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ECONOMIC GROWTH

What has happened recently?

Scotland

Scottish GDP grew by 0.6% in the third quarter (Q3) of 2014, slightly lower than the 0.8% for the UK, despite Scotland hosting both the Commonwealth Games and the Ryder Cup during this quarter.

In areas which might be thought to be affected by the Commonwealth Games and the Ryder Cup, Accommodation & Food Services rose in the third quarter by a robust 2.8% (in comparison, the UK rose by only 0.7%), although Transport & Communications actually fell in Scotland, by -1.1% (in comparison, the UK measure rose by 1.2%).

While positive, this 0.6% growth rate is notably slower than in the previous two quarters (both over 1%). Growth in Q3 was driven by Construction, Business-related services and 'Other' services. However, these were, in part, offset by reductions in Financial services and Transport & Communications services and by the lack of any particularly strong performances in other areas, as achieved in previous quarters (e.g. Manufacturing in Q1).

Over the past year (from Q3 of 2014 to Q3 of 2013), Scotland grew by 3.0%. In comparison, the UK grew by 2.7%. This relatively fast growth rate in the past year was again driven by: Construction; Business-related services; and 'Other' services, each of which has grown by over 5% (1).

UK

While relatively strong as a whole, **UK GDP** (output) growth in the last quarter of 2014 saw a slowdown on previous quarters, due to faltering growth in Manufacturing (0.1%) and a decline in Construction (-1.8%).

At 2.6%, **growth** for 2014 as a whole has been easily the best annual UK performance, post-recession. Although, if the offshore oil and gas sector was excluded, it was not much better than in 2010 (2.3%) and 2011 (2.2%).

In January, the Office for National Statistics (ONS) published revised **UK productivity** figures, in light of a new methodology introduced to calculate UK GDP.

Improvements in (labour) productivity is a key element of output growth. It is usually measured in terms of output divided by a measure of labour force input, typically the number of workers or the number of hours worked. As such, it measures the efficiency gains made per worker or per hour worked from one year to the next.

Productivity

As well as looking at labour productivity as a whole, the ONS analysis also breaks labour productivity growth down into three categories:

- any change in labour quality (labour composition);
- any change in the volume of capital services used per hour worked (capital deepening) and;
- any further change, commonly known as 'Multi-Factor Productivity' (MFP), as used here, or as 'Total Factor Productivity' (TFP). MFP is key to an economy's performance as it measures any increase in output as a result of how efficiently labour and capital are being utilised. In other words, it equates to gains in output resulting from improvements in technology and efficiency, rather than from labour and capital directly.

Analysis of UK output and productivity by the ONS shows that (see also Figure 1):

- the biggest contributing factor to the fall in annual output growth seen around the time of the downturn in 2008 and 2009 came from declining MFP;
- post 2009 most growth has stemmed from increases in the volume of labour inputs (in terms of actual hours worked) and in the composition of labour (in terms of skill composition of the workforce);
- from 1971 up to the early 90s, the most important factor contributing to labour productivity growth was capital deepening, contributing over 1.5% a year;
- between 1997 and 2012, the most important factor contributing to UK labour productivity growth was the improvement in the composition (i.e. skill levels) of the labour force;
- however, for a period overlapping these two periods, 1993 to 2006, MFP was the main contributing factor to UK productivity growth;
- MFP has fallen in 4 of the 6 years since 2007;
- between the mid-90s and 2010, capital deepening contributed less than 1% a year to productivity growth, significantly less than its contribution in the two decades prior to that. Post 2009 this contribution has fallen to virtually nothing;
- labour composition has contributed almost all of the increase in labour productivity since 2009.

For the period 2008 to 2013, some of these disappointing productivity results can be explained by significant declines in labour productivity in the North Sea, where output continues to fall while costs rise, and in Financial services, where changes are more likely linked to the fallout from the root causes of the recession.

However, flat-lining or falling labour productivity performances were also seen in most other industrial sectors. Across most such sectors the largest contributor to labour productivity growth over the period came from improving labour composition, but in almost every case this was more than offset by declining MFP (the only exceptions being 'Information & Communications' and 'Business services').

Table 1: Whole UK Economy: Decomposition of Labour Productivity growth,

Percentage points		Contributions from:		
Year	Labour Produc - tivity	Capital deepen- ing	Labour compos -ition	MFP
2000	3.4	0.9	0.5	2.0
2001	1.5	0.5	0.1	0.9
2002	2.3	0.7	0.5	1.1
2003	4.1	0.7	0.7	2.7
2004	2.0	0.7	0.1	1.2
2005	0.9	-0.0	0.6	0.3
2006	2.3	0.4	0.4	1.5
2007	1.5	0.5	0.5	0.6
2008	0.4	1.0	0.4	-0.9
2009	-2.6	1.0	1.0	-4.6
2010	2.0	0.2	0.9	0.9
2011	1.3	0.2	0.7	0.4
2012	-1.2	-0.1	0.7	-1.8
2013	-0.3	-0.0	0.3	-0.5
1971 - 2013	1.9	1.1	0.3	0.4
1998 - 2013	1.3	0.5	0.5	0.3
2008 - 2013	-0.1	0.4	0.6	-1.1

Source: '*Multi-factor Productivity (experimental), estimates to 2013*', ONS, January 2015

Falls in MFP are often seen at times of recession, but the extent of the recent decline is unprecedented since the second world war. Unfortunately the sources and timing of MFP improvements are not well understood by economists so it is difficult to point to the

potential source(s) of any such slowdown or to what policy responses might be most appropriate to try to rectify the situation.

If anything, the long term and worsening decline in the contribution of capital deepening is even more worrying. However, again the reasons for this long term fall in capital deepening are not well known, although the most recent declines, to near zero, may be due to the lack of investment, post-recession, alongside the increase in UK employment.

Implications of declining productivity?

While the above analysis throws up issues of considerable concern it should be remembered that there are conceptual and measurement difficulties involved in measuring productivity and that the ONS continue to label this data series as 'experimental'.

Nevertheless, the recent declines seen in MFP and capital deepening are worrying as, historically, they have contributed substantially to the overall growth rate of the economy.

Both trends, if not reversed, are likely to reduce the expected long term growth rate of the economy and in turn act as a brake on future tax revenues which are used to fund public services. In addition, if productivity gains remain elusive, this will dampen both earnings growth and future increases in living standards. All of these potential knock on impacts are unwelcome. However, the appropriate policy responses are not straightforward due to the complexity of the underlying issues involved.

World

The IMF's latest growth projections for 2015 and 2016 include downward revisions to world growth by -0.3 of a percentage point in each year, despite the recent fall in the oil price (see Table 2).

Of the 'advanced economies', the United States is forecast to grow fastest, followed by the UK, while both Japan and the euro area remain sluggish. Forecasts for Russia, China and Brazil have also all been downgraded, with the Russian economy now expected to contract in both years.

Overview

2014 has been a relatively good year for the UK and Scottish economies and prospects remain relatively good for 2015 and 2016 although, as ever, caveats do apply. The first concern is in relation to the reliance on faster growth in the US economy in driving the pace of world growth. Other economies remain sluggish or are slowing in their growth rates. The second relates to ongoing geopolitical concerns in Russia, the Middle East and the euro area.

Table 2: IMF growth rate projections, January 2015, %

	2013	2014	2015	2016	2015 revision	2016 revision
World	3.3	3.3	*3.5*	*3.7*	-0.3	-0.3
USA	2.2	2.4	*3.6*	*3.3*	0.5	0.3
Euro Area	-0.5	0.8	*1.2*	*1.4*	-0.2	-0.3
Japan	1.6	0.1	*0.6*	*0.8*	-0.2	-0.1
UK	1.7	2.6	*2.7*	*2.4*	0	-0.1
Russia	1.3	0.6	*-3.0*	*-1.0*	-3.5	-2.5
China	7.8	7.4	*6.8*	*6.3*	-0.3	-0.5
Brazil	2.5	0.1	*0.3*	*1.5*	-1.1	-0.7

Source: IMF WEO update January 2015
Note: revisions from IMF projections made in October 2014

DISTRIBUTIONAL IMPACTS OF AUSTERITY RELATED TAX AND BENEFIT CHANGES ON HOUSEHOLD INCOMES

There have been two reports of late looking at how the tax and benefit policy changes implemented by the UK government over the years of austerity have impacted on different income and socio-groups. The first was by the IFS, '*The Effect of the Coalition's Tax and Benefit Changes on Household Incomes and Work Incentives*', while the second was by Social Policy in a Cold Climate (SPCC), '*The Coalition's Social Policy Record: Policy Spending and Outcomes 2010-2015*'.

The **IFS** found that the hardest hit households were at the top and the bottom of the income range i.e., the highest and lowest earners (2). However, another interesting finding is that, until the richest 10% of earners is reached, the impact of austerity measures on households falls as income rises. Indeed, for some 'better off than average' earners, the overall impact has been nil.

Rather than a 'squeezed middle', such households tend to have been more protected than high or low earners. This may reflect practical political decisions in light of those households most likely to vote. The IFS also found that, across all income levels, pensioners did not lose out over this period and that middle-to-upper income earner households, which were of working age but without children, actually ended up noticeably better off.

In contrast, the biggest losers were those households of working age with children. Here again, the richest and the poorest were worst affected. Furthermore, non-working households, with the exception of the richest 10%, have suffered far more than working or pensioner households.

The IFS note that, if the overall impact of tax and benefit policy changes are calculated going back as far as 1997, then the poorest households have benefitted the most.

By region, London (-£1,042 per household) has suffered more than anywhere else, followed by the South East (-£642). The three regions to have suffered the least (each at around -£300 per household) are the East Midlands, East Anglia and Scotland.

SPCC found a similar distributional shape to how austerity related tax and benefit policy changes have impacted on households across income levels. The principal exception to this was that SPCC did not find the highest earners to be as badly off as the IFS did. This can largely be explained by the fact that SPCC looked only at changes to personal direct taxes and cash benefits, whereas IFS also looked at the impact from indirect races (e.g. VAT). (3)

However, the finding that those in the top half of the income range (excluding the top 5-10 %) were least effected, sometimes even benefitting overall, remains true.

THE HEALTH BUDGET AND NON-PROTECTED BUDGETS POST 2015-16

England

January saw calls for higher levels of spending on Health in England post the next UK election, as opposed to simply a continuation of the current policy of keeping NHS day-to-day spending rising in line with inflation.

Commenting on its Five Year Forward View, the head of NHS England, Simon Stephens, suggested that even assuming historically ambitious efficiency savings of 2-3% a year, by 2020 the NHS in England would require a further £8 billion to be added to its budget,

beyond what was necessary to match inflationary pressures.

In a later report the Health Foundation, suggested that this £8 billion figure might be a considerable underestimate and that a figure closer to £65 billion might be required by 2030. This higher figure was partly based on an assumption that efficiency savings were more likely to be in line with the recent average (which is 1.5% a year for the period 2004 to 2011) and on projecting demand and cost pressures forward to 2030.

If such a sum were to be made available, it would involve funding of the English NHS to rise by around 2.9% in real terms. In cash terms this is likely to be close to 5% a year and would also be above the expected rate of economic growth of 2.3% a year.

No doubt there will be further pleas for increased future funding for the NHS leading up to the UK election in May, alongside emerging political party commitments. What may be less clear, and less discussed, is the knock-on impacts for non-NHS budgets of any such increases, which are likely to be substantial.

Scotland

While such a lively discussion has been taking place in England, little discussion of a similar nature has emerged in Scotland.

At present in Scotland the funding debate centres around whether or not all the Barnet consequentials relating to decisions on Health spend in England are automatically passed on to the NHS in Scotland. The more fundamental question of what financial sum best suits Scottish conditions is seldom addressed, either by NHS Scotland, political parties or think tanks.

Given the on-going importance of the NHS in the political debate it seems important to move to a more considered position on the future financial needs of the NHS in Scotland.

There is a further important wrinkle in this debate. At present, in England, both NHS resource spending and spending on GPs is protected against inflation, while in Scotland the latter is not (4). Again, the longer term implications and wider knock-on effects of this differential treatment of health funding in Scotland needs to be assessed.

RIP RPI ?

As discussed in the Monthly Bulletin for November 2014, RPI is no longer considered to be a good measure of UK inflation and hence is no longer an official ONS statistic. However, it still remains widely used for a variety of purposes.

In January a report for the UK Statistics Authority, undertaken by Paul Johnston of the IFS, was published which reviewed the current position.

The report - 'UK Consumer Price Statistics: A Review' - concluded that:

- "*RPI is not fit for purpose and should not be used except where existing legal contracts - for example index linked gilts - demand it.*" (see page 40);

- "*No taxes, benefits or regulated prices should be linked to the RPI* …(and) *the government should aim to move away from selling gilts linked to the RPI.*" (see page 40);

- There is a strong case for adopting CPIH as their main price index, where CPIH differs from CPI in that it includes a measure of owner occupiers housing costs.

- Unfortunately, the CPIH measure currently has its 'National Statistics' status discontinued due to concerns over the housing costs element. The report criticised the ONS for not being alert to this issue earlier.

The UK Statistics Authority is expected to respond to the report later in 2015.

While most remaining uses of RPI apply to UK taxes, benefits or regulated prices, it does still apply in some Scottish government circumstances, for example, rail fares, water charges and uprating the poundage for business rates. It may also be used in the private sector for wage negotiations.

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END NOTES

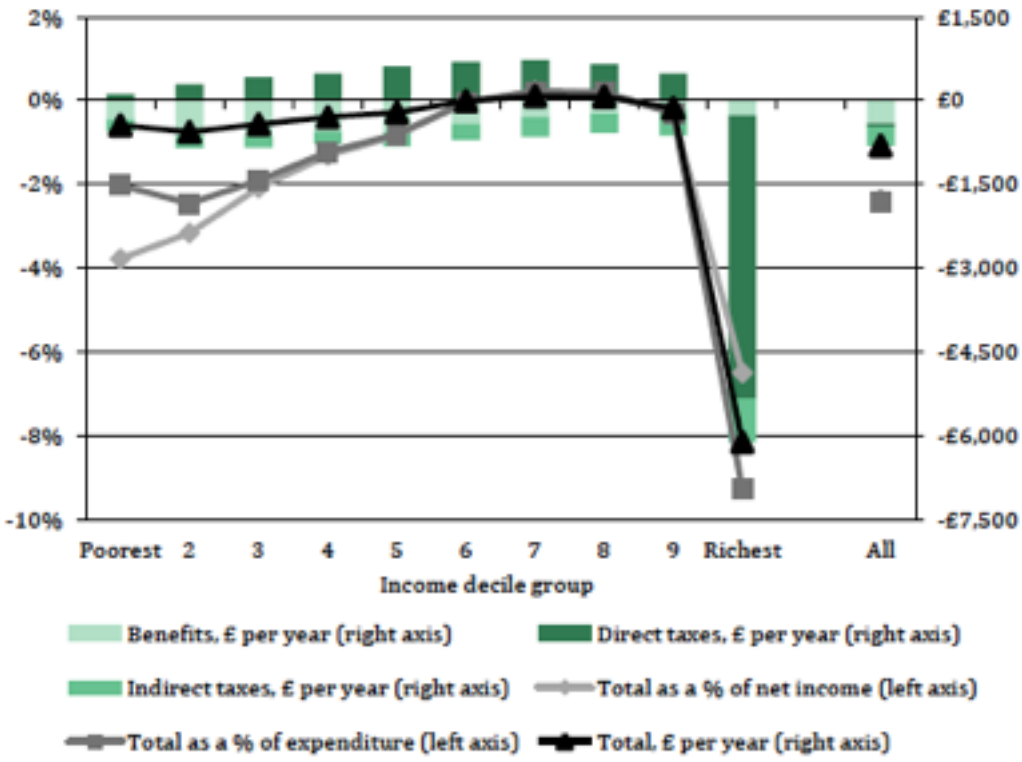
1. See Fiscal Affairs publication 'Analysis of latest Scottish GDP (2014Q3) and Labour Market statistics (September - November 2014) ' for more details.

2. The highest earners are the decile hit hardest over the period May 2010 to May 2015. This position is even more pronounced if the analysis is taken back to January 2010, in order to incorporate the initial austerity measures put in place prior to the Coalition taking office. (See chart below.)

3. Also, while the IFS report largely covered the period from May 2010 to May 2015, the SPCC report analysis finished a year earlier.

4. The reason for this is essentially that, with spend per head on Health in Scotland over 10% higher than in England, then Barnett consequentials are insufficient to protect both the NHS boards and GPs budgets in Scotland against inflation.

Figure 3.2: Impact of tax and benefit reforms introduced between January 2010 and May 2015 by income decile



Source: taken from IFS Briefing Note 159 '*The Effect of the Coalition's Tax and Benefit Changes on Household Incomes and Work Incentives*', January 2015

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