

Fiscal Affairs Scotland Monthly Bulletin

November 2014

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The latest UK inflation data and its implications

Headline inflation

The monthly Consumer Price Index (CPI) was unchanged in September, which means that the annual (12 month) rate of inflation was 1.2%. This is down from the 1.5% inflation rate seen in August and less than half the 2.7% rate seen in September of 2013.

While September's CPI was unchanged, the price of **all goods** rose by 0.5%, while the cost of **all services** fell by 0.5%.

After having had to write to the Chancellor of the Exchequer to explain why CPI inflation was over 1 percentage point above its target rate (2%) for all of 2010 and 2011, the Governor of the Bank of England is now in danger of having to write to explain why it is over 1 percentage point below that target.

The key drivers of this low rate of inflation over the past year are: Food & (non-alcoholic) Drink (-1.4%), Clothing & Footwear (+0.2%), Transport (+0.1%) and Miscellaneous (-0.5%, mainly through Financial Services (-4.6%)).

For September itself, the biggest monthly fall came in Transport (-2.4%, month on month), driven by big falls in Air (-22%) and Sea (-21%) transport costs.

Underlying factors which have helped restrain UK inflation include:

- an appreciation of the exchange rate (£), which reduces the cost of imported goods and those denominated in foreign currencies e.g. oil;
- low inflation in trading partners, especially the EU, which again lowers the cost of imports;
- falling commodity prices, including oil.

The second of these factors is not expected to change soon and utilities have pledged to freeze prices, even before the further recent reductions in international oil prices, which suggests that some of the drivers of low inflation are likely to continue.

CPI vs RPI

September is an important month with regards to inflation as the outcome affects a number of government calculations. Typically it does this by using the Retail Price Index (RPI) measure of inflation rather than CPI.

However, the continued use of RPI for these calculations is difficult to reconcile with the demotion of RPI by the Office for National Statistics (ONS). In its official monthly publication, the ONS make clear that CPI is its primary measure of inflation. Moreover, the Bank of England, who are tasked with controlling inflation to around 2%, also use CPI as their target measure.

The RPI measure is now officially labelled as "*NOT NATIONAL STATISTICS*" as it has been "*found not to meet the required standards for designation as National Statistics*".

Despite this, the RPI (often with reference to the September rate), is still used in relation to:

- to up-rate non-domestic rates (NDRI);
- to up-rate some public transport fares;
- to up-rate some public utility prices (e.g. energy and water);
- to negotiate pay deals in the private and public sectors.

To highlight the impact that using RPI can make, Table 1 illustrates the differences in inflation using a variety of measures.

Table 1: Differences in UK inflation using different measures, September on September

% change	change in 1 year	change in 3 years	change in 5 years
CPI	1.2	6.2	15.2
RPI	2.3	8.3	19.6
RPIJ	1.6	6.3	16.0

Source: ONS, Consumer Price Inflation, September 2014

Definitions:

CPI = UK Government's target measure for inflation, first published in 1997

RPI = long-standing measure of inflation, no longer used as a National Statistic

RPIJ = improved variant of RPI, calculated using formulae that meet international standards

The Bank of England has calculated that the long-run wedge between RPI and CPI inflation is around +1.3 percentage points a year.

Clearly, when deciding how to update or renegotiate settlements over time, the choice of inflation measure can have a significant impact on the associated cash terms costs.

Scotland vs UK inflation

There is no official measure of inflation calculated for Scotland. However, it is likely that any inflation rate for Scotland would differ, to some degree, from that seen in the UK due to, for example, differences in consumer preferences, housing costs, geography, etc.

One known variation that would have been having an impact in recent years is the increase in tuition fees in England. This impact started in 2012 and will continue to 2015 (as it applies to new students over the 3-4 years of the typical undergraduate course). For example, in October 2012 the impact of tuition fees pushed UK education inflation up to almost 20%, contributing to about 0.4 of a percentage point increase in the overall measure of CPI inflation.

Since tuition fees do not apply in Scotland, their impact on the education element of any Scottish measure of general inflation would have been lower for these years.

In the absence of other differential inflation impacts, then the above analysis suggests that, due to the absence of such steep tuition fees rises, Scottish inflation may have been even lower than UK inflation over this period.

The more general point of interest here is, should Scotland's inflation rate be different to that of the UK as a whole, then the inflationary uplift required to maintain the real value of spending would similarly be different.

UK inflation vs other international inflation rates

Since 2008 the UK has had one of the highest inflation rates across the EU. Only some eastern European countries, such as Romania and Hungary, have been higher. In comparison to the European monetary union area, the UK's CPI has been higher by an average of 1.4 percentage points over this period.

For the last month for which full data are available (August 2014), only Austria matched the UK rate (1.5%), while within the monetary union average of 0.4%, eight countries were exhibiting deflation (including Greece, Italy, Portugal and Spain).

Worries over deflation

At 1.2% the UK is not yet showing any deflationary signs as measured by CPI. However, this is not the case for the Euro area which is very close to having its price index falling (i.e., only +0.3% for September). This begs the question, if low (and preferably stable) inflation is generally seen to be a good thing, why is very low inflation, or even falling prices, seen as being such a bad thing?

As is often the case with such economic issues, the answer is not straightforward.

Inflation tends to be problematic if it is high and unstable. A high rate leads to costs for those who are not protected against inflation as it will erode the value of their income and assets. An unstable rate leads to uncertainty and can damage confidence as well as having a negative affect on consumption and investment decisions.

High inflation is often seen to be a symptom of deeper problems and a sign of an ailing economy. Once established, a government can find it difficult to regain control over inflationary expectations and in the worst cases may struggle to keep it from getting higher and higher.

However, when inflation gets very low there is a growing concern that prices may actually start to fall. In this event consumers and investors may delay their spending in order to benefit from even lower prices in the future. This can potentially turn into a negative cycle, as the real value of savings continue to increase. This makes saving a more attractive prospect compared to spending available funds on new consumption or investment.

A further issue concerns the impact of deflation on debt ratios. A 'benefit' from inflation is that the real value of government debt falls over time. Deflation, on the other hand, tends to worsen the situation as the real cost of the debt can start to rise.

For the reasons outlined above, both high inflation and deflation, or even very low inflation, are seen as potentially damaging to a country's economic prospects. As a result, most countries target a rate of low, but not zero, inflation. Such 'moderate' inflation has the advantages of allowing for labour markets to be more flexible and for monetary policy to be more effective than if inflation were around zero.

The latest life expectancy data across Scotland and the UK

The latest life expectancy figures for Scotland were published in October, covering an average of the years 2011 - 2013. Table 2 shows the best and worst performers in terms of both:

- (i) life expectancy at birth: and
- (ii) change in life expectancy over the past decade.

The overall picture is of a rising life expectancy over time. This is not unexpected and is seen in most countries. The more relevant aspect is the relative pace at which life expectancy is improving.

In general, the highest and lowest life expectancy outcomes across Scottish councils are positively correlated with prosperity levels and negatively correlated with poverty and unemployment rates. Hence, East Dunbartonshire tops the rankings with Glasgow last.

However, the changes over the past decade show some more unexpected results.

For example, the Western Isles exhibits the biggest increase in male life expectancy but the smallest increase in female life expectancy. Across the island councils it is also noticeable that the Orkney Islands has performed poorly in terms of both men and women, over the last decade. In contrast, for men at least, both the Shetland Islands and the Western Isles have performed relatively well.

The results for smaller councils, especially the island councils, need to be treated with care due to the small sample sizes that apply. While there is a 95% chance that male life expectancy in Glasgow will lie within the narrow range of 72.7 to 73.3 years, for Orkney males this (95%

chance) range extends from just over 77 years to over 80 years. Similarly wide ranges apply for the Shetland Islands and the Western Isles.

For men, some of the poorer performing councils are catching up, with both Glasgow and Inverclyde being amongst the fastest improving over the past decade. However, this effect is not seen for women, where the gap with the Scottish average life expectancy has either remained the same (Glasgow) or widened (for most lowly ranked councils) over the past decade.

We are not aware of any analysis that attempts to explain these asymmetric shifts.

While changes to the health of the indigenous population will affect life expectancy estimates over time so too will the impact from net migration patterns, especially in smaller councils.

Compared to other constituent countries of the UK, Scotland has the lowest life expectancy for both men and women and in most cases this negative differential has been growing over time. For example, Scottish women have seen the lowest increase in life expectancy since either devolution (+2.3 years) or since the early 80s (+5.6 years). In comparison, women in Northern Ireland (NI) have gained by 2.5 years and 6.8 years respectively.

A similar story is seen for men, where the long term gain of 7.7 years for Scots compares with 8.8 years in NI, although post devolution this has been reversed to some degree with a gain for Scots of 3.7 years versus 3.2 years in NI.

Apart from being a key measure of the success of a society, life expectancy can also impact on the expected length of working lives and on private and public pension commitments. With over seven years separating the highest from the lowest average male life expectancy in Scotland, this is not an insignificant factor in such potential sources of future revenues and costs.

Fiscal Affairs Scotland's publications in October

The following papers have also been published by Fiscal Affairs Scotland during October and are available from our website at www.fiscalaffairsscotland.co.uk.

- Analysis of the Scottish Draft Budget 2015-16;
- Analysis of the latest Scottish GDP and Labour Market statistics;
- The Smith Commission submission;
- Scotland's future funding arrangement: implications of the 2014-15 first half North Sea tax revenues out-turn and longer term forecasts.

Table 2: life expectancy across Scottish councils

Male	2011-13	10 yr change	Female	2011-13	10 yr change
SCOTLAND	76.9	3.4		81.0	2.1
<i>Highest</i>			<i>Highest</i>		
East Dunbartonshire	80.5		East Dunbartonshire	83.9	
East Renfrewshire	79.7		East Renfrewshire	83.0	
Borders	79.3		Perth & Kinross	82.8	
Perth & Kinross	79.3		Orkneys	82.5	
Aberdeenshire	79.2		Shetlands	82.5	
<i>Lowest</i>			<i>Lowest</i>		
Glasgow	73.0		Glasgow	78.5	
West Dunbartonshire	74.2		West Dunbartonshire	79.1	
Inverclyde	74.7		North Lanarkshire	79.4	
North Lanarkshire	75.1		East Ayrshire	79.7	
Dundee	75.1		Dundee	79.7	
<i>Biggest improvement</i>			<i>Biggest improvement</i>		
Western Isles		5.4	East Dunbartonshire		3.4
Inverclyde		4.5	Midlothian		3.1
Shetlands		4.3	Inverclyde		2.9
West Lothian		4.1	Stirling		2.9
Glasgow		4.0	Highland/Perth & Kinross		2.8
<i>Smallest improvement</i>			<i>Smallest improvement</i>		
South Lanarkshire		2.5	Western Isles		0.8
Fife		2.6	Clackmannanshire		1.2
Midlothian		2.6	Aberdeen		1.4
Orkneys		2.8	Aberdeenshire		1.4
Edinburgh		2.8	Orkneys/Moray/East Lothian		1.5

Source: National Records of Scotland, Life Expectancy for Areas within Scotland 2011-13, October 2014.



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