

Customer Forum Briefing Paper

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Outline of proposal:

The Customer Forum would find it helpful to gain a sense of the scale of the changes in the economy seen since 2009/10. This might be by reference to GDP levels, unemployment levels, changes in employment patterns, and particularly to impacts on disposable family income, from which water charges have to be met.

An explanation of the different sorts of inflation and what they encompass would also be useful.

It would be interesting to know, given the changes in the economy experienced since 2009/10 how affordable the water charge is today, compared to when the current framework for charges was set for commencement in 2010.

As well as a view of relevant changes in the economy that have occurred and the impact on relative affordability today, the Customer Forum would be interested in looking forward to the 2015 to 2020 period and gaining some insight into current projections for rates of economic growth which might have an impact on the customers disposable income.

Introduction

This Briefing Paper outlines past and future movements in various measures of: (i) income; (ii) the labour market; and (iii) inflation, for both the UK and Scotland. It then considers the longer term implications of recent economic events on how affordable future water charges might be for Scottish families.

The dominant theme is the underlying economic and financial uncertainty that has been generated by the recent widespread recession. This recession was unprecedented, in terms of its impact on developed economies over the past half a century. For example, in 2009 the OECD area suffered the only year of contraction in overall GDP since its records began in 1970, falling by almost 4%. Since then many countries, including the UK and Scotland, have struggled to recover.

Income – definitions and trends

Income is important in determining levels of, and changes in, prosperity.

The tables below highlight past outcomes and future forecasts with respect to a variety of income measures.

(a) Historic UK

Table 1: Income related outcomes, growth rates 2008-2012

	2008	2009	2010	2011	2012
GDP (real)	-1.0%	-4.0%	1.8%	0.9%	0.0%
Average Earnings (cash)	2.8%	2.8%	2.8%	2.0%	2.7%
H/H disposable earnings (real)	0.3%	1.8%	0.5%	-1.0%	(2.1%)

Sources: ONS, NIESR. Estimates are shown in brackets.

Main points:

- The UK underwent a major downturn in 2008-2009
- In the short term, earnings were not as badly hit but in the medium term they have continued to grow well below the rate of inflation (see Table 7) and cash terms GDP
- The figures shown concentrate on averages, the position will be different across the country (i) by region, (ii) by income decile.

(b) Projections and forecasts UK

Table 2: Income related forecasts, average and variation across independent forecasts & OBR

	2012	2013	2014	2015	2016
GDP (real)	-0.2%	1.1%	1.7%	2.0%	2.1%
Variation GDP		2.1-0.4%	2.5-0.8%	2.6-1.3%	2.7-0.9%
<i>OBR:</i>					
GDP (real)	-0.1%	1.2%	2.0%	2.3%	2.7%
Average earnings (cash)	2.7%	2.2%	2.8%	3.7%	4.0%
H/H disposable income (real)	2.1%	0.4%	0.8%	1.6%	2.0%

Sources: OBR Economic and Fiscal Outlook December 2012: A comparison of independent forecasts, November 2012 edition, HM Treasury.

Main points:

- Income growth in all measures (eg, GDP, earnings and household disposable incomes) returns to higher rates over time
- However, much of this is built into the assumptions of the forecasting models, the reality is highly uncertain, as the variation in forecasts of GDP suggests
- Even this degree of variation probably underplays the inherent uncertainty as they are all central forecasts, this is especially true in relation to the large downside risks (as discussed in the final section)

(c) Historic Scotland vs UK

Table 3¹: Income related outcomes, growth rates 2008-2012, Scotland vs the UK

	2008	2009	2010	2011	2012
GDP (real)					
- Scotland	-0.5%	-3.8%	1.5%	0.3%	(0.1%)
- UK	-1.0%	-4.0%	1.8%	0.9%	0.0%
Weekly earnings (F/T, cash)					
- Scotland	4.8%	0.6%	2.1%	2.0%	6.3%
- UK	3.8%	1.9%	2.1%	2.1%	2.2%
H/H disposable income (cash)					
- Scotland	4.1%	3.0%	3.2%	-	-
- UK	3.0%	2.4%	3%	-	-

Sources: Scottish Government quarterly GVA publication; ONS regional GVA publication; ONS EARN05 table.

Main point:

- Scottish and UK performances are, by and large, fairly similar post 2007

Labour Market trends

The Labour Market is important as it offers an alternative view of the state of the economy to GDP and as reflects the degree to which hardship is being shared out ie, the higher is unemployment the more people will be struggling financially. It is also generally accepted that it is better for more individuals to be in a job of some kind rather than have more F-T jobs along with higher unemployment, as this reduces the rate at which skills atrophy.

The tables below highlight past outcomes and future forecasts with respect to a variety of income measures.

(a) Historic, UK

Table 4: Labour Market, growth rates 2008-2012

	2008	2009	2010	2011	2012est
Employment (million)	29.4	29.0	29.0	29.2	(29.5)
Claimant unemployment (million)	1.78	2.39	2.48	2.56	(2.55)
ILO Unemployment rate	5.7%	7.6%	7.9%	7.9%	(8.1%)

Sources: ONS, NIESR.

Main points:

- Unlike GDP, employment has held up remarkably well, in comparison to previous downturns. In fact we appear to be seeing the reverse of the dreaded ‘jobless recovery’, that is, a recovery in jobs that has no impact on output
- These extra jobs have been created in the private sector, particularly over the past year (up 500,000) with public sector jobs recently falling in line with budget cuts

¹ In all Scotland vs UK tables, no forecast years are included as there are few available for Scotland and none from official sources (eg, OBR and Bank of England at the UK level).

- As a result of this rise in employment, the UK is faced with a productivity puzzle, that is why are jobs being created that do not appear to result in increased output or profits? The worry is that this decline in productivity will mean that the UK is not well placed to be competitive when a worldwide recovery arrives. Part of this productivity puzzle can be explained by a relative increase in Part-time working, at the expense of Full-time jobs and by an increasing use of (potentially lower paid) Self Employed and Temporary jobs
- Recently both employment and unemployment have been rising. This appears to be counter-intuitive but is possible due to behavioural change amongst the economically inactive

(b) Projections and forecasts, UK

Table 5: Labour Market forecasts, average across independent forecasts and OBR

	2012	2013	2014	2015	2016
Claimant unemployment (million)	1.6	1.63	1.61	1.58	1.52
Variation in unemployment		1.7-1.55	1.78-1.46	1.8-1.33	1.76-1.23
<i>OBR:</i>					
Claimant unemployment (million)	1.59	1.66	1.69	1.63	1.53
ILO Unemployment rate	8.0%	8.2%	8.2%	8.0%	7.6%
Employment (million)	29.5	29.6	29.7	29.9	30.2

Sources: OBR Economic and Fiscal Outlook December 2012: A comparison of independent forecasts, November 2012 edition, HM Treasury.

Main points:

- The main worry, not reflected in the forecasts above, is that the relatively good labour market performance will deteriorate if a revival in economic growth is not forthcoming

(c) Historic Scotland vs UK

Table 6: Labour Market outcomes, growth rates 2008-2012, Scotland vs the UK

	2008	2009	2010	2011	2012
Employment change (000s)					
- Scotland	-13	-21	-34	-7	+1
- UK	-1	-466	+191	+42	+553
Unemployment (million)					
- Scotland	140	200	223	231	207
- UK	1,943	2,442	2,476	2,675	2,490
Unemployment rate					
- Scotland	5.2%	7.4%	8.3%	8.6%	7.8%
- UK	6.2%	7.8%	7.8%	8.4%	7.7%

Sources: ONS Labour Market Summary Tables, UK and Scotland, Labour Force Survey, data applies to Sep-Nov, rather than year as a whole, and for all aged 16 & over.

Main points:

- Unlike with GDP, the performance of elements of the Scottish labour market is in stark contrast with the UK's, especially over the past year

- In particular, while UK employment has bounced back strongly over the past year, this has not been reflected in the Scottish data
- The position in terms of the shift in the pattern of working is also starker in Scotland, with changes from the latest year (to September 2012) to the previous year showing a greater movement from employees to self-employment and from full time working to part time working.
- Scotland's lack of job creation means that it is suffering from less of a productivity problem but also that it has not created nearly as many new jobs in the private sector
- In contrast to this, other data (on workforce jobs and unemployment) suggest a more similar labour market performance over the past year
- The share of total employment taken up by the Public Sector is slightly higher in Scotland, at 22% as opposed to 19% for the UK.

Inflation – definitions and trends

(Note: no Scottish inflation rates are published so the following considers the UK only.)

Inflation is important in determining changes in prosperity levels as it affects the buying power of the household's income. The higher the rate of inflation the lower becomes the spending power of a set cash income. (Annex 1 explains the principal different ways of measuring inflation.)

The tables and charts below highlight past and future trends with respect to some of these inflation measures.

(a) Historic, UK

Table 7: Inflation related outcomes, 2008-2012

	2008	2009	2010	2011	2012
CPI	3.6%	2.2%	3.3%	4.5%	2.8%
RPI	4.0%	-0.5%	4.6%	5.2%	3.2%
Difference	+0.4	-2.7	+1.3	+0.7	+0.4

Sources: ONS CPI and RPI reference tables, December 2012.

Main points:

- Even though the UK economy has been stagnating over the last 2 years, prices have nonetheless, continued to rise (as they did for CPI even when the economy was contracting in 2008 and 2009) and at well above the Bank of England's target rate of 2% (CPI)
- This is unexpected as usually a drop in demand and a rise in unemployment results in lower pressure on prices and so lower inflation
- This has been due in part to UK policy decisions on tax changes and monetary expansion, as well as to largely external energy and commodity price shocks
- However, UK inflation has also been significantly higher than in other G7 countries over the last four years

Within this general price inflation index, how utility and commodity prices (which are less of a discretionary spending item) have risen even further than CPI or RPI, as to have Water charges (see later).

(b) Projections and forecasts, UK

Table 8: Inflation forecasts, average and variation across independent forecasts and OBR

	2012	2013	2014	2015	2016
CPI	2.7%	2.2%	2.0%	2.1%	2.2%
RPI	3.1%	2.7%	2.6%	2.9%	3.1%
Variation CPI		3.2-1.6%	2.9-1.4%	3.8-1.5%	4.7-1.4%
Variation RPI		3.4-1.7%	3.6-1.0%	5.1-1.4%	5.7-1.7%
CPI (OBR)	2.8%	2.5%	2.2%	2.0%	2.0%
RPI (OBR)	3.2%	3.0%	2.6%	3.1%	3.4%

Sources: OBR Economic and Fiscal Outlook December 2012: A comparison of independent forecasts, November 2012 edition, HM Treasury.

Main points:

- Inflation is forecast to fall towards the Bank of England's target for CPI of 2%
- There is considerable variation amongst independent forecasters on future inflation
- RPI remains well above CPI (see Box 1 for explanation of this)

(c) Water prices

Water prices in the UK have risen at a far higher rate than either CPI or RPI for some time. Disaggregated ONS inflation figures show that, in the 1990s RPI rose 36%, while Water inflation was 74%. In the 2000s RPI rose by 31% while Water rose by 63%.

From 1997 to 2012, CPI rose by 37% while Water supply charges rose by over 80%. Over this period CPI was above Water inflation in only three years, 2000, 2010 and 2011.

Clearly Water charges for the UK as a whole have been rising at well above average inflation rates for some time. Water companies and the OFWAT (the Water Regulator in England and Wales) would no doubt argue that this is because of improvements in quality and necessary large scale investments in order to catch up with underinvestment in previous decades.

The position in Scotland is a little different to the UK as a whole, which is dominated by changes to English water user charges. In Scotland, over the decade 2001-02 to 2011-12, charges have grown faster than CPI but have been almost in line with RPI and so well below the rises seen for the UK (ie, for England & Wales)². As a result of these changes, the average household water bill in Scotland is now (2012-13) 16% below the average bill for E&W. Up until 2005-06, the average bill in Scotland had been above that for E&W.

The short-term price shifts described above illustrate only a part of the longer term picture, which needs to be viewed in the light of a number of important factors such as, past investment levels, water quality and EU regulations. These factors will also influence future prices.

The OECD's latest Economic Survey of the United Kingdom (published February 2013) included a section on 'Tackling fuel and water poverty in the United Kingdom'. It noted that about 5 million households in England spend more than 3% of their income (after housing costs) on water and sewerage bills and discussed ways of improving affordability.

² These comparisons will not be exact due to differences in household composition and use of meters. Furthermore within this decade long view it can be seen that Scottish prices have not risen at all since 2010-11.

Looking Forward, 2015-2020 – Big Issues

The forecasts shown here only go as far forward as 2016. Some forecasts go beyond this but, in present uncertain economic and financial circumstances, even forecasts upto 2016 can be viewed with considerable scepticism. Economic models are just not very reliable during transitional phases, as the steady relationships assumed between key variables are proved not to be so. For this reason no longer-term forecasts are shown here.

The potential longer term outcomes range from

- continued low economic growth due to on-going issues involving:
 - debt deleveraging;
 - the euro;
 - the US deficit;
 - Chinese growth;
 - Middle East/Oil instability etc;
- higher growth due to:
 - the existing output gap for the UK closing over time;
 - some of the above mentioned problems being resolved more quickly than is currently expected.

In both cases inflation could well stay above the BoE's 2% target, due to external commodity price pressures, or through policies aimed at deliberately generating higher inflation (as a means stimulate higher growth). Equally, however, some commentators still fear a move to the sort of deflation that Japan has experienced for much of the last 20 years.

General overview

In addition to the current economic problems there are worries about the continuation of a general slowing of growth in developed economies, as shown in Figure 2.

Figure 2: Annualised growth rates, in constant price terms, GDP per capita

Countries	Decades					
	70s	80s	90s	00s	(00 to 07)	1970-2010
Ireland	3.3	3.3	6.0	0.7	3.0	3.3
Finland	3.4	2.6	1.7	1.4	2.9	2.3
Japan	3.2	4.1	0.9	0.7	1.5	2.2
United Kingdom	1.8	2.6	2.6	1.1	2.4	2.0
Belgium	3.1	1.9	1.9	0.8	1.4	1.9
Germany	2.8	2.2	1.6	1.0	1.4	1.9
OECD*	2.5	2.3	2.0	0.9	1.7	1.9
Netherlands	2.3	1.7	2.5	0.9	1.6	1.8
USA	2.2	2.3	2.2	0.6	1.4	1.8
Scotland	1.5	2.1	2.2	1.2	2.4	1.8
France	3.1	1.8	1.5	0.5	1.1	1.7
Italy	3.3	2.4	1.6	-0.2	0.7	1.7
Sweden	1.6	1.9	1.7	1.5	2.6	1.7
Denmark	1.9	2.0	2.2	0.2	1.3	1.6
Switzerland	1.1	1.6	0.5	0.9	1.2	1.0

Sources: OECD, Scottish Government; * OECD here incorporates an estimate over 34 countries.

This slowing is seen for the OECD as a whole, but is even more pronounced in many EU economies, including: Belgium, Finland, France, Germany and Italy. This slowing down of growth was previously recognised by the OECD up to 2000 and would appear to have continued, indeed worsened, in the 00s. So, whereas most governments are seeking ways of returning to historical ‘average’ growth rates, it may be that such rates are no longer realistic.

Prospects for UK/Scottish households

The recent slowdown in economic growth has been reflected in figures for UK household income growth (see Table 9).

Table 9: Annual growth rates, by decade, for UK real household disposable income per capita

	1960s	1970s	1980s	1990s	2000s
UK	1.7%	2.5%	3%	3.3%	0.6%

Source: Final Report on the Commission for Living Standards, Resolution Foundation, 2012, Figure 1.2. (A similar scenario is shown, over different time periods, in ‘Living Standards, Poverty and Inequality in the UK: 2012’, Institute of Fiscal Studies, 2012, Table 2.2).

In addition to this overall growth worry there are further concerns with regards to distributional impacts (see Table 10).

Table 10: Average annual real income growth by quintile group (GB)

	Poorest	2nd	3rd	4th	Richest
1979 to 1996-97	0.8%	1.1%	1.6%	1.9%	2.5%
1996-97 to 2009-10	1.7%	1.8%	1.6%	1.5%	1.7%

Source: ‘Living Standards, Poverty and Inequality in the UK: 2012’, Institute of Fiscal Studies, 2012, Table 3.1.

In the UK, inequality grew substantially in the 80s and has remained fairly flat since the early 1990s. From the late 90s much of this levelling off was achieved by greater use of government redistribution through taxes and benefits.

Figure 3 (below) shows the distributional shifts across different earnings levels since 1999. Whilst very high earners have suffered post the recession, this is in contrast with much higher than average gains in all earlier periods and overall. By contrast, while the very lowest earners did well initially, since 2003 they have suffered more than any other group.

Looking forward, with the UK Government now cutting back on the level and availability of benefits in particular, there may be some re-emergence of widening income inequality.

Average annual growth across the earnings distribution among full-time employees (real-terms annual earnings)

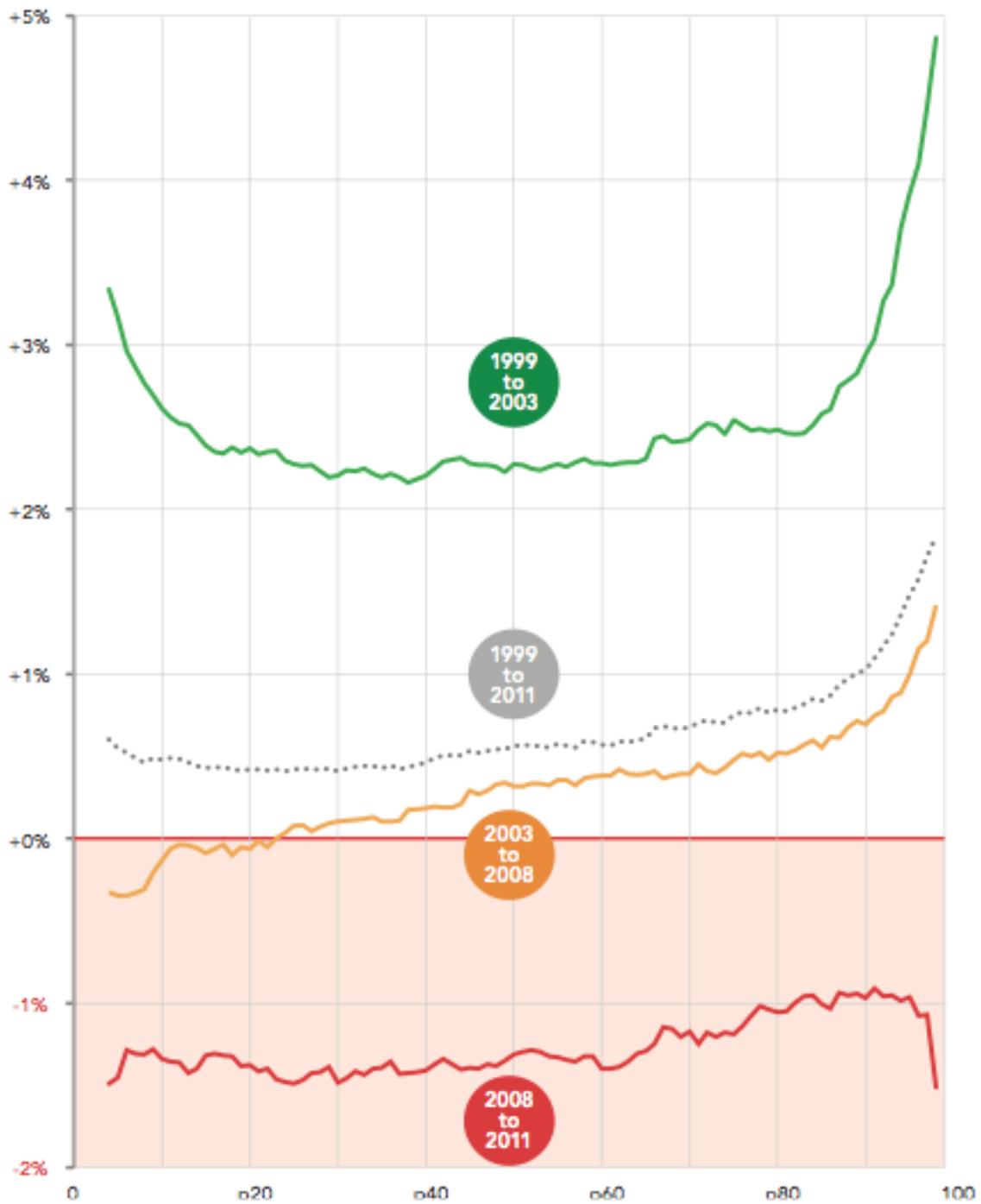


Figure 3:
Source: Squeezed Britain 2013, Resolution Foundation, 2013.

How affordable are Water charges likely to be over the next 5-10 years?

This is not a simple question to answer as it depends on the outcome of a number of key trends:

- to what extent will the economy pick up
- to what extent will any such pick up be reflected in increases in jobs and/or earnings
- how will any such increase in earnings be distributed across income bands

None of these outcomes is knowable at this stage. However, what may occur is that:

- earnings growth remains sluggish
- inflation struggles to meet the BoE target and remains above earnings growth
- the cost of basics, like utilities, continue to grow at a rate above average inflation and so take up a greater proportion of household income, particularly for the poorest households
- again for poorer households, which depend disproportionately on benefits which are now planned to rise at 1%, income growth remains well below inflation.

At the same time as these trends may be continuing, the Scottish Governments budget for public services will be falling in real terms. These public services can also be seen as elements of household prosperity and their reduction has a negative impact on living standards. CPPR have calculated that between the peak funding year (in real terms) of 2009-10 and 2017-18, the last year currently forecast by the Office for Budget Responsibility (OBR), the Scottish budget will fall by 20%. Furthermore, only half of these cuts have taken place so far.

In general terms, care needs to be taken in terms of picking a baseline comparator when looking at such relative shifts in affordability. For example, average earnings growth was strong in the years preceding the recession and so the **net** overall prosperity position now is a difficult thing to judge. Also, this net position will be different depending on which income bracket is being considered.

A future of continuing uncertainty

The major uncertainties and worries in relation to future prosperity, both nationally and individually, can be summarised as:

- the ability to achieve sustained economic growth at historic levels (ie, 2-3% per annum)
- the distribution of any such related income growth across households, especially whether such gains are increasingly garnered by those at the top of the income (and skills) distribution
- the degree to which inflation continues to be concentrated on those items which have a greater impact on low income household ie, basics like energy, utility and food prices
- taken together, these worries can be expressed as a concern that poorer households will, relatively, suffer to a greater degree in the future than an analysis of mean or median data for Scotland/the UK would otherwise suggest.

Box 1: RPI vs CPI – explaining the differential

For some time it has been known that there is an upwards bias to the RPI inflation measure, as opposed to the CPI measure. While the measures can be different for a variety of reasons, including: coverage differences, principally due to the inclusion of more housing items in RPI; target population differences, principally due to the narrower coverage in RPI; in both these cases the differences might allow CPI to be above or below RPI. (See Annex 1)

However there is a third difference, in the aggregation formula used to achieve the overall indices, which results in a bias towards RPI inflation being repeatedly higher.

Up to 2010, this bias was estimated to be worth about 0.5 of a percentage point a year. However, since a methodological adjustment to the clothing index in 2010, the difference has averaged around a full 1% difference. The reason for this bias is quite technical³ but it is now internationally widely accepted that the CPI methodology is more appropriate. Almost no other country uses the upwards biased methodology used for UK RPI.

The ONS has been reviewing its position on this and reported in mid January that it accepted that the current RPI methodology was flawed. As a result it is to introduce a new measure RPIJ⁴, which will be calculated in line with international best practice. RPIJ will be noticeably lower than RPI, by about 1 percentage point. (Note: CPI and RPI may still differ due to continued differences in the coverage and populations.)

Despite the introduction of this new measure, and the acceptance that it is a more accurate measure of retail price inflation, ONS do not intend to do away with RPI or downgrade its role. The ONS's chief statistician explained that this was because it wished to maintain continuity, especially in relation to indexation of inflation-linked gilts and bonds. Ultimately it will be for the UK government to decide whether it wishes to use the alternative, more accurate, measure with regards to such indexation in the future.

The importance of this statistical debate relates to how inflation measures are used in various negotiations, for example, wage deals and the uprating of various charges and benefit payments.

Beyond 2014, annual inflation is currently forecast to be around 2% for CPI and 3% for RPI. Cumulatively this makes a very large difference in budgeting terms, for example, over a 10 year period annual inflation of 2% results in an increase of 22% while a 3% annual inflation rate results in an increase of 34%. Hence, while this may appear to be a somewhat arcane discussion of statistical methodology it actually has important on-the-ground impacts on the real spending power of incomes, public sector budgets and on the affordability of future government policy pledges.

³ The bias results from the use of different formulae to calculate weighted averages, principally as a result of using arithmetic mean (for RPI) as opposed to the geometric mean (for CPI), see 'International Comparison of the Formula Effect between the CPI and RPI', ONS, March 2012.

⁴ The J stands for Jevons, the revised formula methodology being used.

Annex 2

Inflation Glossary

There are various ways of measuring inflation. The two main consumer price inflation indices are CPI (Consumer Prices Index) and the RPI-All items (Retail prices Index).

Both indices seek to measure the change in the price of a fixed basket of representative goods and services bought by UK consumers. There are variations in the composition of the basket for RPI and CPI. Weights are applied to the price movements of each item measured to reflect the relative importance of these items in the household budget. The weights used to compile both the CPI and RPI are updated annually.

The CPI was first introduced in 1996 as the Harmonised Index of Consumer Prices (HICP). HICPs were deemed consistent measure of inflation to help assess inflation convergence for prospective EMU membership and for the ECB to assess price stability in the Euro area.

CPI	<p>The CPI covers all expenditure within the UK made by private households, residents of institutional households (such as University halls of residence or nursing homes) and tourists.</p> <p>CPI is the UK Government's inflation target set for the Bank of England's Monetary Policy Committee.</p> <p>In the June 2010 Budget, the Chancellor announced the Government's intention to use the CPI for the indexation of benefits, tax credits and public service pensions from April 2011.</p>
RPI-All items	<p>The RPI is based on the spending of private UK-based households only and excludes (a) the top 4 per cent of households by income and (b) 'pensioner' households (where the head of the household is retired and economically inactive) and where at least three-quarters of the household income is derived from state benefits.</p> <p>These households are excluded because they are considered to have 'atypical' spending patterns and therefore their inclusion would distort the overall average price movement of the RPI.</p>
RPI-X	<p>This measures the same as RPI-All items but excludes mortgage interest payments.</p>