	5.3	4.7	5.0	5.0	4.9	5.1	5.4	5.2	5.1
November	5.1	4.5	4.9	4.6	4.7	5.0	5.1	5.1	4.9
December	5.0	4.1	4.9	4.4	4.5	4.8	4.8	5.0	4.7
January 2009	5.2	4.4	5.1	4.3	4.7	4.8	5.0	5.0	4.8
February	4.6	4.0	4.7	3.9	4.2	4.3	4.9	4.5	4.4
March	4.7	3.9	4.7	3.6	4.1	4.0	4.6	4.3	4.2
April	4.3	3.7	4.4	3.0	3.5	3.6	4.3	3.9	3.8
May	4.2	3.4	4.3	2.7	3.2	3.4	4.1	3.8	3.6
June	3.8	2.6	3.6	2.4	2.8	2.8	3.4	3.2	3.1
July	3.6	2.5	3.5	2.1	2.3	2.6	2.9	3.0	2.8
August	3.3	2.6	3.2	2.0	2.2	2.3	2.6	2.7	2.6
September	3.1	2.5	3.0	1.6	1.9	2.0	2.3	2.4	2.4
October	3.1	2.5	2.9	1.6	1.7	1.8	2.2	2.0	2.2
November	3.1	2.5	2.8	1.6	1.7	1.8	2.3	2.0	2.2
December	3.1	2.6	2.4	1.5	1.7	1.9	2.0	1.9	2.1

Forecasters: **ABN** ABN AMRO; **BC** Barclays Capital; **C** Citigroup; **DB** Deutsche Bank; **GS** Goldman Sachs; **HSBC** HSBC Financial Markets; **OEF** Oxford Economics Forecasting; **RBS** Royal Bank of Scotland.

2.6 Pay rises compared

Looking at pay reviews in both the private and public sectors, there is still a gap of a little over 1 per cent on average between them (in favour of the private sector). The latest IDS analysis of pay settlements, to be published late October, shows that the median settlement level for the whole economy in the three months to the end of September has remained steady at 3.8 per cent, unchanged from the previous analysis. The inter-quartile range has narrowed slightly with the lower quartile moving to 3.2 per cent, up from 3 per cent last month, while the upper quartile has remained the same at 4.3 per cent. This indicates that there are still relatively large numbers of pay increases being awarded at the higher end of current settlement levels. Just over two-fifths of the deals (44 per cent) for this period are at or above 4 per cent. As in September's analysis, the majority of the deals at or above 4 per cent are in the construction, engineering and chemicals sectors.

The median pay settlement for the manufacturing and production sector has risen from 4 to 4.2 per cent in this analysis period. Of the 20 deals in this sector, all but five are at or above 4 per

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cent. For example, National Grid paid 4.7 per cent from 1 July 2008 and Vauxhall Motors paid 5 per cent, based on the July RPI figure, from 1 September 2008. The private services sector median has also risen this time, from 3.5 to 3.7 per cent, with deals ranging from 2 to 5.5 per cent.

Just over two-fifths (22 per cent) of pay settlements monitored in the three months to the end of September are in the retail and not-for-profit sectors. The median for pay settlements across both of these sectors for this period is 3.8 per cent, the same as the increase to the National Minimum Wage from October 2008. Somerfield applied 3.8 per cent on its minimum rate for customer service assistants from 28 September 2008 and Sainsbury's also paid 3.8 per cent from 7 September 2008. While some of the awards in the not-for-profit sector are lower, some higher-end awards are holding up the median rise.

2.7 Public sector

There are eight public sector deals effective in the three months to the end of September 2008 and the median for these deals is 3.3 per cent. This is higher than would be expected for the sector due to the inclusion of average earnings or paybill increases across four Government departments. The total range is from 2.45 per cent, awarded to teachers in England and Wales in the first year of a three-year deal from September 2008 and also to firefighters from July 2008, to 4 per cent on the paybill at the British Library from August 2008, in the second year of a three-year deal.

August is a key month for pay setting in the civil service, however many of this year's settlements have been delayed. IDS focuses on the average earnings or paybill impact of civil service awards. This is because the 'basic award' has a very different structure in each case, and it is not possible to use this as a valid basis for analysis and comparison. Also, the 'headline' average earnings or paybill increase disguises the fact that many civil service employees at the top of their scale receive very low or even zero consolidated rises.

If civil service awards are excluded, the median pay rise in the public sector turns out to be very different. The median for all private sector settlements in 2008 so far is 3.7 per cent. For the

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public sector – excluding civil service awards – the median pay rise for 2008 is 2.75 per cent, which happens to be identical to the NHS pay award.

2.8 Outlook for pay rises in 2009

As the economy turns, it is likely the range for pay settlements will widen as different firms experience the downturn in different ways. If inflation falls significantly, the median level for pay rises is likely to fall as well. However, commitments under long-term deals in the private sector represent a generally upward pressure, since many of these are linked to current and forthcoming RPI inflation levels. Recent analysis by IDS of the increases due under 70 long-term deals across the entire economy shows that, if inflation forecasts are correct, the median rise under these deals will be 5 per cent. Excluding the small number of public sector long-term deals, the predicted rise is even higher, at 5 per cent.

Predicted falling inflation will have a downward impact on the likely pay rises under these deals, but since most of them are based on inflation figures that are due to be released in the final quarter of 2008, the broad picture is unlikely to change significantly. For example, Barclays' long-term deal is set to pay out 5 per cent in April 2009 (it's based on the average RPI for August to October, plus 0.9 per cent, but capped at 5 per cent), and Jaguar will shortly pay 5.5 per cent, based on the September RPI plus 0.5 per cent.

In addition, some new deals continue to be at the higher end of the range of settlements. For example, Virgin Trains has just agreed a new four-year deal covering its 3,000 staff. In the first year of the deal, employees receive basic rises of 5.1 per cent, or a flat-rate £750, whichever is greater, backdated to 28 May 2008 for drivers, and to 1 April 2008 for all other grades. Subsequent pay increases on the respective anniversary dates in 2009, 2010 and 2011 will be equal to the RPI figure for January of each year plus 0.5 per cent. The increases will be subject to a minimum figure of £750, which will itself be increased by RPI plus 0.5 per cent each year.

So far, there have been few pay freezes (for 12 months or more), or deferrals, where firms say they will postpone a pay review, usually for less than six months. However we may see more of these if (or as) the economy deteriorates further.

Our expectation for 2009 is that private sector pay deals will run in a range between 2½ and 4½ per cent. In the public sector, it's more difficult to put an exact figure on the expected outlook, particularly since much depends on whether 2009 negotiations for NHS staff, teachers and police officers are re-opened. Many public sector awards will be centred on around 2½ per cent. Certainly the median for public sector awards in 2009 is unlikely to shift upwards from its 2008 level. The current strategy of permitting some wriggle room with pay increases is unlikely to continue into 2009 as public sector funding comes under pressure from other sources. As a result, a more difficult year remains in prospect.

2.9 Labour market prospects

A weakening labour market will reduce upward pressure on pay. The Bank of England, in its recent inflation report (August 2008), said: 'Employees are likely to want to resist the erosion of their real pay by inflation but, with a weakening labour market, they are likely to have to accept some moderation'. The extent to which this is true will depend on what happens to employment and unemployment.

Currently, the number of people in employment remains high, but the trend is now falling (see box below). At the same time, unemployment is steadily rising, having fallen throughout 2007. Redundancies have also started to rise, although these are a feature of some sectors more than others. The number of economically inactive people remains high. On the plus side, the latest figures continue to show a strong picture on women's labour market participation. And outflows from the claimant count, while lower than inflows, also remain high, indicating that many (or most) unemployed people are still able to find work.

Higher levels of unemployment won't necessarily solve recruitment problems as unemployed workers don't always have the skills employers require. Indeed, a number of employers have signalled their desire to recruit large numbers of trainees in order to plug skills gaps. These include British Gas and Bombardier. With different sectors experiencing the downturn in different ways (and some perhaps escaping the worst), skills shortages are unlikely to disappear completely.

What will happen to women's employment? There are a number of clues in the latest labour market statistics. These show that the recent fall in employment has taken place overwhelmingly among male full-timers, with the drop in female full-time jobs much smaller by comparison. We are clearly at an early phase in the economic downturn, but it may be the case that a recession will impact less on those areas of the economy where women are employed – the public services, and lower-paying sectors like retail which tend to employ large numbers of women workers – than on construction, finance and manufacturing where, overall, women are in a minority.

Certainly, this was the experience during the last recession, in the early 1990s. An IDS research paper for the Low Pay Commission (the body that sets the National Minimum Wage) in 2006 looked at pay, prices and employment during this period, from 1990 to 1993. We found that most unemployment arose in middle and lower-ranking jobs in manufacturing, finance and construction. By contrast, employment generally held up in lower-paying sectors such as retail, hospitality and social care. In addition, pay rises matched inflation in lower-paying sectors (and pay freezes were rare) though this was undoubtedly helped by the fact that inflation came down sharply over the period, from a high of 11 per cent in autumn 1990, to below 2 per cent in 1993.

Latest labour market statistics, October 2008

The latest labour market statistics show signs of a deteriorating economy, with falling employment, rising unemployment and the previous falling trend in economic inactivity appearing to be levelling off. Employment figures for the three months to August show a fall of 122,000 in both full-time and part-time jobs, a substantial increase on the quarterly fall of 16,000 last month and the largest quarterly fall since the period in the three months to February 1993, during the last recession, when it fell by 131,000. The employment rate has also fallen, down 0.4 percentage points to 74.4 per cent. However over the year the employment rate has only fallen 0.1 percentage points.

The fall in employment was mainly among men, with full-time male employment down by 149,000 compared with a fall of 3,000 in the number of women in full-time employment. These figures indicate that the impact of the economic turmoil is varied between sectors, with job losses in finance, construction and manufacturing affecting more men on average, and rather less impact on those low-paying sectors where more women are employed. However the true extent of this will not be known until December when the next round of workforce jobs figures are published.

Unemployment, on the broad ILO definition, rose by 164,000 over the quarter to stand at 1.79 million. This is the largest quarterly rise since June 1991. The unemployment rate in the three months to August was 5.7 per cent, up 0.5 percentage points over the quarter and 0.4 percentage points over the year. The number of people claiming Jobseeker's Allowance rose 31,800 over the month and 104,900 over the year totalling 939,900. At the current rate of growth it is

possible ILO unemployment could reach 2 million by the end of the year, with 1 million people claiming Jobseeker’s Allowance.

Inactivity had been declining although the falling trend now looks to be levelling off and next month’s figures may show the numbers of economically inactive starting to rise again. A look at economic inactivity by reason shows that looking after the family or home has fallen to its lowest level as a reason for inactivity since comparable records began in 1993.

Despite the weakening picture it is worth noting that these changes are taking place against a backdrop of a previously strong labour picture with record levels of employment at nearly 30 million. The number of unemployed fell throughout 2007 and, despite a large rise with this month’s figures, the level is still relatively low compared to periods of economic downturn in the past. For example the claimant count is currently less than 1 million, compared with an extended period between 1982 and 1987 and again in 1993 when there were around 3 million people claiming unemployment benefits.

The Department for Work and Pensions records information about inflows and outflows from the claimant count on a monthly basis. These figures for people who are starting to or ceasing to claim Jobseeker’s Allowance can be helpful when it comes to interpreting changes in the claimant count. In September 2008 claimant count inflows were 261,300 and the outflows, which is the number of people no longer claiming the allowance, was 227,400. In other words, while the numbers of people coming into the claimant count are higher than those finding work and coming off it, the later group is still relatively large. This shows that, currently, many people are still able to find work.

	Reference period	Levels	Rate (%)
Employment	Jun-Aug 2008	29,419,000	74.4
Unemployment	Jun-Aug 2008	1,792,000	5.7
Claimant count	September 2008	939,900	2.9
Economic inactivity	Jun-Aug 2008	7,886,000	20.9

Source: ONS

2.10 Recruitment and retention

There is some evidence that raising pay leads to fewer recruitment and retention problems. This can be shown with reference to groups like social workers. Back in May 2002, IDS produced a report for Unison on comparative earnings for social workers, which looked at pay for this group and compared it with that for other key public sector groups such as nurses.

Analysis of figures on average earnings for these two groups, from the Government’s New Earnings Survey (which has since been replaced by the Annual Survey of Hours and Earnings),

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shows that for most of the period between 1991 and 2001, nurses' earnings were marginally lower than those for social workers. However, this situation was reversed in 2000, when nurses' earnings overtook those of social workers.

This was because under the pay award for nurses in April 2000, while national scales were increased by 3.4 per cent, higher increases of up to 7.8 per cent were awarded to staff on the top of grades C (enrolled nurses and experienced auxiliary nurses) and E (experienced staff nurses), in order to improve retention among these staff. (In fact, this was one of the early indications that extra money was to be released to deal with serious staffing issues in different parts of the public sector.)

Conversely, settlements for local government, under which social workers' pay is set, had been at the lower end of pay rises in the public sector over the years between 1991 and 2001.

This deterioration in the relative position of social workers – placing them at the bottom of the earnings table for public sector professionals – was the reason Unison asked us to produce a report. And the union subsequently used the report in a major campaign for an improvement in the pay and conditions of social workers.

This campaign, plus the aftermath of tragedies like the Climbié case, and the Government and employers' responses to both, has meant that in the intervening years, there has been a much greater focus on the recruitment and retention of social workers, with measures to improve this, including initiatives to boost pay and progression. Most of this has taken place outside of annual pay reviews for the local government services NJC group, which covers social workers who work for councils (the bulk of the social work workforce).

It took the form of initiatives around grading for social workers, and the payment of market supplements for key posts in areas like children and families. As a result of these initiatives, social workers' earnings are ahead of those for nurses once more. The table below shows the current position. It shows key public sector groups, sorted by average earnings (with the highest average – column 4 – at the top). Social workers' earnings are ahead of those for nurses by £3,262 a year on average.

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In terms of the impact on recruitment and retention, after a period in which social workers were consistently the group most frequently mentioned by councils when it came to shortfalls (in successive IDS surveys of pay and conditions in local government), they are now further down the ‘league table’ of recruitment and retention problems. For example, the latest survey put planners at the top. This is not to say that councils are not having problems recruiting and retaining social workers (NHS trusts are doubtless having the same problems), but our impression is that these difficulties are not as serious as before, with the various initiatives (many of which have been around pay) having an effect. However we recognise that our research in this area is preliminary and tentative, and more work could be done, both on analysing changes in earnings over time, and taking a closer look at the sorts of initiatives taken by local authorities to boost social workers’ pay.

Average earnings for key public sector occupations (April 2007)

	Median £pa	Annual change, %	Average £pa	Annual change, %
Police officer (sergeants and below)	36,343	2.5	36,021	2.9
Secondary education teaching professionals	32,253	1.4	31,340	3.0
Social workers	26,960	4.1	26,306	4.0
Fire service officers (leading fire officer and below)	28,410	6.3	25,863	8.5
Nurses	23,696	4.8	23,044	5.4
Local government clerical officers and assistants	17,196	3.0	17,737	1.8
Civil service administrative officers and assistants	14,977	-1.8	15,217	-1.6

Note: the figures above are based on all employees, both full-time and part-time.

Source: ASHE 2007