



**Damage
done**

**Routes to
Recovery**

Impact of Austerity on Scotland

A UNISON Scotland report
April 2016

**The Impact of Austerity
on Scotland**
Damage done and routes to recovery

The Impact of Austerity: damage done and routes to recovery

UNISON Scotland has commissioned this report from leading economist Professor John Maclaren in order to offer analysis of the impact of austerity in Scotland and of what policy measures the Scottish Parliament might be put in place to mitigate its effects.

Introduction

The financial crisis of 2008 continues to provide the backdrop to much of what happens in our economy and society. This report provides a dispassionate look at the impact the twin pressures of recession and austerity have had on Scotland. Its pages show that the years since the crash have not been easy ones for UNISON members either in or out of the workplace.

This report outlines the damage that has been done, the current state of play in our economy and suggests some of the options that are open to us. It makes clear the need for, and value of, an urgent exit from austerity. Our aim in commissioning this work is not to provide a blue print, but a solid factual base on which alternatives can be based. We publish it as a contribution to public debate on how we build a better Scotland.

Mike Kirby, Scottish Secretary

Lilian Macer, Convener

UNISON Scotland

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Key points

- The world economy took an unprecedented hit after the financial crisis of 2008.
- This resulted in rapidly rising fiscal deficits due to falling government revenues and rising, recession related, public expenditure.
- After initial efforts at fiscal stimulus to support demand, many governments, including that of the UK, put in place a plan of austerity, arguing that this was a necessary measure in order to bring about market stability via the creation of a more balanced budget in the short to medium term.
- This austerity involved large cuts to Departmental spending, initially concentrated on capital spending but latterly moving on to day-to-day budgets. Overall, UK government spend as a share of GDP is expected to fall by over 9 percentage points (i.e. by 20%), with a third of this decline still to come.
- This size of cut is on an unprecedented scale and will result in government spending (as a share of GDP) being reduced to a level seen only twice, for very brief periods, since 1948. In both instances, such low levels have proven to be unsustainable and been followed by decade long surges in public spending.
- Such an erratic pattern for funding essential public services suggests an inefficient system, with the low points being consistent with periods of widespread underinvestment.
- The public spending cuts have a number of distributional effects, including:
 - protection of the NHS and pensions, at the cost of other budgets, in particular Local Government and Transport;
 - bigger tax and benefits losses falling on the richest and poorest households, with relatively smaller ones applying to mid to upper income households;
 - bigger tax and benefit losses applying to single parents and smaller ones to pensioners;
 - bigger cuts to more deprived localities than to less deprived ones.
- There are a number of ways in which the Scottish Government could mitigate the effects of austerity, the most important of which, in the longer term, would be a return to average, or above average, rates of economic growth.
- While no silver bullet exists to do so, most academic economists and international bodies believe that higher levels of public investment would help improve future growth prospects.
- Further possible measures to mitigate could include:
 - increases in different rates of Income Tax;
 - increases in other devolved taxes, i.e. property, landfill, aviation, new taxes;
 - increases in local forms of taxation, i.e. Council Tax and NDRI;
 - increases in borrowing for capital projects and/or day-to-day spending;
 - removing or restricting universal provision of services and benefits;
 - reallocation of relatively over provided for budgets, e.g. Scottish Enterprise.
- The greatest scope to offset future cuts to public services appears to rest with tax rises.
- None of these measures will be cost free, they will inevitably involve some degree of ‘trade off’. Such policies will also involve a variety of distributional choices.

1 The impact of the financial crisis on the national economy

Scottish and UK GDP

The financial crisis that emerged during 2008 led to widespread economic difficulty across the globe. The scale of the crisis led to negative growth rates in many economies and the banking led nature of it led to a sluggish recovery path thereafter.

Table 1 illustrates the scale of this downturn. It highlights that, while no different in scale to past UK and Scottish recessions of the mid 70s and early 80s, the current recession has been exceptional in terms of its impact on advanced economies as a whole. Post 1970 the OECD area had, collectively, never experienced a downturn until 2009. Growth of 0.1% in 1982 had been the previous low point prior to the -3.5% figure seen in 2009.

The more global nature of the most recent recession, with few countries avoiding the pain, helps explain why it has been harder for any individual country to recover.

Table 1: Decline in GDP over past periods of UK recession

Annual average, real terms, percentage points

	Scotland	UK	OECD
1973-1975	-3.4%	-4.0%	+2.4%
1979-1981	-3.0%	-3.0%	+3.5%
1990-1991	+0.3%	-1.4%	+1.5%
2007-2009	-3.4%	-4.6%	-3.2%

Sources: Scottish Government, ONS and OECD National Accounts.

Within Scotland the pattern of recession and recovery has been different across different industry sectors, as Table 2 shows:

- The deepest recession, but also greatest recovery, was in relation to the Construction sector;
- Services had a mild downturn and have continued to grow steadily since;
- Within this, Public Sector services (Administration, Education and Health) was the only sector not to slip into recession but has barely grown during the recovery period.

Relative to the UK:

- Scotland's recession was shallower but its recovery has been weaker, leaving it relatively worse off;
- This result is still true after taking into account relative population changes (i.e. in terms of GDP per head), but to a lesser extent;
- The prime reason for this poorer relative performance has been slower growth of Scottish Services, for both the Private and Public sectors. In the latter case it is unclear why this should be so given that spend on Public Services in both Scotland and the UK are driven by UK public spending decisions which are reflected in Scotland via the Barnett formula;
- More recently Scottish growth has been heavily dependent on a (temporary) boost in the Construction sector.

Table 2: GDP growth rates by Industrial Sector, 2007 to 2014**Real terms changes in percentage points**

	Whole economy	Manufact'g	Construction	Services	Business services	Government services	GDP per capita
2007-2009	-3.4	-6.4	-16.4	-1.5	-0.7	0.6	-4.6
2009-2015	7.5	4.6	40.0	5.1	9.7	1.3	4.9
Overall - Scotland	3.8	-2.1	17.1	3.6	8.9	1.9	0.1
Overall - UK	8.8	-6.0	-1.9	12.7	16.8	9.5	1.2

Source: Scottish Government, GDP Quarterly Statistics Quarter 4 2015.

Note: for the UK, 'Whole economy' excludes the North Sea but 'GDP per capita' includes the North Sea. For Scotland all data excludes the North Sea.

The above analysis concentrates on GDP rather than on a more sustainable measure of economic growth, due to the lack of data on alternative measures. While lower growth should cut pollution levels there has also been an apparent downplaying of climate change as a government priority, so that the net impact is difficult to ascertain.

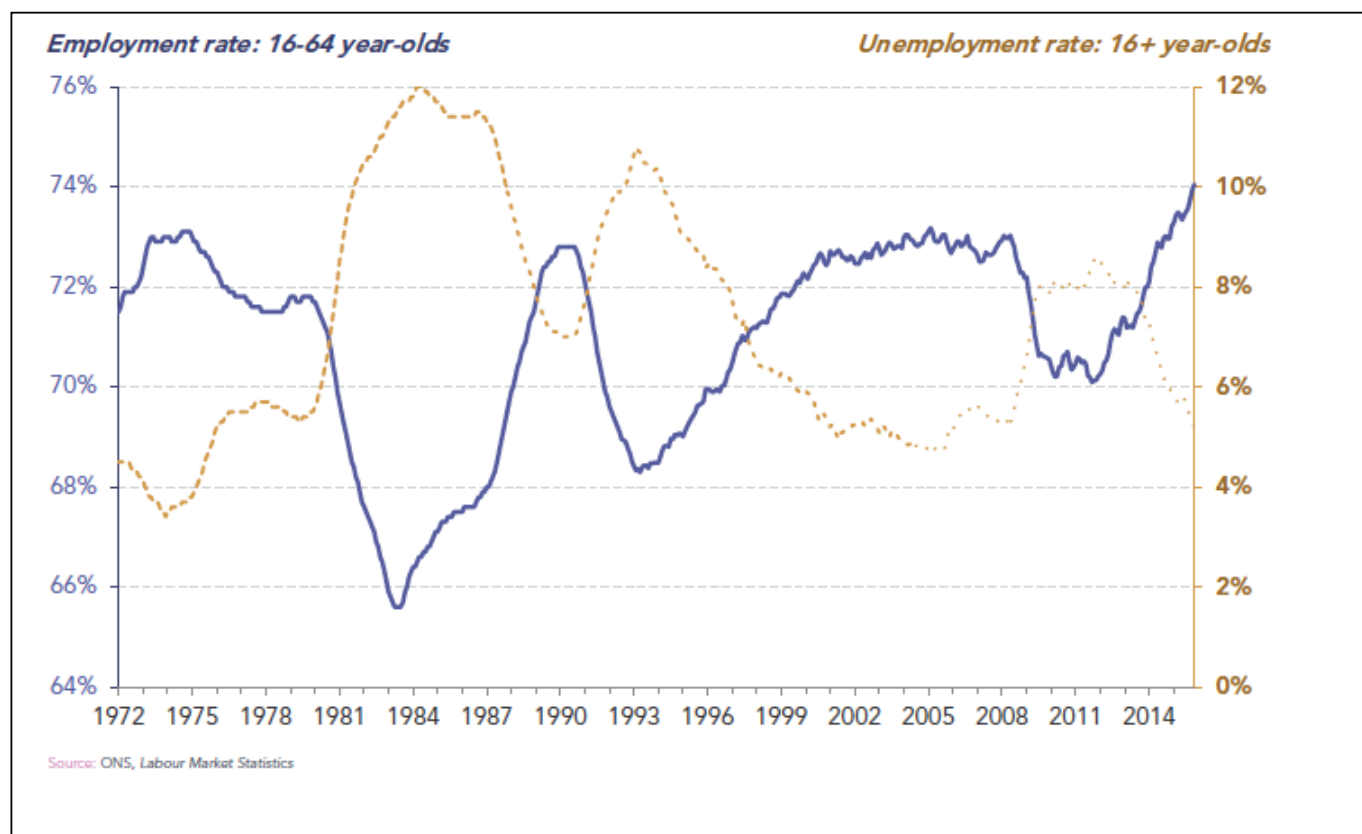
Scottish and UK Labour Market

While the impact of the global financial crisis on GDP was as large as in previous recessions, the reaction of the labour market has been more moderate than in previous recessions (see Figure 1 below, 'Emmerson & Tetlow, Fiscal Studies/36/4' or RF Living Standards 2016 Fig 1.)

This was not expected and the reasons for it are still being debated amongst economists. Some of the most discussed reasons are:

- a shift from Full time to Part time jobs;
- a shift from Employees to Self employed, also involving lower wages and/or fewer hours;
- a more flexible labour market than in previous recessions allowing for faster reallocation of jobs;
- labour hoarding by employers;
- support for 'zombie' companies.

Figure 1: Employment and unemployment rates



An unwelcome consequence of this relatively good labour market performance, over that of GDP, has been a decline in productivity. In a ‘normal’ recession it is expected that employment will decline more than output resulting in a productivity boost.

Scotland’s labour market position in 2015 was not dissimilar to that pre crisis, in 2008 (see Table 3).

Table 3: Labour Market changes 2008 to 2015

Changes 2008 to 2015, shown as rates

	Employment	Unemp’t	Claimant Count	Youth Unemp’t	Economic Activity	Economic Inactivity
2008	73.3	5.1	3.5	13.9	77.3	22.7
2015	74.9	5.4	2.7	13.0	79.3	20.7
Change - Scotland	1.6	0.3	-0.8	-0.9	2.0	-2.0
Change - UK	1.8	-1.1	-1.3	-2.6	1.0	-1.0

Source: Scottish Government, Labour Market Monthly Briefing Summary Tables

Relative to the UK, Scotland’s position has worsened but this, in turn, was on the back of a little understood, long term improvement relative to the UK from the mid 1990s to 2008 (see Figure 2).

Figure 2: Employment rate by nation/region

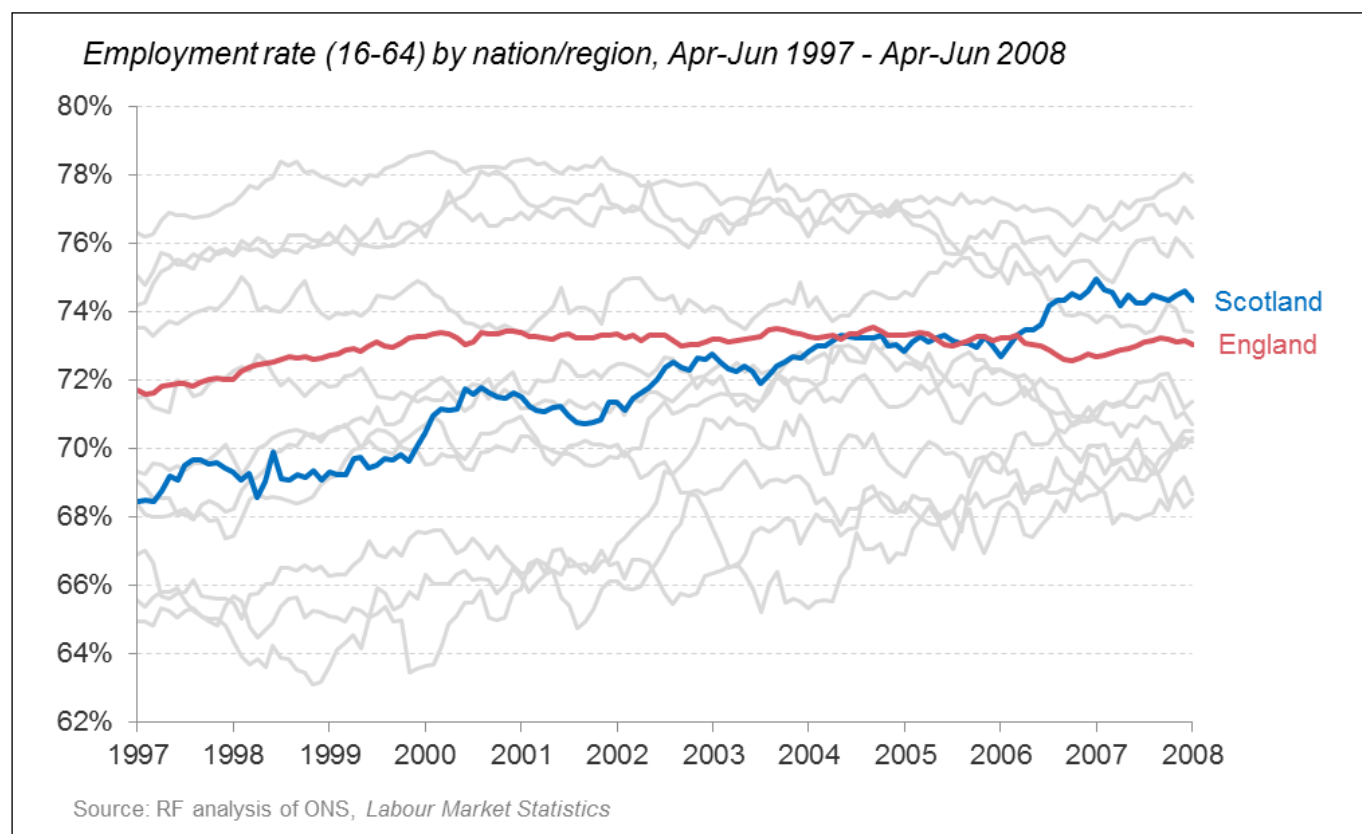


Table 4: Unemployment levels, 2008 to 2015

Levels by age group, 000s

	age 16-24	age 25-34	age 35-49	age 50-64
2008	58	29	36	16
2015	56	29	36	30
Change - 000s	-2	0	0	14
Change - %	-3	0	0	88

Source: as Table 3

The number of people unemployed in Scotland has risen by 12,000 since 2008, with the entire increase being found in those over 50. Much of this could be down to the changes in retirement practices, especially the raising of the retirement age for women to match that for men.

Table 5: Labour Market changes - males

Change 2008 to 2015, Male, 000s							
	All	Employees	Self employed	Full time	Part time	With 2nd jobs	Temporary workers
Level 2008	1,335	1,129	197	1194	139	41	58
Level 2015	1,348	1,151	192	1170	175	40	69
Change - 000s	13	22	-5	-24	36	-1	11
Change - %	1	2	-3	-2	26	-2	19

Source: as Table 3

Table 6: Labour Market changes - females

Change 2008 to 2015, Female, 000s							
	All	Employees	Self employed	Full time	Part time	With 2nd jobs	Temporary workers
Level 2008	1,200	1,115	81	726	472	54	63
Level 2015	1,280	1,181	92	755	522	55	72
Change - 000's	80	66	11	29	50	1	9
Change - %	7	6	14	4	11	2	14

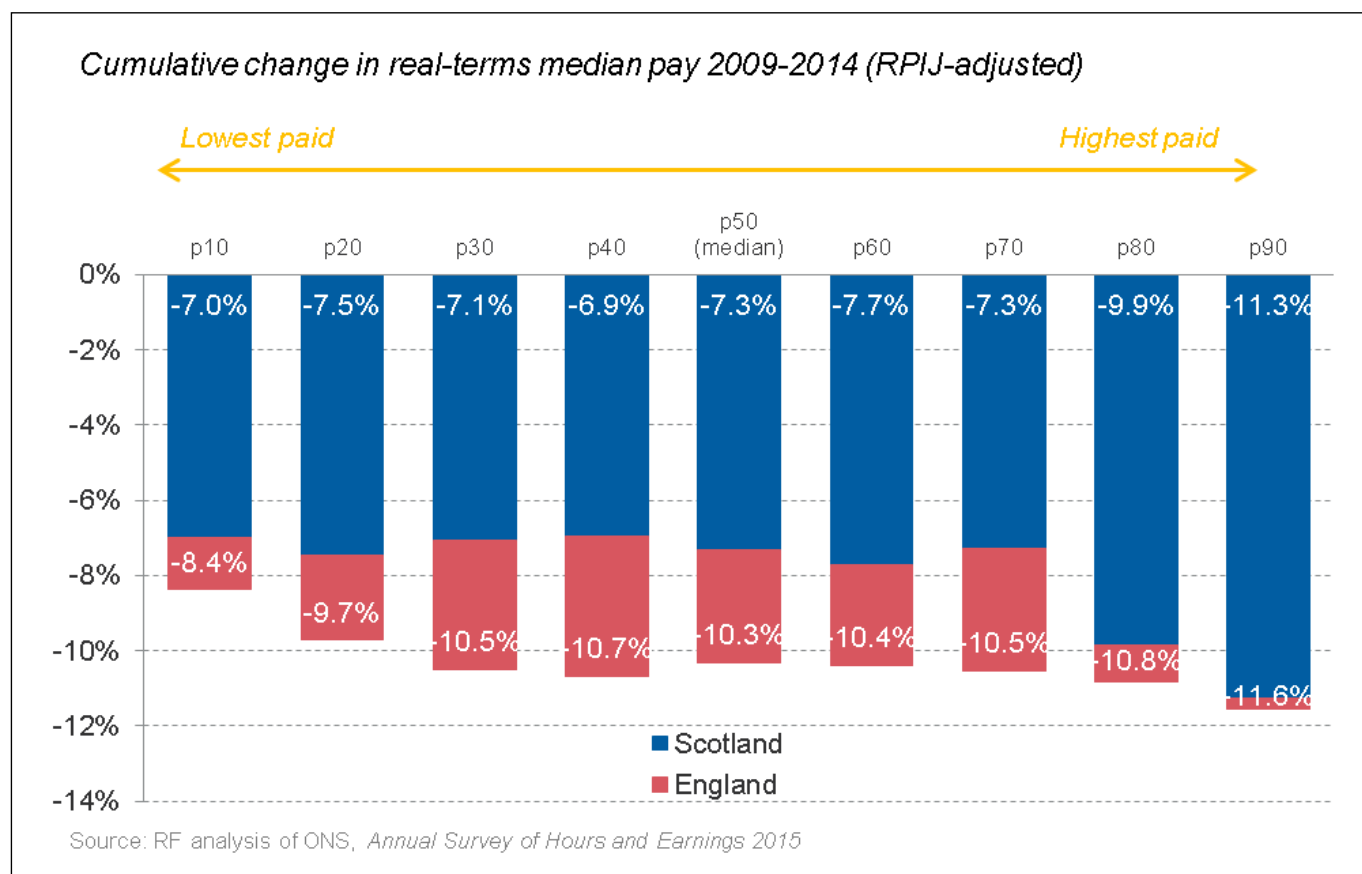
Source: as Table 3

The composition of employment, by type, has altered post the financial crisis. For men, there are now many more Part-time and Temporary workers, while for women there has been an increase in Self employed as well as, smaller than for men, increases in Part-time and Temporary workers.

Income and Wages

While the employment related picture turned out to be better than had been expected over the recession, the same cannot be said for the rewards from employment. The Resolution Foundation's analysis of real terms median pay from 2009 to 2014, shows it falling by around 10.5% on average at the UK level and by around 7.5% in Scotland. This fall was distributed fairly evenly across earning levels in the UK but was notably larger for the most well off in Scotland (see Figure 3, page 17 of RF Scottish analysis).

Figure 3: Cumulative change in real terms median pay



2 The impact of the financial crisis on local economies

There is not an abundance of economic data available at the local level for Scotland, but what is exhibits a fairly consistent pattern, as seen in Tables 7 and 8 below.

Table 7: Labour Market by Local Authority

	Unemployment Rate		Employment Rate	
	Oct 2014 - Sep 2015	Change from 2008-09	Oct 2014 - Sep 2015	Change from 2008-09
Scotland	6.0	+1.5	73.1	+0.7
best performers	<4	<0.5	>80	
Shetland Islands	2.3	0	84.2	-1.7
Orkney Islands	2.6	+0.4	87.5	+4.2
Aberdeenshire	2.7	+0.4	81.6	+0.5
Highlands	3.4	+0.4	80.7	+0.3
			Renfrewshire	74.6
			South Lanarkshire	75.6
worst performers	>8	>2.4	<70	
North Ayrshire	9.5	+2.6	65.1	-0.6
Glasgow City	9.2	+2.6	66.7	+3.0
Dundee City	8.7	+2.5	63.3	-5.2
East Ayrshire	8.1	+2.4	69.7	+1.1
			Moray	72.8
			Angus	71.4

Source: as Table 3

In terms of unemployment, the smallest impact since 2008 was felt in the Highlands and Islands and around Aberdeen. In contrast, the cities of Glasgow and Dundee and much of Ayrshire suffered the most.

The picture was slightly different when looked at in terms of employment, with Renfrewshire and South Lanarkshire performing relatively well since 2008 but with the Highlands and Islands and around Aberdeen still out in front.

In terms of economic activity (GDP), the best performers were again the Orkneys, Shetlands and Aberdeenshire, but also North Lanarkshire. In the case of the latter two this was a continuation of the improved performance since 1997.

The worst performers tended to be commuter areas around Glasgow and Edinburgh, in most cases again continuing a trend seen since 1997.

Table 8: GDP per head by Local Authority**GDP (Income based) per head by Local Authority by local (NUTS 3) level**

	2014	Change from 1997	Change from 2008
Scotland	23,100	83	12
<i>best performers since 2008</i>			
Shetland Islands	26,083	68	22
Orkney Islands	20,072	83	22
Aberdeen & Aberdeenshire	37,460	105	19
North Lanarkshire	18,273	127	18
<i>other 'good' performers</i>			
Edinburgh	35,779	96	6
Glasgow	32,208	94	11
<i>worst performers since 2008</i>			
West Lothian	19,990	48	3
Inverclyde, East Renf & Renf	17,421	45	4
E & W Dunbart, Helensb & Lomond	14,532	74	5
Falkirk	17,524	42	6
East & North Ayrshire	13,546	33	7

Source: Scottish Government, ONS statistics

1. The level of GDP per head shown here is based on workplace rather than residence and as such distorts the relative wealth of local authorities towards those large job centres, in particular the major cities.
2. The post 2008 trend suggested above is also reflected in ONS data (NUTS 2 level) for Production based regional GVA from 2009 to 2013, which shows North Eastern Scotland and the Highlands and Islands growing much faster than Eastern (including Edinburgh) and South Eastern (including Glasgow) Scotland.

Overall, the local impacts are not unexpected. Those areas which already had relatively high unemployment suffered by more than those with low unemployment, although, proportionately, the rise was less pronounced.

Edinburgh, which had been growing up to 2008, in part due to an expanding financial sector, has since slowed down. However, this slowdown is less evident in the rise seen in its unemployment rate, which was just below the Scottish average, possibly due the movement of financial sector ex- employees out of the area. Aberdeenshire has been doing particularly well, but this was mainly during a period of high oil prices and investment activity, whereas the position now is very different.

Other sub national analysis

Work by the Joseph Rowntree Foundation ('The Cost of the Cuts: The Impact on Local Government and Poorer Communities', March 2015) has found that across local council services, in general terms:

- more rural councils have suffered more than more urban ones;
- poorer councils have suffered more than richer ones;
- these distributional impacts have been much more evident in England than in Scotland;
- as the Scottish funding distribution system was less progressive than for England, this relative shift has led to a convergence between the two, towards relatively limited recognition of differential needs;
- despite the cuts, up to 2012, public satisfaction with local government services in Scotland had, in general, not declined.

3 The impact of the financial crisis on public finances

As a result of the global economic slowdown, pressure was put on public finances in many countries due to both declining revenues, from the slowdown in activity, and to still rising public expenditure, as ‘automatic stabilisers’ kicked in. In some cases an extra boost was given to public expenditure, a ‘fiscal stimulus’, in order to help alleviate what was hoped to be a temporary slowdown in the economy.

However, when growth remained weak and borrowing high, resulting in sharply rising debt levels, then many governments including the UK started to introduce ‘austerity’ plans which would eliminate borrowing over a relatively short period of time and eventually lead to declining debt levels.

Such plans have proved controversial amongst economists and others, with the majority of academic economists supporting a greater role for continued fiscal stimulus, particularly with regards to public investment in capital projects that improve future economic potential and productivity.

While progress towards greater balance in the public sector finances has been made, it has been slower than expected. The period of austerity is now up to ten years, double the initial estimate. This has been largely due to the sluggish return to growth, with the consequent knock on impact of lower than anticipated tax revenues.

Overall spending budgets - UK

In the case of the UK, pre crisis levels of public spending as a share of GDP were not high in historical terms. However, post-crisis, falling revenues and rising expenditure has led to a growing fiscal gap. This gap, in terms of borrowing as a % of GDP, peaked at 10.2% in 2009-10, having been only 2.7% two years earlier. The previous peak had been 7.2% in 1993-94, just after the previous UK recession.

As the economy stubbornly refused to return to growth (or to higher than the historical growth rate, as might be expected from the evidence of previous recessions) then the UK Government, like many others, decided that cuts to spending were needed in order to achieve greater balance in the public sector finances.

As a result, in overall spending terms the annual rises since 2009-10 have been unprecedented in their modesty in comparison to the past 60 years (see Figure 4, chart from Resolution Foundation ‘The Shrinking State’, page 3).

Total UK Government spending grew in real terms by an annual average of around 2.5% between 1955-56 and 1999-2000, before accelerating in the 2000s (2000-01 to 2008-09) to an annual rate of 4.5%. However, between 2009-10 and 2019-20 total government spending is not expected to see any growth, actually a small fall.

Differing degrees of austerity in the UK

The degree to which different public spending budgets have been affected by ‘austerity’ has varied widely. As a consequence, care is needed when discussing the extent to which, and where, austerity has occurred. Table 9 highlights some of these different public spending trends, in both cash and real terms, for the whole period (2009-10 to 2019-20) and for the period still to come, (2015-16 to 2019-20).

Figure 4: Government spending - UK

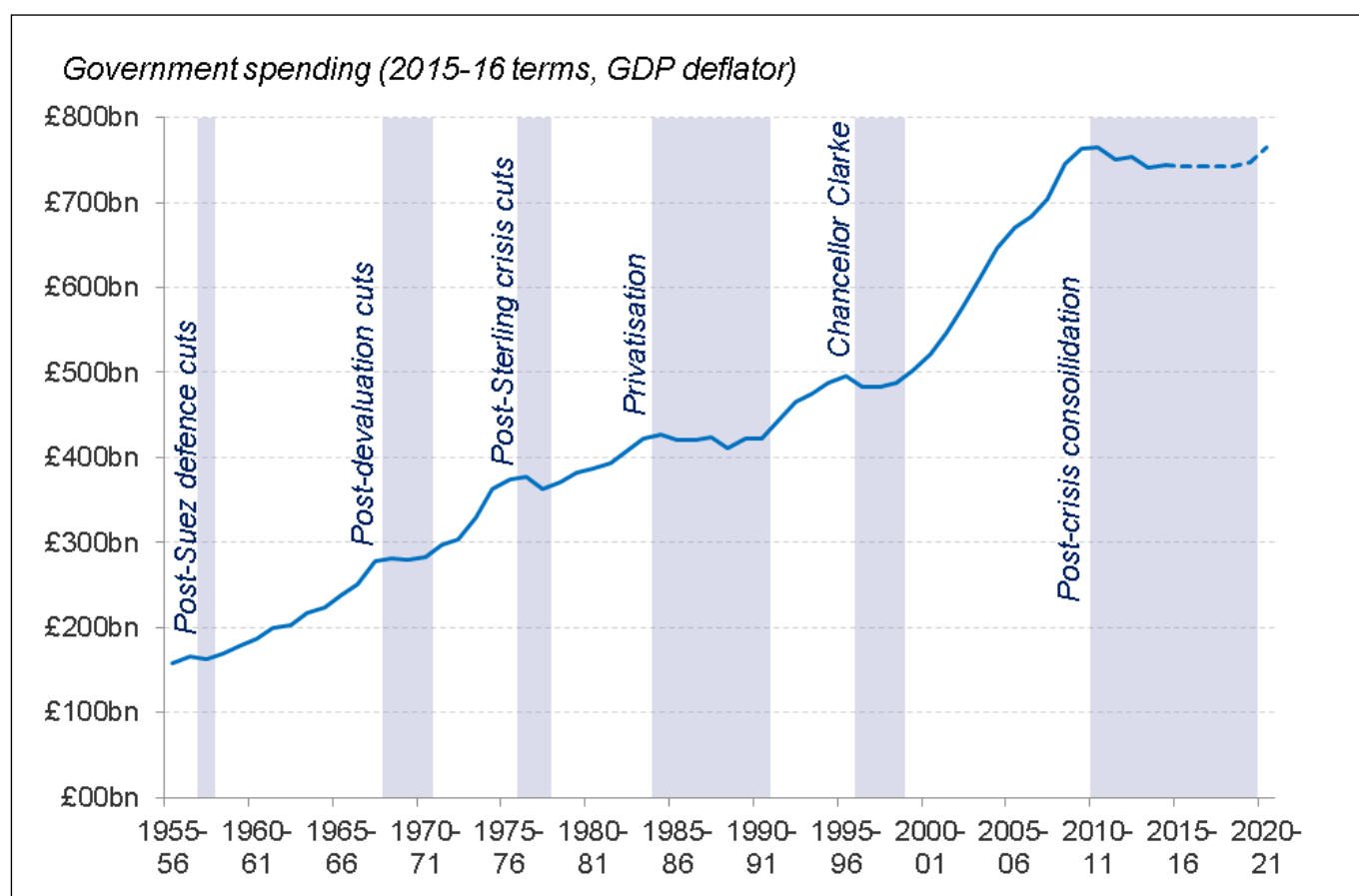


Table 9: Changes in UK public spending totals*

	Change between 2009-10 and 2019-20				Change between 2015-16 and 2019-20			
	Cash terms £bn	%	Real terms £bn	%	Cash terms £bn	%	Real terms £bn	%
Total	118	+17	-10	-1	+56	+7	0	0
Benefits & Pensions	121	+42	58	+18	+38	+10	+7	+2
Public Services	-3	0	-63	-17	+18	+5	-8	-2
Day-to-day Services	+15	+5	-41	-12	+11	+3	-12	-4
Capital	-12	-21	-18	-34	+7	+21	+4	+12

Source: OBR, Economic and Fiscal Outlook, March 2016, Supplementary Fiscal Table 2.17 for cash terms, real terms calculated by author using UK GDP deflator.

Note: in more technical language, Total Public Spending is known as Total Managed Expenditure (TME), Benefits & Pensions as Annual Managed Expenditure (AME) and Public Services as Departmental Expenditure Limits (DEL) spending.

* Data is consistent across the full period for day-to-day (RDEL) services but involves some, relatively small, historical discontinuities for other component parts in earlier years. As a result, over the full period, the Public Services components do not add up to the overall figure in column 1.

Total Public Spending has continued to rise in cash terms in every financial year and this trend is forecast to continue. Even in real terms (i.e., after adjusting for inflation), total spending has only fallen significantly in three years, 2011-12, 2013-14 and 2015-16.

Spending on Benefits and Pensions, which accounts for around half of total UK public spending, has risen in both cash and real terms every year, due to:

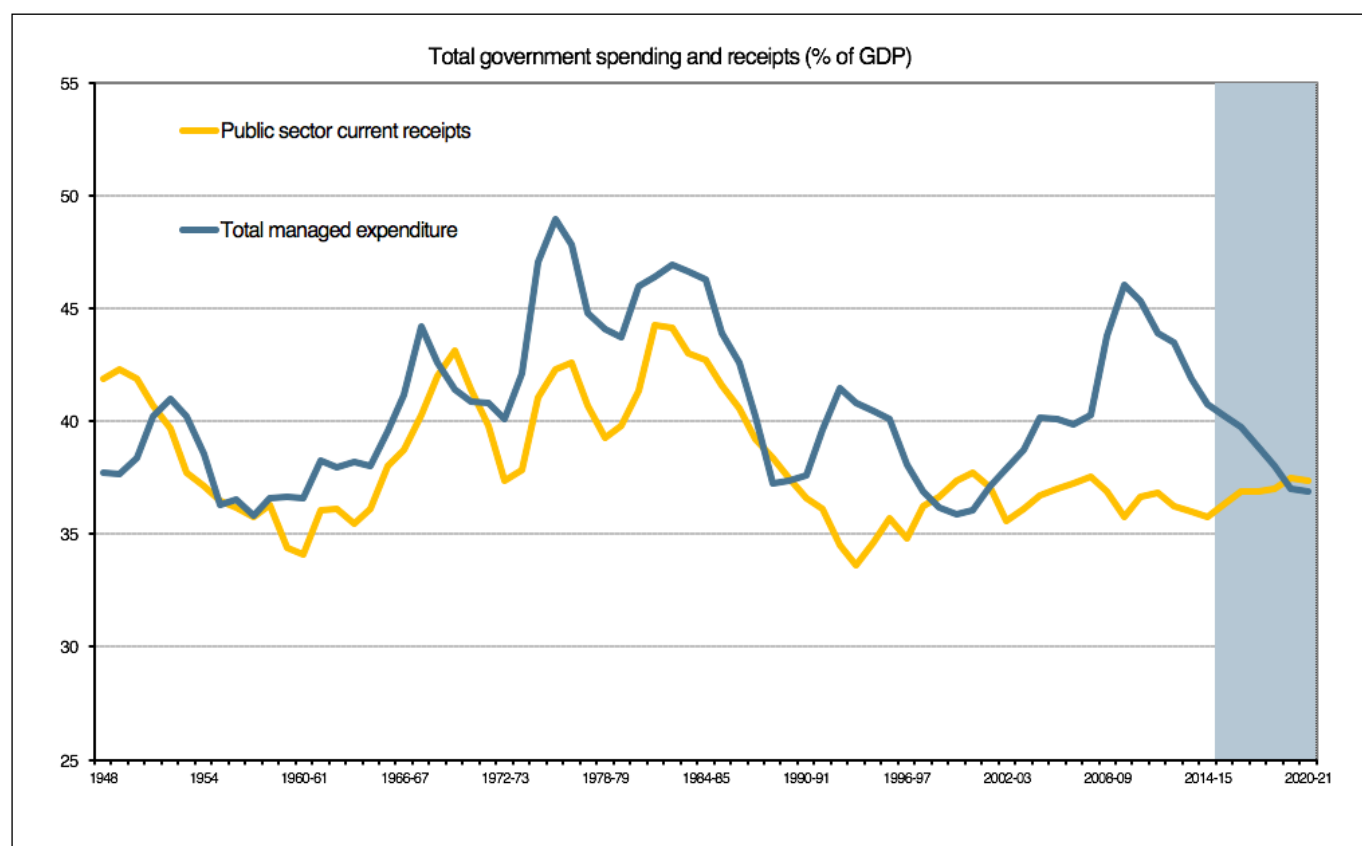
- most benefits having been protected against inflation;
- the total sum spent on unemployment benefits initially rising; and,
- pensions having risen above the rate of inflation, as a result of the 'triple lock', whereby pensions increase by the highest of, the growth in CPI, the growth in average wages or 2.5%.

Given the flat (real terms) profile of Total Spending, the rise in Benefits & Pensions (+18%) means that a corresponding fall has taken place in relation to spending on Public Services (-17%). As discussed later, the distribution of cuts across public services has also been uneven.

Going forward, the remaining cuts to UK Departmental resource (day-to-day) budgets amount to nearly 30% of the overall cuts from 2010-11 to 2019-20. (The figure for Scotland is even higher, see next section.)

Looking at these shifts in public spending from a historical perspective shows that the level of spending planned for 2019-20, as a share of GDP, is equivalent to the lowest such level seen since 1948, see Figure 5A. Only twice, and for very short periods of time, has such a level been seen before. The first time was in the mid-to-late 1950s and the second time at the end of the 1990s. On both occasions such relatively repressed levels of public spending led in turn to prolonged periods of rapid growth in public expenditure. In the 1950s this was funded by higher taxes whereas in the 2000s this was largely funded by increased borrowing.

Figure 5A: Total Government spending and receipts - UK



Source: OBR, PSF aggregates databank.

Such a pattern suggests that the decline in public spending currently planned may be unsustainable in the medium to long term, for economic and/or political reasons. It also implies that reaching such a low ebb is unwise and inefficient as the subsequent injections of funding have to pay, in part, for retraining of new staff and repairs to infrastructure that has not been properly maintained, before any new capacity is introduced.

Austerity in Scotland

The UK austerity plans have fed through to the Scottish Government's budget via the continued use of the Barnett formula, which allocates a population share of (relevant) UK spending changes to Scotland. On top of this, any cuts to reserved services or benefits payments will also have a direct effect on Scottish households.

The Scottish Government's latest estimate (December 2015) of the impact of UK austerity on Scotland is that the budget will, in real terms, be 12.5% lower by 2019-20 than it was in 2010-11, equivalent to a cut of £3.9 billion. (Note: if the decline in the value of the Scottish budget was calculated from a starting point of 2009-10, it would increase the overall decline by a further £0.9 billion. It is not clear why this earlier date is not used.)

This is split between a cut to resource (day-to-day) spending of £3.3 billion (-12%) and to capital (investment) spending of £0.6 billion (-22%). (See Draft Budget 2016-17, Table 1.01.)

At present (2015-16), 8.7% (£2.7 billion) of the overall 12.5% real terms cut has been undertaken, with a further £1.2 billion still to be imposed up to 2019-20. Within this total, capital spend is estimated to rise by £260 million, which means that day-to-day spending is to be cut by almost £1.5 billion. This is equivalent to a further 5.6% real terms cut to such spending to 2019-20, on top of the 6.6% cut already experienced from 2010-11 to 2015-16 (i.e 45% still to come).

This is clearly a higher reduction over future years (in percentage terms) than is seen for the UK due to a variety of factors, including the deferral of 2015-16 cuts to 2016-17 in Scotland and the way that UK devolved and non-devolved budgets evolve over time.

(Note: these figures are consistent with UK Spending Review data from November 2015, as shown in the Scottish Government's Draft Budget paper for 2016-17. Further changes from UK Budget 2016 are not included. These involve a boost of around £200 million in 2017-18 and an unknown further cut in 2019-20 due to, as yet unspecified, efficiency savings.)

Similarly to the UK, this decade of austerity in the Scottish budget followed a decade of growth (around 5% a year in real terms over the first decade of the new Scottish Parliament) which was in turn preceded by another period of austerity.

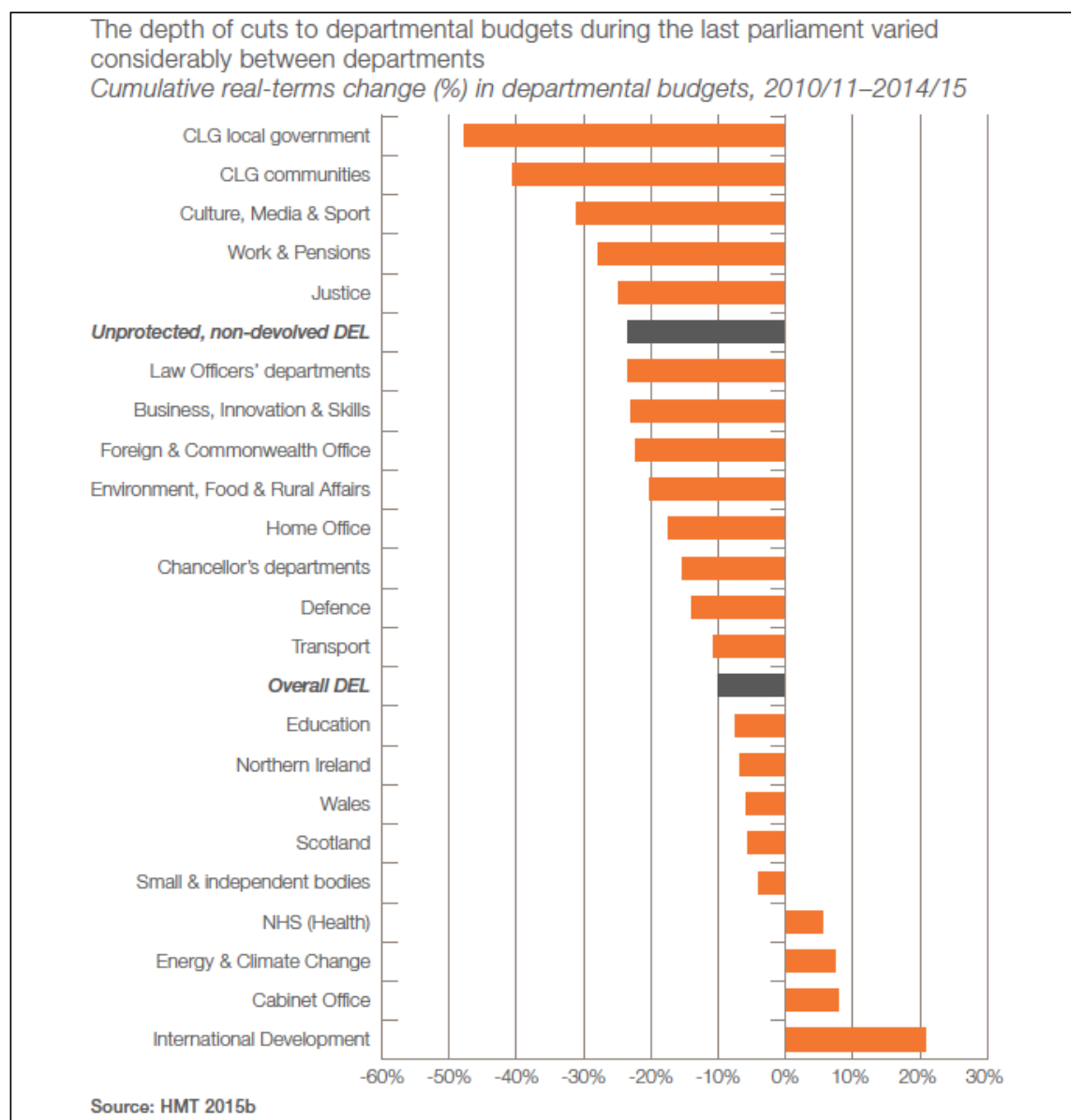
As discussed above, such an erratic profile may well lead to a more costly and inefficient provision of public services. Furthermore, with selective, on-going, protection of some large budget services in place, those services which are unprotected face very large cuts. This could ultimately result in a public service landscape which is much changed from the past and much narrower in its scope.

Individual spending budgets - UK

Within overall UK Departmental spending, two budgets in particular have been protected, the very large NHS (resource) budget and the relatively small Overseas Development Aid budget. Some protection has also been given to Schools and, latterly, to the Police budget.

As a result of this protection other budgets have suffered more, the biggest losers being: Local Government; Justice; Home Office; Transport; Business; Work & Pensions; Environment; and Culture (see Figure 5B, from IPPR, 'The Chancellor's choices: How to make the Spending Review as progressive as possible, while still delivering a surplus', 2015).

Figure 5B: Cuts to UK Departmental budgets



Overall spending budgets - Scotland

Like the UK, the Scottish Government has provided protection to its biggest budget, the NHS, resulting in larger cuts elsewhere, particularly to Justice and Local Government, although the latter has not suffered to the same extent as in England.

These UK led budgetary pressures can be exacerbated, or relieved, by use of Scottish raised taxes, in particular Council Tax and NDRI (business rates). Up to 2015-16, the former had exacerbated the squeeze, by being frozen since 2008 in cash terms and so falling in real terms, while the latter had been rising at above inflation levels and so relieving the squeeze to some extent. However, in 2016-17 NDRI is estimated to fall in cash terms, although it remains unclear why this is.

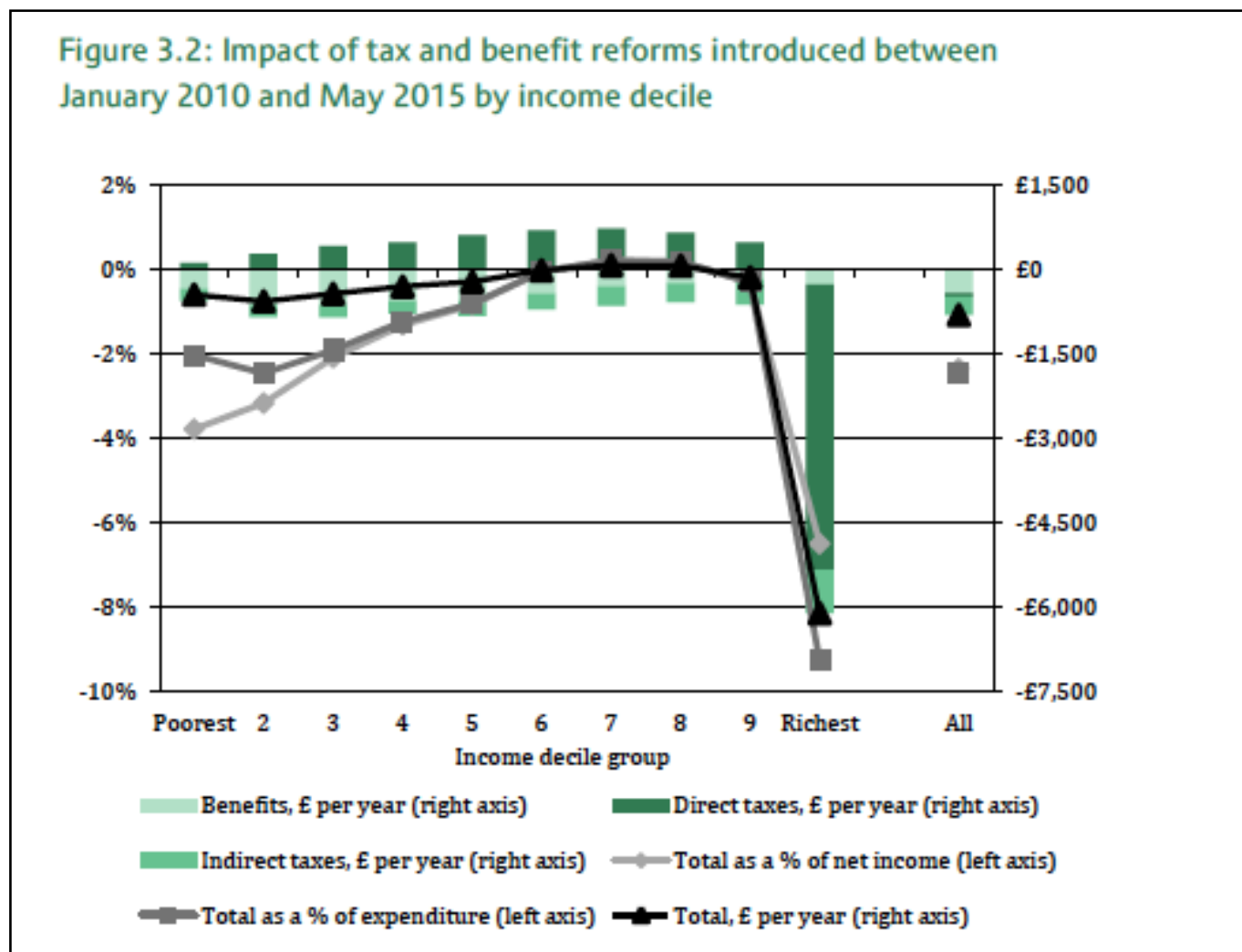
Effects across households types

The Institute for Fiscal Studies has undertaken extensive analysis of the impact of changes to UK taxes and benefits during the period of austerity. It's general findings can be summarised as:

By income decile: (see J. Browne & W. Elming, The Effects of the Coalition's Tax and Benefit Changes on Household Incomes and Work Incentives, IFS January 2015)

- The negative impact (as a % of net income) of tax and benefit reforms introduced between January 2010 and May 2015 has been greatest, by far, on the top (richest) decile. However, excluding this decile the impact has been greater the lower the household income (see Figure 5C, below, IFS Figure 3.2). In fact for those in the relatively wealthy deciles 6 to 9, the overall impact has been close to zero.

Figure 5C: Impact of tax and benefit reforms



- The negative impact (as a % of net income) of tax and benefit reforms introduced between January 2010 and May 2015 has been greatest, by far, on the top (richest) decile. However, excluding this decile the impact has been greater the lower the household income (see Figure 5C, below, IFS Figure 3.2). In fact for those in the relatively wealthy deciles 6 to 9, the overall impact has been close to zero.
- (Note: the picture changes a little if the period covered is restricted to May 2010 to May 2015, as it excludes significant tax rises for those with very high incomes. This leads to the two lowest income deciles receiving the biggest cuts, in terms of a % of net income.)
- This picture contrasts with the view seen over a longer timeframe, back to May 1997, since when the net benefit has been greater the poorer the household and only the top decile has lost out (see IFS paper, Figure 3.5).
- Looking forward, the IFS estimate that the impact of changes to the benefits system to be introduced between 2015-16 and 2019-20 will be large and negative for the lowest two deciles, gradually decreasing until they are small and positive for the top two deciles (see 'Green Budget 2016', February 2016, Figure 10.1).

By type of household: (source as above)

- The negative impact (as a % of net income) of tax and benefit reforms introduced between May 2010 and May 2015 has been greatest on, in order of impact: lone parent, no work; couple with children, no work; lone parent, in work; and single, no work. In contrast, there will be a small gain for a two earner couple without children and almost no impact on: pensioner couple; single, in work; and multi family household, no children. (See IFS paper, Figure 3.8.)

By region:

- The negative impact (as a % of net income) of tax and benefit reforms introduced between May 2010 and May 2015 has been greatest on Greater London (-2.3% of income) followed by the South East (-1.6%). The smallest impact has been on East Anglia (-0.9%), the East Midlands and Scotland (both -1%). (See IFS paper, Table 3.1)

By sex, race, disability:

- Less analysis has been done using such criteria, possibly due to data limitations. However, given the scope for differential impacts on women, ethnic minorities and the disabled then further work would be useful in order to gain a fuller understanding of the relative effects of austerity across key groupings in society.

Additional impact of cuts to public services

It is important to remember that the calculations above consider only the impact of (some) tax and benefit changes and do not include (directly) the impact from cuts to public services. It is generally thought to be the case that poorer households will suffer more, in terms of the impact on their quality of life, as opposed to their standard of living, from such cuts to key social services e.g. provision of elderly care, access to public sports facilities etc.

Furthermore, as the JRF report mentioned earlier shows, those local areas which are better off tend to have suffered proportionately less than those areas which are most deprived.

Overall impacts from recession and austerity on household income

In order to judge the full impact on different households since financial crisis of 2008 it could be argued that each of the following impacts need to be adjusted for and cumulated over time:

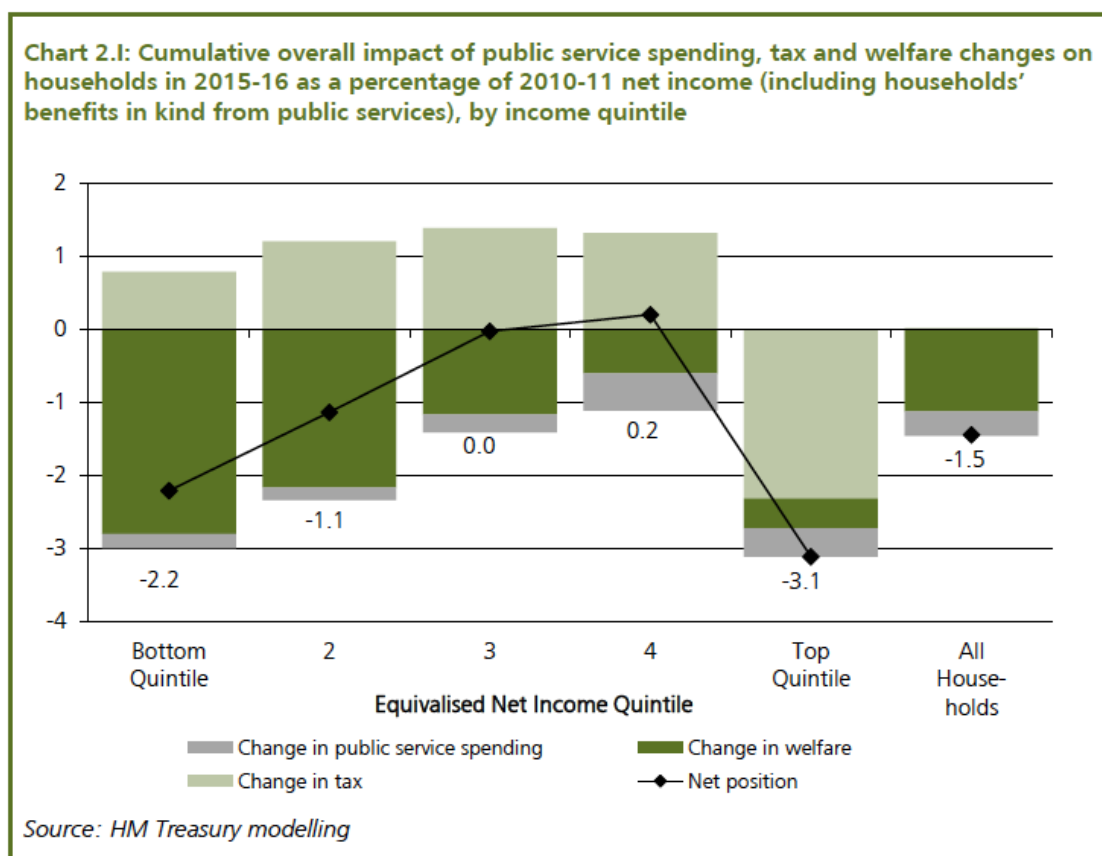
- changes to taxes and benefits;
- changes to provision of public services; and
- changes to earnings.

Together, these three elements will proxy the overall impact on households.

H.M Treasury have published estimates of the combined impact of the first two of these elements (see Chart 2.1 below). This illustrates, by quintile rather than by decile, the effects over the last UK Parliament (May 2010 to May 2015) and shows a similar pattern to Figure 3.2, with the negative impact weakening as income rises, except for the wealthiest.

Figure 3 (from Section 1) estimates the impact on pay levels, which, if added to the impacts seen in Chart 2.1 suggest a similar overall shape, but with the lowest quintile a little better off and the highest one a little worse off.

Figure 5D: Impact of changes in tax and benefit and in public services on household income



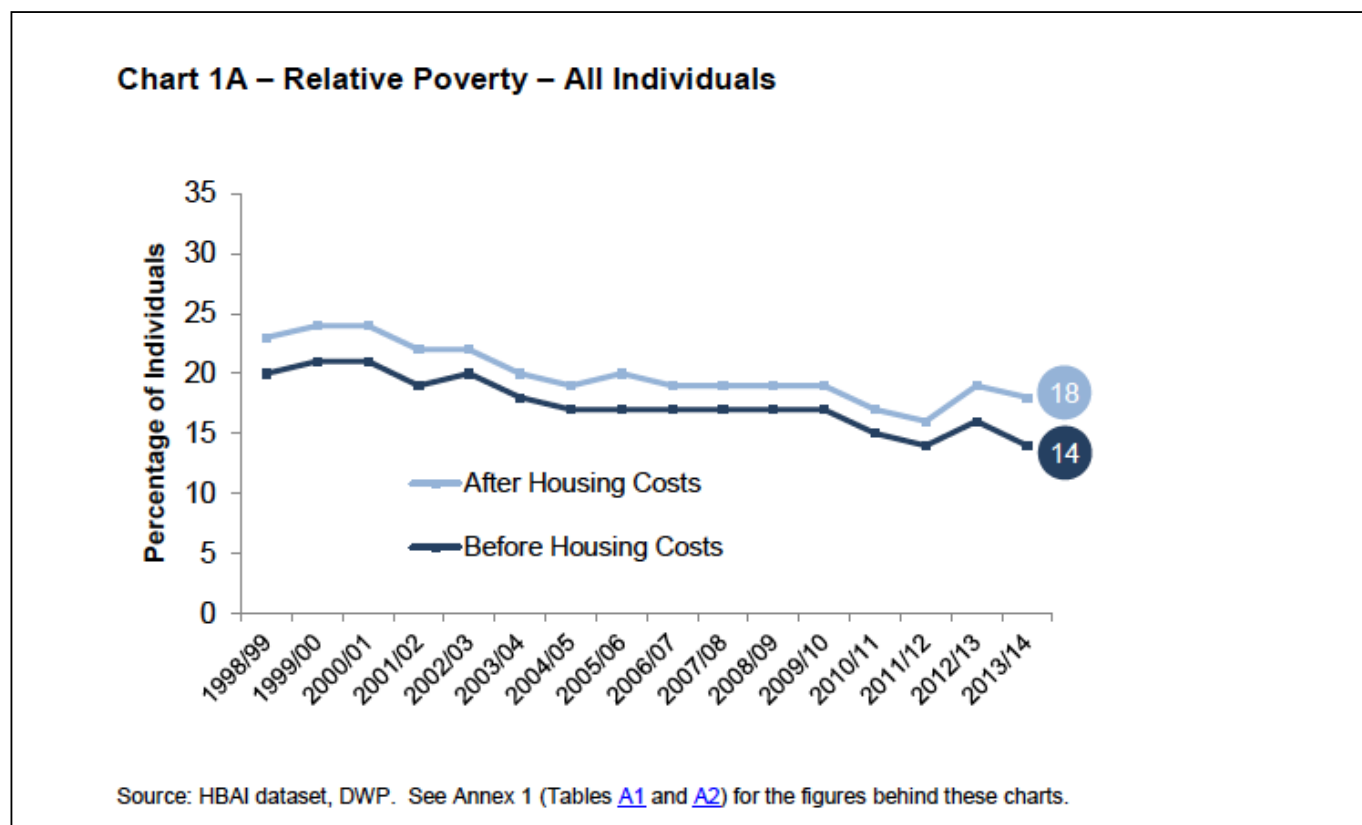
Effects on poverty and inequality

The decline in relative poverty, both before and after housing costs, in Scotland seen since 2000 has continued during the period of UK austerity (see Figure 6, Chart 1A from latest Scottish Poverty Report), although the pace has slowed. The picture on absolute poverty is more mixed, with a small fall before housing costs but an increase after housing costs.

Inequality (as measured by the Gini co-efficient) has also declined a little post the recession.

Neither result is particularly surprising as recessions often have a bigger impact on the most wealthy, thereby temporarily reducing inequality, just as booms typically have the reverse effect, so increasing inequality.

Figure 6: Relative poverty



4 Possible ways to mitigate the effects of ongoing austerity

Within Scotland and the UK there are no major political parties who oppose a rebalancing of the public sector budget, to at least a balance in terms of the current budget (i.e. a balancing of public sector tax revenues with day-to-day public spending levels, which still allows for borrowing to invest in capital projects).

Where they differ is:

- in the timescale over which this should be done;
- in the composition of this rebalancing between higher taxes, lower spending and more borrowing;
- in the distributional impact across different household types of any such measures.

Much of the current political discussion boils down to (i) what policies will result in the highest rate of long term growth, which in turn allows for sustainable increases in public spending, (ii) whether a higher tax level/environment is needed to properly fund public services, and (iii) how to distribute any policy driven costs and benefits across different sectors of society.

Increasing the rate of long term economic growth

Improving the long term growth rate is a key goal in allowing for higher future spend on public services. Even if such spending is constrained to grow at the same rate as GDP (i.e. kept as a constant share of GDP), this should allow for real terms annual growth of around 2-3% a year, based on historical trends.

Unfortunately, the evidence available on what works to increase a nation's economic growth rate is far from conclusive.

At present, there are two principal economic growth issues that economists are grappling with. First, what has led to the rapid decline in productivity, post crisis, and how can this be reversed? Second, how to deal with the declining growth rates that have been seen across most advanced economies since the 1970s and which appears to have worsened post crisis.

Both these issues make it very difficult to predict what a 'normal' long term future growth rate might look like. Without knowing what a reasonable estimate for such a target is, it is difficult to gauge the appropriate degree to which monetary and fiscal stimulus should continue to be used in order to achieve it.

Raising Productivity

The recent decline seen in the growth of Scottish productivity should allow for scope to raise future productivity growth and with it overall economic growth.

However, our understanding of why this decline happened remains poor and so too does our understanding of what policies are needed to reverse it. As a result, while raising productivity should be a key goal for the Scottish Government, the means by which to do so remain elusive.

This is one of the key areas in relation to improving future public spending prospects but is not the focus of this report. (For more information on Scottish productivity issues see the author's recent Productivity background paper for SCDI, 2015).

Increased Investment

One common argument put forward for raising future output is to increase the level of public investment, either temporarily or permanently.

Typically, economists associate higher investment rates with higher future growth potential, but the relationship is not a straightforward one. If ‘secular stagnation’ is a reality and demand remains low then such investment may not produce the scale of benefits that would be foreseen under normal conditions.

A further difficulty is the degree to which high return investment projects will be pursued, as opposed to politically popular ones. At present neither the Scottish nor the UK Government has in place a robust institutional architecture that identifies and prioritises such investment projects. (See LSE Growth Commission, 2013.)

Nevertheless, most academic economists (in contrast to ‘City’ economists) support the view that, at present, spending on public investment should be higher in order to improve growth prospects. So too, at least intermittently, do international bodies like the OECD and the IMF.

This point is addressed further in the section on Borrowing below.

Changes to the levels of, and distribution of, taxes, expenditure and borrowing

If an increase in the long term rate of economic growth is thought to be too difficult to achieve, or to be insufficient, or not immediate enough, to meet necessary future spending levels, then consideration of changes to current tax, spend and borrowing patterns might wish to be pursued. (See End-notes (1) and (2).)

The latter point may well be relevant in current circumstances, where UK and Scottish public spending levels (as a % of GDP) are heading to historically low levels which may, as they have in the past, prove unsustainable.

Tax Powers

Table 10 illustrates the scale of extra tax revenues which are, or soon will be, available to the Scottish Government:

Table 10: Extra tax revenues available to Scottish Government, 2016-17 to 2019-20

**Extra revenues available from changes to principal Scottish determined tax powers
2016-17 to 2019-20, £ millions**

	2016-17	2017-18	2018-19
1p on Basic rate of Income Tax*	-	396	416
1p on Higher rate of Income Tax*	-	89	94
1p on Extra rate of Income Tax*	-	10	10
1p on SRIT	475	-	-
Council Tax rising at RPI	38	96	160
Council Tax rising at CPI	19	54	91
NDRI rising at GDP growth rate	112	237	374

Source: HMRC (2015) and personal correspondence (2016), OBR and authors own calculations

* Approximations, derived by applying UK shares at different rates to the SRIT total.

Income Tax (IT)

The use of new Income Tax powers would considerably increase the Scottish budget, particularly when applied to the basic rate. A 1p rise in the basic rate could result in over £400 million of extra revenue by 2017-18. However, if such a rise were dependent on raising the higher and extra rates then it would take an extra 4p to achieve a similar result. For reasons of political acceptability in Scotland, it may be that if any increase in the basic rate were to be imposed, then it would need to be accompanied by an increase in the higher and extra tax rates of more than 1p.

An alternative to raising the actual rates would be to amend the thresholds at which each rate is paid, as the SNP is currently proposing, or to introduce new rates.

Prior to 2017-18, it will be possible to use the existing SRIT power. Analysis of whether the use of this power is progressive, or not, depend on the way in which such progressiveness is measured. However, it should not be forgotten that the use to which such tax revenues are put will also affect the degree to which different households gain or lose. This can be seen in Scandinavian tax systems, which tend not to be very progressive in nature, but due to their size and the way they are used, ultimately result in considerable redistribution from richer to poorer households (see OECD report, 'Growing Unequal', 2008).

As a result, it is possible that the immediate use of SRIT could, on any reasonable measure, be seen as progressive once all the tax and spend impacts have both been taken into account.

There is also a counter argument which can be made for lowering the higher and additional rates of Income Tax. The principal rationale for this is not based on a Laffer Curve type explanation but rather on an Irish style mobility of high earner one. At present Scotland is relatively under-represented in this category of higher end taxpayers but a significant cut could lead to an inflow of high earners, who tend to pay disproportionately large amounts of the overall IT take.

However, there is a considerable risk attached to this approach in terms of whether or not any such cut would attract sufficient new taxpayers to even pay for the tax receipts lost initially. There is also the question of whether such a 'beggar-thy-neighbour' policy is thought to be morally acceptable.

The Scottish Government has published a range of possible outcomes for what the impact of raising the additional IT rate by 5p might be in Scotland. These range from a gain of £50 million to a loss of £30 million, depending on the impact such a change has on the behaviour of tax payers in higher tax brackets. These estimates also suggest that anything above a raise of 5p in the additional rate is likely to lower the overall tax take.

It should be emphasised that these figures are very much 'guesstimates'. For example, due to the small number of high rate tax payers, and the wide differences in their personal circumstances, it is a particularly difficult to predict how such individuals' behaviour will alter as a result of any such change.

Another way of understanding the range of possible outcomes is to consider the impact of applying a 5p differential in the additional rate with respect to Wales and to Scotland. In the case of Wales there is a highly populated belt of relatively wealthy individuals living near to the border. In the case of Scotland there is not. Indeed on the western side of Scotland, households would need to travel getting on for 200 miles to go from a sizeable Scottish city (Glasgow) to a sizeable English one (Manchester). This would undoubtedly affect the size of any behavioural impact as a result of the same policy change.

For the reasons stated above, and more besides, the net impact of any change to the additional rate of IT remains highly debatable.

Unfreezing of, or replacement of, Council Tax

While a central government policy of a Council Tax freeze has applied in both England and Scotland of late, the penalty conditions applying to councils who ignore it have meant that the freeze has been upheld universally in Scotland but much less so in England.

Unfreezing the Council Tax, or reducing the penalties that apply, would allow for higher revenues, depending on what future increases are then pegged to. Table 10 (see previous page) shows the impact for the next three years of using CPI and RPI. Although the use of RPI results in more revenues, as it is no longer an official statistic it is difficult to come up with a strong rationale for choosing it.

The recent Commission on Local Tax Reform report ('Just Change: A New Approach to Local Taxation', 2015) on options for changing from the Council Tax system allows for both the introduction of higher taxes in general and a redistribution across who pays.

Any such change is also likely to have knock on effects in terms of differential ability to raise revenues across local areas. It may be that a transition mechanism needs to be introduced to help overcome this effect.

In its response to the report the Scottish Government outlined a revised system, with only minor reforms, that would raise an extra £100 million revenue a year

NDRI

As with Council Tax, NDRI rates and uprating could be revisited to increase revenues, although the impact on economic activity and therefore on net receipts would be much more difficult to predict than for Council Tax (or its replacement).

Table 10 shows the impact of compounding on a tax, with the linking of NDRI to GDP growth meaning that after 3 years the increase in revenue is almost equivalent a 1p rise on the basic rate of Income Tax.

At present there is some confusion over what the future holds for NDRI receipts as the Scottish Government forecast for 2016-17 is for a fall (in cash terms, even after an increase in rates for some businesses). This is counter to the UK position and to previous years in Scotland and the driver for it has not been explained.

Land and Buildings Transaction Tax (LBTT), Landfill Tax and Aggregates Levy

Further revisions to the levels and rates at which LBTT could be introduced which affect the amount raised (currently £400 million) and who pays for it.

LBTT revenues are already forecast to rise quickly, up by 75% to 2019-20.

There is scope for increasing receipts further, by making the LBTT even more progressive, especially as this applies to a largely immobile tax base and so is difficult to avoid.

At present Landfill Tax raises £140 million and the Aggregates Levy £46 million.

Air Passenger Duty (APD)

While there are no proposals at present to raise APD, there are political commitments to reduce it. For example the SNP have proposed to halve APD, which could amount to a reduction in funding of over £115 million.

New Taxes - Tourism Tax

A number of countries or localities have a tourism tax that is normally small and applies to hotel accommodation.

If such a proposal were to be made it would clearly have differential impacts on individual local areas, depending on whether they were a popular tourist destination or not.

In addition modelling would need to be carried out to determine the impact of different levels of tourism tax and their impact on net extra revenues, in order to settle upon an optimal tax level. This will involve estimating behavioural impacts which may not be straightforward.

Introducing New or Extending Existing Charges

Previous Recommendations

A number of reports have been produced since the start of the new Scottish Parliament looking at how to make public spending more efficient, for example the Budget Review Group report ('Choices For a Purpose') from 2006 and the Clyde Valley Review from 2009.

The most recent and most comprehensive was the Independent Budget Review (IBR), led by Crawford Beveridge (now Chair of the Scottish Government's Council of Economic Advisers), from 2010.

This recommended a variety of changes or reviews in relation to: the Public Spending Environment; Efficiency; Remuneration and Workforce; Universal Services; and Capital.

In practice the Scottish Government has done little in the way of following up on these recommendations, for example in relation to avoiding narrow health related protection, i.e. to just NHSScotland and to discontinuing the council tax freeze. As a result, there remain opportunities to revisit some of these recommendations and avert cash savings to other budgets.

Reallocation of existing spending levels

One area where Scotland spend disproportionately more than seen in England, Wales or Northern Ireland is Economic Affairs, and in particular support for Enterprise and Economic Development. The most recent data (HM Treasury, PESA database) suggests that, per head of population, spending in this area is almost 4 times higher than in England and between 20% to 30% higher than in Wales or Northern Ireland.

Clearly the biggest players here are the Enterprise Bodies (Scottish and Highlands and Islands) whose combined budget amounted to £340 million in 2015-16. While there would inevitably be downsides to cutting this budget, the real comparison to weigh up is whether this money would be better used in the current ways e.g. industry grants and advice, or in alternative ways e.g. to boost spending on early years education and investments, which evidence suggests could both improve future economic prospects and reduce future public spending on 'negative' services.

No doubt there will be other areas where such savings might potentially be made. There is no shortage of public services where any such freed up sums could be used. In particular, the Christie Commission report (2011) on 'Future Delivery of Public Services' highlighted the need for far greater spending on preventative measures in Scotland, for example in relation to increasing funding on early years investments and on preventative and mental health measures.

There is also an important issue with regards to the scale of taxes and the potential for skewing of expenditure. Governments that follow a path of widespread universal services usually base this on a relatively high tax structure. In the case of Scotland however, such attempts at universalism are done on the back of a low-to-medium level, by international standards, of tax take. This can result in a lopsided form of public service funding which favours some services (e.g. treatment based like the NHS) over others (e.g. preventative based like early years investment) and even unequal provision within a service (e.g. Higher Education over Further Education). Furthermore, there can be political incentives on focussing funding on services that favour middle income over lower income families. Whether such a system is 'fair', effective or sustainable, with regards to such universal 'targeting' of limited funds, is another area worthy of more debate.

Further Devolution of Economic and Tax Powers

While the Scottish Government has been encouraging the maximum degree of devolution, or decentralisation, of economic and budgetary powers in recent years, within Scotland it has been following a policy that has centralised such powers. However, the same arguments that are used at the UK level could apply to the Scottish level, that decisions made closer to where policies are to be implemented are better informed, that democracy is enhanced and that tax raising powers should more closely match tax spending powers in order to enhance the 'responsibility' shown by any level of government.

Borrowing Powers

Increased borrowing is generally recommended as a funding source to raise the level of spending on capital (e.g. infrastructure) projects, rather than on day-to-day spend. As a result, if the current level of resource spending is considered to be insufficient then an increase in taxes is a more immediate and appropriate mechanism for alleviating underfunding.

Bearing in mind this qualification, there remain strong arguments for increasing investment via higher borrowing (see Investment section above).

The new, post Smith Agreement, capital borrowing limit available to the Scottish Government has risen to £3 billion, capped at a maximum of £450 million a year. There is also another £600 million available in relation to resource (day-to-day spending related) borrowing, in relation to specific purposes.

In addition to any increased powers resulting from the Smith Agreement there are a variety of other ways by which borrowing for investment might be achieved.

Previous UNISON research ('Combating Austerity', 2015) looked into measures to improve ways to fund investment projects through: changes to PPP/PIF schemes; refinancing existing borrowing; and greater use of bonds and/or local authority pension pots as a source of funding.

The present report does not go into any greater detail on the issues UNISON has raised but notes that some of these ideas are now receiving wider recognition, particularly in relation to the use of Local Government pension funds. This is a route that the UK Government has been pressing on and which the IFS has recently discussed in terms of ways to enhance the attractiveness, to the fundholders, of such a funding route (see IFS Green Budget 2016, Chapter 7).

The cost of any such borrowing (in terms of interest rate related debt servicing charges) is currently extremely low and this applies to long term loans too, allowing for some protection against future changes in economic conditions.

Review of the scope for mitigating austerity

The above analysis has highlighted the scope that exists in terms of tax, borrowing or changes in spending patterns, in order to increase the level of funding available for public services. It is clear that the greatest leeway exists in relation to tax.

If, for example:

- the basic rate of IT were to rise by 1p; and
- higher rates of IT by 3p; and
- Council Tax by RPI; and
- NDRI by GDP;

then the current real terms decline in the Scottish budget due to 2019-20, of around £1.2 billion, could be offset, although without making any inroads into the cuts already imposed.

In terms of borrowing, leeway also exists, although this may be constrained in terms of what it is spent on and by HM Treasury, UK-wide, fiscal targets.

In terms of spending, some scope exists but decisions to free up any such sums would be politically contentious and have so far been avoided.

This suggests that any strong move to offsetting future cuts would need to involve increased use of tax powers.

5 Conclusions

The economic and budgetary landscape in Scotland and the UK has changed markedly since 2008.

In terms of the economy, the presumption of a quick return to long term trend growth has not been realised and future growth prospects remain highly uncertain.

Furthermore, the long term trends with regards to demographics, raising of education standards and increases in non traditional employment rates all point to more difficult times ahead rather than to the strongly positive contributions experienced in recent decades.

In terms of public sector funding, this more negative outcome for the economy has led to moves to rebalance government tax receipts and public spending, resulting in relatively lower spending levels than before. In some cases to levels not seen since at least the late 1940s.

Political priorities within this tightening budget have led to protection for two of the largest budgets, the NHS and pensions, at the expense of most other budgets, which has considerably amplified the pain felt in most public services.

Within Scotland, decisions over which budgets should be protected or cut have largely mimicked those seen at the UK level, particularly in relation to the NHS.

The greatest contribution, in the longer term, to alleviating these budgetary pressures would be a resumption in the growth rate of the economy to a level around, or above, the historic average. However, this is not currently foreseen, nor are there any straightforward ways of bringing it about.

In such a scenario, the best way of providing relief to public services would be to raise borrowing or to raise taxes.

Raising borrowing, if it is spent on high return capital and infrastructure projects, should raise future economic capacity and the growth rate. However, if this does not come about, or if demand remains low, then debt and debt servicing levels may rise as a result. Equally this approach might be better seen as a temporary adjustment measure rather than a way of permanently funding a higher level of service.

Raising taxes, ideally in a way that minimises any incentives to avoid it and any disincentives to work, may be more appropriate as a permanent source for funding increased day-to-day services. However, such a policy tends to be politically unpopular, within the UK at least, and so may be difficult to implement. (3)

A further alternative would be to move away from universalism, with respect to providing public services, and towards a more targeted approach instead. To maintain the existing policy of universalism may require a transition to a higher tax regime, as seen in other countries that follow such an approach.

Of these three sources, tax increases appears to offer the greatest scope for raised funding of public services in the future.

Beyond the issue of how to raise the funding level of future public services, a second issue concerns the future distribution of who pays for any such increase and who receives the benefits.

At the UK level, the distribution of changes to tax and benefits has so far highlighted a political preference to protect ‘middle earners’ at the expense of those at the top and bottom.

At the Scottish level, the continued support for a council tax freeze and for subsidising higher education highlights a similar set of priorities as is shown at the UK level.

In terms of politically preferred budgets, at present pensions and the NHS are doing best, both of which predominantly aid the elderly.

In terms of who pays and who benefits, it is the reasonably well off and the elderly who are suffering the least. However, this pattern may not be able to continue for much longer as (i) non-protected services are cut to historically low levels and (ii) the inter-generational compact may have become too slanted away from those who are providing the taxes that pay for the benefits of the non working (pensioner) households.

If, ultimately, the public choice is for some of these trends to be halted, or even to start to be reversed, then the degree of extra income needed may be substantial and the political decisions needed to be made will be difficult and far-reaching.

In order to fully understand the distributional impacts of any policy decisions then detailed modelling will be needed which estimates the impact of, not only tax and benefit changes, but also of changes to the provision of public services.

End-notes

1. There is little in the way of definitive evidence about what levels of public sector tax, spend and borrowing achieves the best growth rate. Furthermore, different countries have been able to achieve good economic results by different means. It is likely that extremes of high tax or high borrowing are likely to prove detrimental. The same might also be said for unduly low taxes, although no advanced economies work in an environment where taxes are so low that they threaten such basics as the rule of law or universal education. Such findings allow, in theory, for different mixes of tax and spending to the one that currently exists without any negative knock on effect on future growth. Thus, carefully implemented tax rises could allow for higher public spending without lowering growth, although with the trade off of lower income available for private spending.
2. Due to the variety of economic, social and political conditions that apply, crisis by crisis and country by country, there is little scope for learning from past experience with regards to exit paths (see Hood et al, 'When the Party's Over: The politics of Fiscal Squeeze in Perspective', OUP, 2014).
3. Latest opinion poll surveys suggest a majority of Scots support the same or lower rates of Income tax rather than higher. (By a ratio of approximately 5:2 for the basic rate and 5:4 for higher rates.)

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