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Northern Ireland Economic Outlook

Northern Ireland is growing – but where's the feel-good factor?

December 2014

pwc

Executive Summary

Northern Ireland is growing - employment is increasing and unemployment is falling, but this is not being matched by a feel-good factor of growth in average wages or increasing productivity. The prosperity gap between Northern Ireland and the other UK regions - as measured by gross value added (GVA) - is widening, with modest growth in manufacturing sales and exports mostly being delivered by fewer than a dozen companies.

With even greater austerity looming and an anticipated slowdown in growth, the prognosis for 2015 is worrying; The Executive must also agree a final Budget that offers the opportunity to addresses legacy issues of under-performance and the need for radical economic reform.

Northern Ireland has shown steady recovery since 2012, when the region experienced 0.5% negative growth. Consequently, our forecast of 2.2% growth for 2014 represents significant progress. However, it is less than the 3% growth forecast for the UK and is the lowest projected growth amongst the 12 UK regions.

Claimant count unemployment fell by 8,700 to 5.9% in the year to October 2014 but remains over twice the UK's 2.8% level; the rate of decline is about half the UK rate and local unemployment is the highest of the 12 UK regions.

Employment grew by around 14,000 over the past 12 months to more than 821,000, taking the region's employment rate for those aged 16-64 to 68.5%, an increase of 1.4% points over the year. However, this is well below the UK average of 73.0% and is the lowest rate among the UK regions.

Northern Ireland has 566,000 economically inactive people, 5,000 more than a year ago and at 27%, is the highest amongst the UK regions and significantly above the UK average of 22.2%.

Despite steady jobs growth, the latest data from the *Annual Survey of Hours and Earnings* suggest that, in the year to April 2014, average earnings in Northern Ireland declined in real terms and at a greater rate than the rest of the UK.

Residential property prices increased by 7% in the year to September 2014 with over 5,000 properties sold during Q3, 2014 - a 21% increase on Q2 2013.

Northern Ireland's GVA per head (the increase in the value of the economy that accrues from the production of goods and services), fell from the 2007 high of 83.7%, to 76.7% of UK average in 2013 - the lowest level since the current series of records began in 1997.

Looking forward, we expect Northern Ireland's growth to slow to 1.9% in 2015 matching a decline in overall UK growth to 2.5%. This reflects a fall in consumer spending, the key driver of growth over the past two years. We also expect public sector employment to decline and private sector employment growth to slow.

A commitment in the Chancellor's Autumn Statement to devolve corporation tax to the Executive is conditional on political progress. If the conditions are not met quickly, enabling legislation may not be enacted before the 2015 General Election.

The Executive agreed a Draft Budget 2015-16 based on real spending power for current programmes about £1bn less than in 2010-11, when the Assembly last agreed a Budget. Given the circumstances, producing a Draft Budget at all was an achievement and represents a starting point for a final agreed Budget. It also offers the Executive a brief breathing space to redress the unresolved concerns in the Budget 2011-15 that were carried forward to the Draft Budget 2015-16, insofar as it does not really balance, it fails to provide for fundamental reform and does not directly link to objectives in a Programme for Government.

Northern Ireland Economic Outlook

Northern Ireland (NI) economic growth is estimated as 2.2% in 2014 and 1.9% in 2015.

UK economic growth is estimated as 3.0% in 2014 and 2.5% in 2015.

Republic of Ireland (RoI) economic growth is estimated as 4.3% in 2014 and 3.3% in 2015.

- We anticipate gross value added (GVA) growth in NI of 2.2% in 2014- this is the best performance since the banking crisis in 2007-2008 but NI remains the poorest-performing of the 12 UK regions, with growth expected to slow in 2015.
- UK growth is also likely to decelerate in 2015 as there are limits on the extent to which consumer-led growth can continue to be based on a reduction in savings.
- Globally, there are various external downside risks to sustained recovery including the continued slowdown in growth in the Eurozone and China and the impact of trade sanctions on Russia.
- NI property price growth has stabilised at a modest level, well below the UK average rate, however one of the domestic downside risks to growth in NI is the continued legacy of the mid 2000s property bubble.
- The NI Executive agreed a Draft Budget 2015-16 at the end of October. Notably, this contains an increased level of borrowing to meet short-term commitments, with the Draft Budget still subject to consultation and Assembly approval. In his Autumn Statement, the Chancellor committed to devolve Corporation Tax, but has made this conditional on the Executive's ability to manage the financial implications and on delivering agreement in the inter-party talks. It also remains unclear whether the likely benefits of reducing Corporation Tax to match the RoI 12.5% rate would exceed the likely costs and work still requires to be done to accurately quantify the benefits.
- NI is achieving impressive jobs growth but doing this without any substantial growth in real wages, productivity or living standards.
- Uncertainties remain in global energy markets, but inflation is likely to continue to be well below the Bank of England's 2% target, while interest rates are expected to rise during 2015.

GDP growth (%)	***2012***	***2013***	***2014***	***2015***
NI*	-0.5	1.1	2.2	1.9
United Kingdom	0.7	1.7	3.0	2.5
RoI	-0.3	0.2	4.3	3.3

*Note: *NI output growth measured by GVA.*

Source: Office for National Statistics (ONS), Central Statistics Office (RoI), PwC (NI 2013-15, and UK 2014-2015) and OECD for RoI 2014-2015 (note, RoI-based forecasters tend to be more optimistic).

Other indicators	***2012***	***2013***	***2014***	***2015***
UK consumer price inflation (annual average)	2.8%	2.6%	1.6%	1.7%
UK interest base rate (Q4)	0.5%	0.5%	0.5%	0.75%
NI claimant count (seasonally adjusted, October)	64,100	60,800	52,100	49,000

Source: ONS, PwC (inflation 2014-2015, interest rate 2014-2015, claimant count 2015), Nomis.

Key: Shaded boxes represent forecasts.

1. Confidence

Business confidence positive for seventeenth month in a row but flagging…

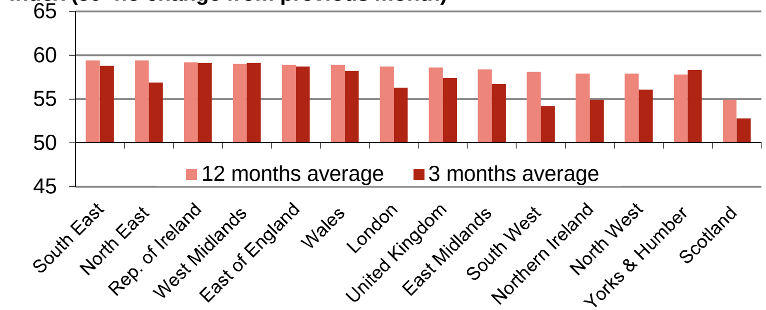
The Ulster Bank Purchasing Managers' Index (PMI) for November 2014 was 52.6; marking a 17 month period of continuous improvement in NI business activity. A PMI score of above 50 represents an increase in the business activity in comparison with the previous month. However, this does signal the lowest rate of output growth within the past 17 months.

Provisional data for 2013-14, suggest that overall manufacturing sales increased by 4% on the year to Q1 2014 to £18.1bn, with sales outside NI rising by 5.4% to £14.3bn[1]. Sales to Great Britain increased 3.1% to £8.2bn.The Republic of Ireland remains the largest export destination at £1.6bn, and exports to the rest of the world, beyond the EU, increased by 4.9%.

Consumer confidence still recovering…

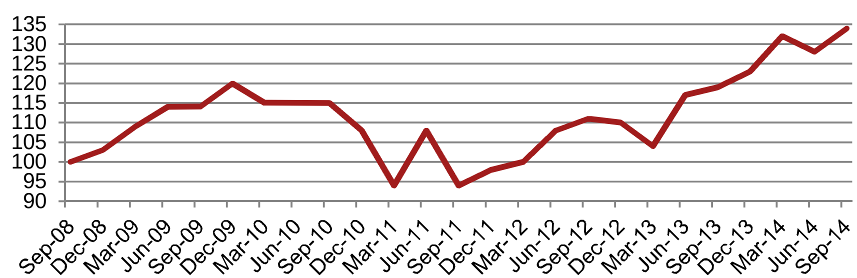
In Q3 2014, the Danske Bank Consumer Confidence Index rose to 134, the highest rate in over six years. Expectations for the future have improved, with 21% of people expecting improved household finances (compared to 15% in Q3 2013), and only 17% now expecting reduced finances (compared to 27% in Q3 2013). However, the recently introduced Consumer Council survey[2] delivers mixed messages around consumer confidence. It signals that 24% of respondent households feel their financial position is better compared with two years ago, but 30% claim to be worse off. It also notes that 70% of consumers feel that they are not experiencing any economic recovery.

Figure 1: PMI output index by region, 12 and 3 month average to November 2014



Source: Ulster Bank PMI.

Figure 2: NI Consumer Confidence Index, 2008-2014



Source: Danske Bank Consumer Confidence Index.

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[1] *Northern Ireland Statistics and Research Agency (NISRA) 3 December 2014,* Manufacturing Sales and Export Survey.

[2] *http://www.consumercouncil.org.uk/news/70-per-cent-of-consumers-not-yet-feeling-the-green-shoots-of-recovery-says*

2. Housing market

Average property price in NI is £124,154…

NISRA and the Land and Property Services (LPS) calculated the average NI property price for Q3 2014 as £124,154; an increase of 7%, or £8,128, on the corresponding figure 12 months before. The Northern Ireland Property Price Index shows that there were 5,094 property transactions during that quarter, an increase of 21.2% from Q3 2013[3].

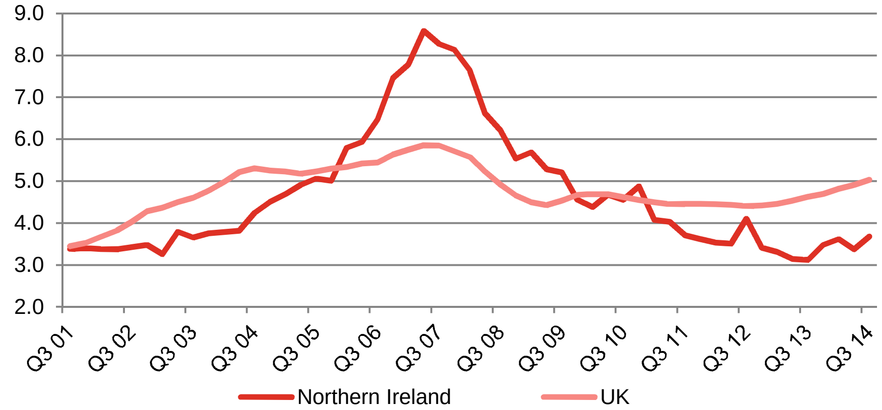
Average NI property prices have risen for the sixth consecutive quarter since the post-crash low of £110,514 in Q1 2013. However the current average remains 46.9% below the peak of £233,733 in Q3 2007. Perhaps a more appropriate measure of the current position would be a comparison to the ten year average, for 2005-2014, of £145,411. NI currently sits 14.6% below that long-term average, and so some further modest growth in prices is possible.

NI housing more affordable than the UK average but also more volatile…

The latest Lloyds Housing and Mortgage Affordability figure for Q3 2014 was 3.68, reflecting the ratio of average prices to average incomes. For the fifteenth consecutive quarter (since Q1 2011), Northern Ireland property has remained more affordable than the rest of the UK and it is still well below the UK figure (5.03). However NI's ratio has increased by 17.9% in the past 12 months (since Q3 2013) in comparison to the UK's 8.8% increase, so, the gap is gradually closing.

The NI long-term average (Q2 1997 to Q3 2014) is 4.29 but if we exclude the exceptional boom and bust period of 2006-2009, we are left with a long-term average of 3.62, very close to the current figure of 3.68, perhaps suggesting that the NI housing market is close to a "normal" level of affordability. The NI affordability figure has also been much more volatile than its UK equivalent, as Figure 3 illustrates.

Figure 3: House price affordability (average house price/ average earnings ratio), 2000-2014



Source: Lloyds Regional House Price Index.

[3] *The attraction of the LPS data is that they are based on a record of* all *transactions in Northern Ireland rather than a sample survey as undertaken by ONS. ONS regional data are not directly comparable in that they include an adjustment to standardise house type mix across regions.*

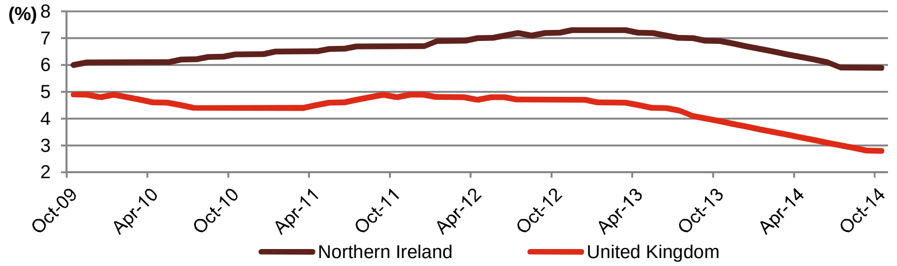
3. Labour market

A mixed picture regarding performance…

Using the Labour Force Survey (LFS) measure, seasonally adjusted unemployment fell by 1.3% points to 6.0% - also the current UK level - in the year to July-September 2014. However, the NI economic inactivity rate remains the highest amongst the UK regions at 27.0%, significantly above the UK average of 22.2%. It should also be noted that the number of economically inactive increased by 5,000 over the year to 566,000.

Seasonally adjusted claimant count unemployment has also continued its downward trend, although the decline has shown signs of levelling off in recent months. The claimant count measure is generally accepted as a more accurate measure of the unemployment level in Northern Ireland and in the 12 month period to October 2014, the figure fell by 8,700 to 52,100; but with declines of only 100 in each of September and October. This brought the rate of people claiming unemployment benefits in NI down to 5.9% leaving NI far above the UK average rate of 2.8%.

Figure 4: Claimant count unemployment rates, 2009-2014



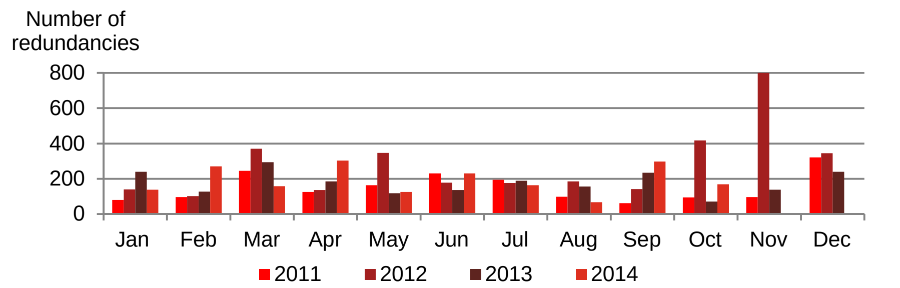
Source: ONS Labour Force Survey, 16+.

October marked the sixteenth consecutive month where NI's claimant count was the highest of the UK regions. Over the last year the number of claimants fell by 14.3%, half the UK's 28.6% decline.

Redundancies continue to fall…

There were 2,300 confirmed redundancies in the last twelve month period to October 2014, 610 fewer than in the preceding 12 month period. September recorded the highest monthly number of redundancies of the quarter with 297, while August had the lowest monthly total since September 2011.

Figure 5: Number of redundancies, 2011-2014



Source: DETI District Council Area statistics.

NI's financial and business services sector boasted several notable job announcements in the last quarter including 807 by PwC, 600 by Citi and 338 by Deloitte. This is in addition to the 486 new jobs announced by EY in April suggests that the NI business services sector has strong prospects. NI and especially greater Belfast has had a strong recent foreign direct investment performance[4]. However, job announcements often occur sometime before actual job creation and it will take several years before all these jobs come to fruition.

There has also been an announcement of 800 jobs to go in JTI by early 2016 with both the Chancellor and NI Finance Minister warning of further public sector austerity. This may cast a shadow on NI's hitherto impressive record of job creation.

Despite the improving employment situation, the latest data suggest that in the year to April 2014 average earnings in NI were still declining in real terms and at an even greater rate than the rest of the UK[5].

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[4] *PwC November 2014,* Good Growth Cities 2014.
[5] *Full-time median weekly earnings,* Annual Survey of Hours and Earnings*, November 2014.*

4. Future prospects

Global economy and productivity prospects
PwC is currently projecting global GDP growth of 3.3% in 2014 and 3.6% in 2015, with average annual growth of 3.9% in the period 2016-20[6]. However, the Prime Minister has spoken of, "*red warning lights flashing on the dashboard of the global economy*"[7], with global growth forecasts softening for some of the major economies, resulting from output growth slackening in the US at the start of the year, a Eurozone which is close to recession and deceleration in growth in China.

Since the middle of the year, global growth has been assisted by a slump in oil prices, but at some point energy prices are likely to start climbing again. NI has only limited exposure to trade with Russia; nevertheless 2012-13 exports to Russia were worth £81m[8], greater than the value of trade to any other BRIC[9] or emerging economy.

The jury is still out on whether we are witnessing a 'new normal' of rather more mediocre growth or even some sort of secular stagnation, especially in the Western economies including Japan. If the latter, this could be a result of a combination of high levels of debt, weakening productivity growth and the impact of an ageing population[10].

[6] *Measured using purchasing power parities. PwC December 2014,* Global Economy Watch. *The latest OECD figures tell a similar story; 3.3% 2014, 3.7% 2015 and 3.9% 2016.*
[7] *At the G20 Conference, November 2014, and repeated by the Chancellor in his Autumn Statement 3 December 2014.*
[8] *NI dairy producers have a small exposure to the Russian retaliatory restrictions on food imports from the West.*
[9] *i.e. Brazil, Russia, India and China.*
[10] *M. Wolf 18 November 2014, "The curse of weak global demand",* Financial Times.

The OBR's central forecast for UK growth is that the economy will grow in excess of 2% annually until the end of the decade, with public sector net debt falling to 72.8% of GDP by 2019-20[11]. That assumes a sharp rise in productivity growth above the current 0.5% rate. However if productivity growth remains at its current level, GDP growth will fall to below 1% from 2016-17 and wages will still be below their 2017 level by 2019-20 – all with serious implications for NI. In fact, the latest figures indicate that levels of GVA per head in Northern Ireland have continued to decline relative to the UK average reaching 76.7% in 2013; the lowest comparative level for any year since 1997[12].

There are two key issues around productivity in NI. One is that NI is sharing in the general UK-wide productivity puzzle whereby growth rates have remained low since the onset of the 2008-9 recession. Various possible explanations for that puzzle have been suggested; scrapping of capital during the recession, the banking system has been allocating capital in a less efficient way, or the growth in part-time employment and self-employment. The second issue is that NI is performing less well than the UK average. Possible explanations include the sectoral structure of the NI economy, or that a greater proportion of NI businesses have opted for a low wage growth and hence low productivity growth business model, or possibly that a higher proportion of very low productivity enterprises in NI have been able to survive during the recession and subsequent recovery.

Whilst the outcome of September's Referendum on Scottish independence has removed one source of potential uncertainty, some turbulence in terms of both

[11] *Office of Budget Responsibility (OBR) December 2014,* Economic and Fiscal Outlook Briefing.
[12] *ONS 10 December 2014, "Regional Gross Value Added, December 2014",* Statistical Bulletin.

policy making and the markets should be expected in the run up to the 2015 General Election and perhaps also in its aftermath.

Local economy
PwC is forecasting GVA growth of 2.2% in 2014 but with a slowdown to 1.9% in 2015. Recent growth across the UK has been heavily dependent on consumer spending and such growth in consumption is not sustainable insofar as it has been dependent on a reduction in savings[13]. During 2013-14, NI had a good year in terms of employment promoted through new foreign direct investment projects but some of this represented investments announced ahead of the EU limits on state aid which came into force on 1 July 2014.

Whereas during 2008-14 the civil service headcount dropped by 16% in Great Britain, the NI Civil Service headcount was static. Public sector employment declined by only 1% during the two years to mid-2014, but that trend will probably now accelerate, with 1150 job losses anticipated in the universities and colleges, Department for Social Development (DSD) expecting around 800 to go and the Finance Minister warning of "considerable" public sector job reductions. The Executive has proposed £100m voluntary redundancy scheme to aid the overall public sector headcount reduction. The Executive's recently agreed Draft Budget 2015-16 indicates a cash reduction in current spending of £200m in 2015-16 or 2.1%, (see Section 6), with the OBR's forecasts for reductions in Whitehall Departmental current spending implying a further reduction of about 10% or £1bn in NI in the three years to 2018-19[14].

The Chancellor's Autumn Statement has confirmed that austerity will continue and that the challenge posed by welfare reform in the rest of the UK will not go away. The report of the Smith Commission[15] confirms that the Scottish government is likely to acquire much wider powers relating to Income Tax, Air Passenger Duty and welfare benefits. This contrasts to the approach of the NI Executive where so far the focus has been almost entirely on seeking devolution of Corporation Tax.

Exports have the potential to be a major driver for growth. Unfortunately, so far there has been little evidence of sustained export-led recovery, with 2013-14 sales outside NI rising by 5.4% on the year to £14.3bn, a marginal increase in real terms[16]. Performance in tourism has been mixed and in manufacturing there is a gulf between a relatively small number of firms which are exporting and the remainder, although NI could benefit from the accelerating recovery in RoI.

At the same time, the euro has devalued and further devaluations are likely if the European Central Bank moves to combat deflation through full-blooded Quantitative Easing. The OECD has indicated that overall UK growth is somewhat sensitive to any appreciation in sterling relative to the euro and that relationship is likely to be stronger in the case of the NI economy.

Inflation
We estimate that UK inflation will remain below the Bank of England's 2% target, averaging 1.6% in 2014 and 1.7% in 2015. However, price shocks in an open economy like the UK are largely imported, so the supply and demand of global commodities like food and fuel are likely to be the prime drivers of inflation.

Interest rates
The Bank of England latest policy line is that it will raise interest rates when the data indicate that the time is right. Certainly, the consolidation of the UK recovery makes this possibility increasingly likely though probably not until well into 2015. A recent survey, conducted for the Bank of England[17] suggests that a 2% increase interest rates could push 480,000 households into mortgage arrears. The proportional impact in NI could be greater.

[13] *The extent to which there could be scope for further reductions in savings is considered in PwC November 2014,* UK Economic Outlook.
[14] *OBR December 2014,* Economic and Fiscal Outlook.
[15] *27 November 2014.*

[16] *Alternative and more up-to-date data from Her Majesty's Revenue and Customs based on VAT payments present an even gloomier picture of recent NI export performance.*

[17] *Bank of England Quarterly Bulletin 2014*, The Financial Position of British Households: Evidence from the 2013 NMG Consulting Survey.

Overall

The overall outlook for NI is particularly downbeat. Recent growth has been largely fuelled by household consumption, a situation that cannot continue at the current rate as saving become eroded and, in the absence of significant recovery in investment, export and/or public expenditure, a decline in the rate of growth is inevitable.While overall employment is increasing, this employment growth is not being matched by either growth in average wages or increasing productivity. The disproportionally small private sector cannot compensate for the sharp decline in both public spending and anticipated public sector employment, with modest growth in manufacturing sales and exports being delivered by fewer than a dozen companies.

The absence of any detailed performance data from the Executive's *Programme for Government* (PfG) for 2011-15 and the decision to create a draft Budget in isolation from a new PfG leaves the economy with few baseline performance indicators.

5. Sector dashboard

Sector	Employment* Jun 12	Employment* Jun 14	Employment* Change	Key Issues
Public sector	214,313	212,206	-1.0%	• NI Draft Budget and the 3.5% real cut in Departmental budgets for 2015-16 means that redundancies in the public sector can be expected. The civil service headcount in Great Britain fell by 16% during 2008-2014. • The previous Budget 2011-15 missed an opportunity to reform and modernise, will it be different this time?
Construction	31,370	30,270	-3.5%	• Little or no recovery in the local market. Larger firms increasingly working in GB.
Tourism and Leisure	53,880	54,970	2.0%	• Recent tourism numbers very mixed. Challenges remain such as better integrating the work of NITB and Tourism Ireland and improving air connectivity. Given EU rules, an NI-specific VAT rate for the sector is probably not feasible.
Food processing	17,020	18,360	7.9%	• Could better branding promote further growth?
Financial and Business services**	50,100	52,040	3.9%	• Job announcements in the business services sector by global firms such as PwC, EY, Deloitte and Citi will fuel strong employment growth although contraction continues in banking.
Retail	112,050	113,780	1.5%	• Employment has grown but reliant on consumer spending growth continuing. Also, impact of switch to on-line.
Manufacturing***	55,940	56,520	1.0%	• Whatever happens to Corporation Tax, existing incentives should be more fully exploited. • Growth in R&D spending continues but at a slower rate than the UK average.
All other sectors	158,107	173,774	9.9%	
Total	692,780	711,920	2.8%	

*Note: *: Employees only (i.e. excludes self-employed), **: F&BS refers to SIC codes 64-66, 69, 70, 81, and 82, ***: Excludes food processing.*

Source: Quarterly Employment Survey.

6. Outlook analysis – Draft Budget 2015-16

Introduction- The previous Budget 2011-15 was flawed…

At the end of October, the Executive agreed a Draft Budget for 2015-16. The measure of agreement which was reached was welcome especially since the apparent alternative was either a much higher degree of supervision of the Executive by HM Treasury or even a return to Direct Rule. One of the reasons why the Executive has been in such a challenging position in fiscal terms were weaknesses in the previous Executive Budget, 2011-15. In analysing that previous Budget, PwC drew three conclusions:

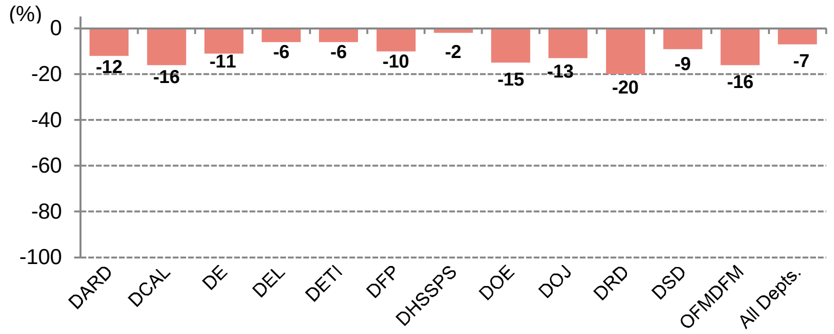
- This was not a balanced budget.
- It was not ideal to agree a budget ahead of a new PfG.
- The Budget failed to provide fundamental reform[18].

There are strong indications that the same conclusions would apply to this Draft Budget.

The Budget 2011-15, which was agreed in March 2011, was challenging.

Figure 6 illustrates that in the Budget 2011-15, the Department of Health (DHSSPS) had a small planned reduction in real terms (2%). Several Departments such as Regional Development (DRD), Culture (DCAL) and Office of the First Minister and Deputy First Minister (OFMDFM) were to face substantial cuts[19].

Figure 6: Change in real terms current expenditure allocations of the NI Departments 2014-15, % change relative to 2010-11



Source: DFP Final Budget 2011-15

Figure 7 illustrates the changes in capital spending. The strong growth in capital spending allocated to DCAL, DFP and OFMDFM was deceptive since all three started from a very low base. Conversely, DOE showed a spectacular decline; from about £200m to only £4m in 2013-14.

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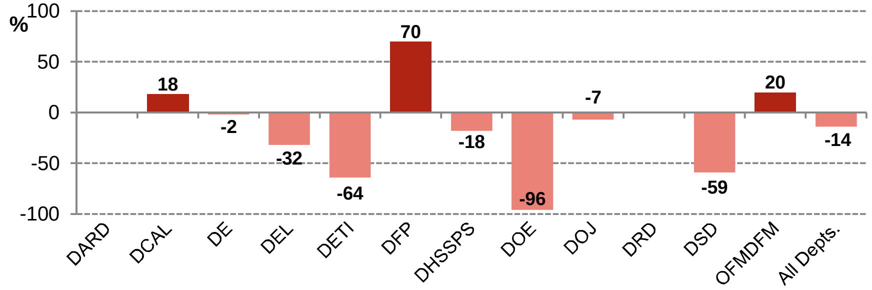
[18] *PwC February 2011,* Overview of the Northern Ireland Draft Budget 2011-15, *Final Report to NICVA.*

[19] *The other Departments are Agriculture and Rural Development (DARD), Education (DE), Employment and Learning (DEL), Enterprise (DETI), Environment (DOE), and Justice (DOJ).*

Figure 7: Change in real terms capital expenditure allocations of the NI Departments 2014-15, % change relative to 2010-11



Source: DFP Budget 2011-15
Note: DARD net capital spend in 2010-11 was implied to be negative. Hence a percentage growth 2014-15 compared to 2010-11 could not be calculated.

Despite the stated Executive commitment in the PfG to make the economy a top priority, the Budget 2011-15 showed DETI suffering a two-thirds decline in planned capital spend in real terms. DHSSPS received an 18% reduction. DRD, the largest spending Department in terms of investment maintained a constant level compared to the 14% average decrease across all the Departments.

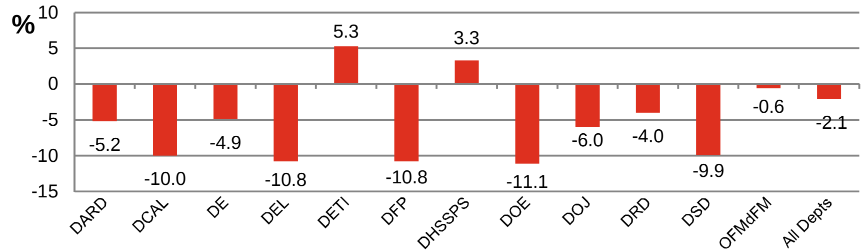
Although the final document agreed by the Executive on 3 March 2011 included some assumptions regarding additional revenue raising, the fundamental problem whereby identified spending demands exceeded available resources, particularly with respect to Health, remained. Any increase in inescapable spending should be matched by some combination of extra resources and savings in other areas of Departmental spend. In fact, analysis of the Budget 2011-15 indicated a substantial shortfall by the end of the Budget period. That is, the financial year we are now in, 2014-15.

The scale of that shortfall depends partly on what is defined as an "inescapable pressure". For example, what assumption should be made about the extent to which the Executive would attempt to tackle shortfalls in the provision of infrastructure in Northern Ireland?

To fund essential investment, Departments might have been expected to make proposals to externalise service delivery, to dispose of publicly-held assets and operations and to consider more radical mechanisms for finance raising and asset leverage. Little of such a modernisation and reform agenda was included in the Budget 2011-15 and little was achieved in practice during the 2011-2015 period. It was this context which explains why the Executive faced such an unfavourable budgetary situation in the late autumn of 2014.[20]

The challenge posed by the spending allocations in the Draft Budget 2015-16…

Figure 8: NI non-ring-fenced DEL spending for the Departments 2015-16, % nominal reductions from 2015-16 baseline position



Source: Draft Budget 2015-16
Note: Additionally, funding is allocated to certain "central pressures" including pension costs, mitigating welfare reform, RRI interest payments, a Change Fund and Departmental pressures and these are set against the revenues raised through Regional Rates income.

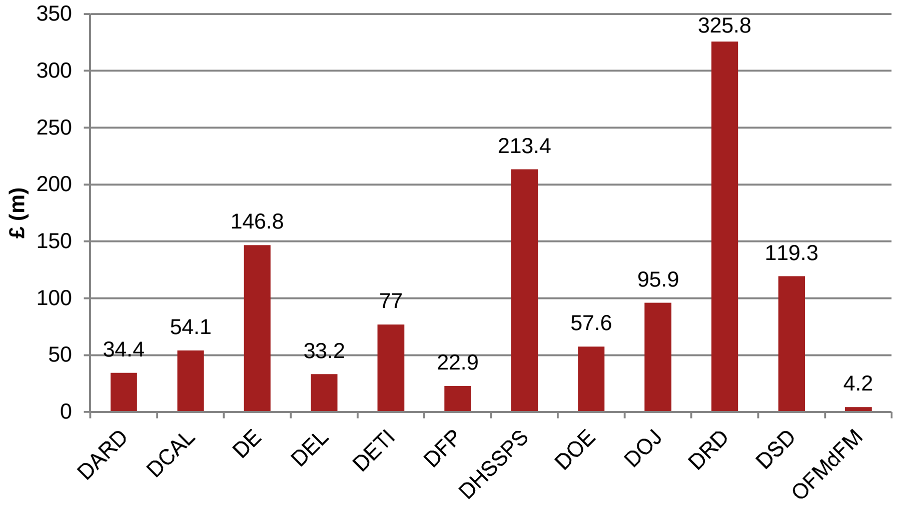
Comparing the 2015-16 allocation to the baseline, the total resource or current DEL is to decline by about £200m or 2.1%, Figure 8. When inflation of at least 1.5% is allowed for, the implied decline in real terms is at least 3.5%. As indicated above (Figure 6) the total real terms decline in NI current spending during the

[20] *The out-turn in terms of real spending power for the NI Departments was broadly in line with the Budget 2011-15 in the case of current spending but considerably more favourable in terms of capital spending.*

four years to 2014-15 was about 7%. So, a real terms decline of about 3.5% in *one year* shows precisely how the pace of austerity has accelerated.

Health is projected to increase its DEL by 3.3%, but this has to be compared to cost increases driven by demography, rising expectations and new treatments[21]. DETI is indicated to have an even larger cash terms increase, while all other Departments are indicated to experience substantial reductions in their resource DEL. Significantly; this is to include DE, hitherto largely protected in real terms.

Figure 9: NI capital DEL spending allocation 2015-16



Source: Draft Budget 2015-16

Figure 9 sets out the capital allocations for 2015-16, although no attempt was made to compare this to a baseline.

[21] *See the McKinsey and Appleby reports in 2010 and 2011, respectively.*

Some outstanding issues in the Draft Budget 2015-16…

The draft budget for 2015-2016 raises many questions and issues for the NI economy in 2015 and beyond. This section discusses the most interesting and important issues to arise out of the draft budget for the 2015-2016:

Borrowing
The Draft Budget 2015-16 indicates that by 2016-17 the outstanding sum borrowed under the Reform and Reinvestment Initiative (RRI) will equal £1.7bn. In per capita terms, the sum borrowed will be more than twice as large as that which the Scottish Government is likely to have borrowed by 2016-17. Admittedly, this comparison should be treated with caution given that local government in Scotland has some of the functions which relates to the Stormont Executive and the level of borrowing by Scottish local government may exceed its NI counterpart.

Additionally, there may be scope for the Northern Ireland public sector, including local government, to borrow more from other sources such as the European Investment Bank or forms of bond finance. Relevant considerations are whether such borrowing would be counted as "on the balance sheet" of the UK government (and hence the impact on the Northern Ireland funding block) and also how far such funding would be invested to increase the productive capacity of the economy. Critically, interest has to be paid on borrowing and past experience suggested potential international investors may look for relatively high rates of return.

A shift from capital spending to current spending
Economists and others tend to stress the importance of government capital spending, especially the funding of infrastructure, as adding to the long run growth potential of the economy. The impact of current spending is more uncertain. It is notable that the Executive is proposing to shift resources in the other direction, with the £100m "loan" from the National Reserve, obtained in October 2014, to be repaid through a reduction in capital spending in 2015-16. Furthermore, permission is being sought from HM Treasury to use £100m of the RRI, originally intended to finance infrastructure and investment programmes, to pay the up-front costs of proposed public sector voluntary redundancies.

Provision for revaluation of public sector pensions
£133.2m is provided for this in 2015-16. It is unclear whether this is a reasonable or appropriate provision.

Department of Justice
Amongst other uncertainties relating to the proposed training college at Desertcreet (jointly with DHSSPS) is the question of whether, given delays in starting construction, HM Treasury will extend flexibility to allow funding previously agreed funding of £53m to be carried forward and used in a subsequent year.

Lack of alignment to the Programme for Government
As in the case of the Budget 2011-15, the Executive is attempting to agree budget lines ahead of agreeing PfG targets. The existing PfG 2011-15 comes to an end in this financial year. It is disappointing that there has been an absence of published detailed data to allow an evaluation of how far the 84 targets in the current PfG were achieved. One of the most important indicators, though not one of the 84 targets in the current PfG, is the level of GVA per head in NI compared to the UK average; this has declined by 7 % points since devolution was restored in 2007.

DHSSPS
Whilst the Executive has committed to a small cash terms increase in current funding of DHSSPS in 2015-16, it remains unclear how far value for money will be achieved from this outlay. Moreover, it is unclear to what extent the *Transforming Your Care* reform initiative will continue. The wider question for Stormont, as for Whitehall, is whether the concept of "protected" areas of public spending is still a useful or even viable concept.

DE contrasted to the DEL Department
Given that the Executive continues with the official line that growing the economy is the top priority, it is unclear what the rationale is for the much larger reduction in the funding for the DEL Department as opposed to DE. The impact of the proposed spending reductions on DEL will impact in the Executive's skills agenda and will also impact on the current successful apprentice and skills development programmes.

Charging
The draft Budget contains little indication that the Executive has reviewed whether its previous policy of containing all charges and local taxes at as low a level as possible remains sustainable in the light of intensifying austerity. This is the issue of so-called "super-parity"; prescription charges, concessionary fares, student fees, social housing rents, industrial de-rating and no water charges. Such low, or zero, charges represent a total "cost" to the Executive of at least £350m of revenues foregone annually and perhaps as much as £0.5bn.

Likely future Budget pressures
This Budget says nothing about how any reduction in the block grant as a consequence of the potential devolution of Corporation Tax varying powers would be accommodated. This is not wholly unreasonable given that any such reduction is not likely to occur until several years after the announcement of such a policy. A more serious omission is the absence of a discussion of how the Executive might handle further "penalties" relating to non-implementation of welfare reform. Crucially, the Institute for Fiscal Studies responded to the 3 December 2014 Autumn Statement by estimating that the Chancellor was implying a further reduction in Whitehall Departmental spending of £55bn over the next Parliament; £35bn has occurred so far. This implies the Executive should be preparing *now* for three or four further very tight Budgets.

Barnett Formula reform
The Barnett Formula will almost certainly survive into 2015-16. Indeed, the Prime Minister himself has recently committed to continuation both in the context of Scotland and Northern Ireland. At the same time, many commentators now feel it is unsustainable[22]. It is perhaps disappointing that the Executive has chosen not to discuss this medium to longer term challenge.

Conclusions about the Draft Budget 2015-16…

It is welcome that a Draft Budget was agreed in October and it is important to stress that the Executive's document is a *Draft* Budget. It is still work in progress and some change may be necessary to allow for the impact of the Talks process and in particular any agreement relating to welfare reform. In particular, the final

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[22] The House of Lords Committee in 2009, the Local Government Association, the Institute for Fiscal Studies and, indeed, Lord Barnett himself who died on 1 November 2014.

Budget will have to be judged credible by HM Treasury given that this was one of the conditions of the £100m loan granted in October 2014.

Nevertheless, it is a matter of concern that the Draft Budget:

- Does not really balance.
- Fails to provide for fundamental reform.
- Has been put forward ahead of the agreement of PfG targets for 2015-16.

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130710-160323-CF-OS