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Briefing Paper

Paper 158/10 | 21 October 2010 | NIAR 545-10

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The Spending Review 2010: estimated impacts on Northern Ireland.

Executive Summary

- This paper summarises the outcome of the Spending Review (SR), focusing on the potential economic implications for Northern Ireland.

[1] We are grateful for the assistance of Victor Hewitt in compiling this paper

The Extent of the Cuts

- According to HM Treasury figures[2], total Departmental Expenditure Limit (DEL) in 2014/15 will be £1.05bn (10.3%) less, in real terms, than in 2010/11.
- However, this figure may understate the true impact of the cuts since changes in accounting mean that it is exclusive of depreciation and other non-cash items. Once these have been accounted for, (which is the approach that has been adopted by PricewaterhouseCoopers (PwC)), the difference is larger. PwC indicate that, on this basis, there has in fact been a £1.4bn reduction in total DEL (2014/15 compared to 2010/11) in real terms (12.6%)
- DFP is viewing the cuts on a cumulative basis, i.e. total cuts over the entire spending period, as opposed to comparing allocations in 2014/15 with those in 2010/11. On this basis, they are estimating that the cuts will amount to £4 billion in real terms between 2010/11-2014/15. We are still awaiting more detailed figures from the Department of Finance Personnel (DFP) to enable us to derive a comparative figure as to their estimation of the reduction in real-terms total DEL between 2010/11 and 2014/15.
- End-Year Flexibility (EYF) is to be abolished from the end of the 2010/11 financial year along with all accumulated stocks.
- There is a lack of clarity surrounding the Northern Ireland baseline for 2010/11. It appears that the Executive decision to incur current year savings in the region of £100m in the baseline year (2010/11) has had a negative impact upon subsequent allocations.

The Impact of the Cuts

- Ultimately, the economic impact of the cuts outlined in the SR will depend upon how they are allocated across departments by the Northern Ireland Executive.
- However, in the absence of this detail, this paper draws upon an analysis, produced by PricewaterhouseCoopers (based on established financial models), which estimates the overall impact of £1.4bn in cuts on the Northern Ireland economy over the four-year period.
- The key findings of this are as follows:
  - According to the SR total, Departmental Expenditure Limit (DEL) funding for all Northern Ireland departments (including the Department of Justice) will be £0.3bn less in 2014/15 than in 2010/11. In real terms, this is equivalent to a reduction of £1.4bn.[3]

[2] Adjusted for inflation using HMT deflators

[3] As calculated by PwC on the basis of Treasury and DFP assumptions regarding inflation rate expectations

- This is equivalent to an average annual percentage decline, in real terms, of 2.0%.
- With regards to the estimated impact on Gross Value Added (GVA), PwC estimates that a reduction in DEL of £1.4bn would be equivalent to -4.8% of Northern Ireland's GVA in 2014. However, a caveat on this estimate is that it does not account for cuts in welfare components of Annually Managed Expenditure (which are likely to be significant). Thus this is likely to understate the true scale of the effect.
- With regards to public sector jobs, PwC estimates that if the entire cut was offset against public sector employment (an unlikely situation, but useful in reflecting, in terms of jobs, the scale of the total cuts), this would result in a reduction in public sector employment of 41,200. This figure is intended to reflect the 'job equivalent' of the cuts, and is not a projection for job-losses.
- In respect of private sector jobs, PwC estimates that, when multiplier[4] effects are accounted for, Northern Ireland could be facing the largest potential reduction in private sector jobs in the UK; with a potential 5% loss in total employment over the five year period.
- Welfare reform is likely to have particular significance for Northern Ireland. There is a greater relative reliance upon the welfare system in Northern Ireland; benefits represent 10% of household income here, compared to a UK average of 7%. Welfare recipients represent a 50% greater proportion of the population in Northern Ireland, compared with the UK average. Furthermore, Northern Ireland's 60+ share of the population is projected to grow more rapidly than in GB over the next fifty years.
- Finally, with regards to the Investment Strategy for Northern Ireland (ISNI), the planned reduction of £500m in capital DEL (40% in real terms) over the next four years will have significant implications for the economy and upon the local construction sector.

[4] The multiplier effects are the indirect or 'knock-on' effects of reduced public sector spending: as fewer people are employed in both the public and private sector, the total spending in the economy is reduced.

1. Overview

The purpose of this briefing paper is to provide Members of the Northern Ireland Assembly with background to, and an initial assessment of, the UK Government's Spending Review (SR). The paper presents consideration of the impact of the spending limits allocated to the Executive.

1.1 What is the Spending Review?

The SR is the mechanism through which the UK Government allocates Departmental Expenditure Limits (DEL) to each of the departments across Whitehall and to the devolved administrations. For the purposes of public expenditure control, the devolved administrations' allocations are set out in exactly the same way as, for example, the Department for Work and Pensions.

SR 2010 sets expenditure limits for current and capital spending for each year from 2011/12 to 2014/15. These are firm and fixed *overall* limits, but it remains at the discretion of the devolved administration or department how to distribute this spending within their areas of responsibility.

1.2 Background to the SR

There has been widespread public debate in recent months about the necessity for, and timing and level of, fiscal consolidation in the UK. This paper does not seek to contribute to that debate; it is concerned with what the potential impacts of the UK Chancellor's announcement might be for Northern Ireland. It is however useful to highlight in broad terms what the UK Government is planning.

The UK Government's deficit-reduction strategy

The Government's top priority is reducing the budget deficit which was £156 billion in 2009/10. The Budget set out plans to cut the deficit, announcing £32 billion of spending cuts by 2014/15. These are in addition to the reductions in spending which had been planned by the previous Labour Government. Public spending is forecast to fall in real terms for each of the next four years. This is a very sharp reduction: since 1970, spending has fallen in real terms in only five years and only once for two consecutive years (1996/97-1997/98). Despite these cuts, public spending as a share of the economy in 2015/16 will still be higher than it was in 2003/04.[5]

[5] See House of Commons Briefing SN/EP/5674 available online at: http://www.parliament.uk/briefingpapers/commons/lib/research/briefings/snep-05674.pdf

What is fiscal consolidation?

Fiscal consolidation is the rebalancing of revenues and expenditures. It may be required to redress the exceptionally high UK public debt levels to avoid the possibility of the UK's credit rating being downgraded. This would result in a reluctance to lend to the UK on international money markets, making credit less accessible, more expensive and thereby adding to current costs of servicing the public debt.

More detail on fiscal consolidation, lessons from other Governments' attempts at re-balancing and a summary of some characteristics of those approaches that were deemed to have been successful are available in Assembly Research Paper NIAR 367-10 *Re-balancing Public Finances: Lessons from Past Experiences.*[6]

The UK Government's approach has been to focus the effort of consolidation mostly on the implementation of expenditure reductions rather than on tax rises.

The May 2010 spending reductions

The incoming Coalition Government announced in May 2010 total UK public spending reductions of £6.2 billion for 2010/11.[7] The Northern Ireland Executive's share of these reductions was £127.9 million.[8] This has been mostly managed through the in-year monitoring process, although there is an option for the Executive to carry forward the reductions into 2011/12.

Giving evidence at the Finance and Personnel Committee on 29 September 2010, an official stated:

> *As we leave September monitoring, the position is that the overcommitment is cleared on the capital side, and we still have a balance of just under £17 million of an overcommitment on the current side.*[9]

This means that if there is to be no carrying over of overcommitment into 2011/12, the Executive has to find a further £17 million in the remaining monitoring rounds this year (December and February); as usual it will also have to manage any further in-year expenditure pressures that emerge. Assuming it can do so, it will start the next fiscal year with a clean slate. If it cannot, any overcommitment will have to be met from the Executive's allocation set out below in section 3.

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[6] Available online at: http://www.niassembly.gov.uk/researchandlibrary/2010/14710.pdf

[7] The Chancellor's speech is available online at: http://www.hm-treasury.gov.uk/press_05_10.htm

[8] DFP Press release 25 May 2010, available online at: http://www.northernireland.gov.uk/news/news-dfp/news-dfp-25052010-wilson-cut-in-public-spending.htm

[9] http://www.niassembly.gov.uk/record/committees2010/FinancePersonnel/100929_OutcomeofSpendingRound.htm

1.3 How is the Northern Ireland Executive's share determined?

For the most part, the Executive's DEL allocation is calculated formulaically according to changes to comparable spending programmes in Whitehall departments' allocations; there is also the application of a population-based element. For more detail on the workings of devolved funding see Assembly Research Paper NIAR 49/09 *The Barnett Formula.*[10]

Other elements of public expenditure are *not* set through the Barnett Formula. Prior to 2006-07 as well as getting an equivalent share of spending on programmes, Northern Ireland also attracted some additional funding through what could be called 'extra-Barnett' allocations – such as for match funding under European Peace programmes, for example. The Executive was also granted limited borrowing powers under the Reinvestment and Reform Initiative (RRI) for funding infrastructural development.[11]

The major components of the assigned budget outside DEL are known as Annually Managed Expenditure (AME):

- Social security benefits;
- NHS and teachers' pensions;
- Non-cash costs (such as depreciation, for example) in relation to Executive functions in Northern Ireland that are the responsibility of local authorities in Great Britain – for example local roads;
- RRI self-financed borrowing;
- district councils self-financed expenditure; and,
- Regional rates.

The former two elements are determined and forecast twice yearly. It should be noted that AME funding is on a 'sale or return' basis; if the level of expenditure on these items is lower than the forecast, there is no mechanism for the Executive to transfer the surplus into DEL.

The latter three are determined locally by the Executive and Northern Ireland's district councils.

The treatment of the Department of Justice in Northern Ireland is also handled differently. In evidence to the Committee for Justice in September, an official stated:

> *If our budget is ring-fenced — which I believe it probably will be, although that will be an Executive decision, not one that we can make — we will take the direct Barnett consequentials of the Home Office and the Ministry of*

[10] Available online at: http://www.niassembly.gov.uk/io/research/2009/4909.pdf

[11] See http://www.ofmdfmni.gov.uk/index/economic-policy/reinvestment-and-reform-initiative.htm

> *Justice. If those Departments receive a 25% cut, it will probably mean around a 12% to 15% cut for us.*[12]

Later on, the consideration of ring-fencing was touched on again:

> *Overall, the view is that there is still a willingness to ring-fence our budget for the next four years.*[13]

It should be noted that this concept of 'ring-fencing' is rather different from the Executive choosing to protect a certain area of its budget from cuts. In the context of the Department of Justice it means that any changes to the Home Office and Ministry of Justice's allocations would be passed via the Barnett Formula to the Northern Ireland Department of Justice. If this is what the Executive chooses it will mark a departure from the established approach whereby *all* of the Executive's DEL is unhypothecated.[14]

For clarity, it should be noted that funding for the Department of Justice *has* been included in the Northern Ireland Executive's DEL in the CSR.

Statement of Funding Policy

The UK Treasury's Statement of Funding Policy[15] published in October 2007 (the same time as the last SR), explained the rules for carry-forward of unused resources from one year to the next – known as 'End-Year Flexibility.' (EYF) It is important to note in the current context that access to stocks of EYF is not automatic and requires the approval of the Treasury.[16]

The new version of the Policy (published alongside SR 2010.[17]) no longer has any reference to EYF (see below).

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[12] http://www.niassembly.gov.uk/record/committees2010/Justice/100902Budget2010.pdf (see page 9)

[13] http://www.niassembly.gov.uk/record/committees2010/Justice/100902Budget2010.pdf (see page 10)

[14] If an allocation is hypothecated it is must be spent for a particular purpose. If it is unhypothecated it is at the Executive's discretion.

[15] HM Treasury (2007) 'Funding the Scottish Parliament, National Assembly for Wales and Northern Ireland Assembly: Statement of Funding Policy' available online at: http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/pbr_csr07_funding591.pdf (see chapter 15)

[16] HM Treasury (2007) 'Consolidated Budgeting Guidance from 2007-08' available online at: http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/media/0C7/B0/consolidatedbudgetingguidance_2007-08.pdf (see Chapter 15 for more detail on EYF)

[17] HM Treasury (2010) http://cdn.hm-treasury.gov.uk/sr2010_fundingpolicy.pdf

End-Year Flexibility

The EYF scheme allows departments and devolved administrations to carry forward underspend resources from one year to the next and accumulate these as stocks. According to the UK Treasury's provisional outturn for 2009-10 the Northern Ireland Executive's total EYF stock was £624,478,000.[18] As stated above, drawdown of these stocks requires approval from the Treasury. However, the SR announces that the UK Government is:

> *abolishing the EYF scheme at the end of 2010-11, including all accumulated stocks, and replacing it with a new system from 2011-12 which will retain an incentive for departments to avoid wasteful end-year spending and strengthen spending control. Further detail will be set out later this financial year.*

Whilst the policy for the new system is yet to be announced, it is clear that the existing stock will no longer be available to the Executive from the next financial year.

[18] http://www.hm-treasury.gov.uk/d/peowp200910.pdf (see Table 6, page 17)

2. SR 2010: Summary of key messages – UK level

- The SR sets out departmental spending limits for the four years until 2014-15 (refer Table 1 below) and further savings and reforms to welfare, environmental levies and public service pensions.
- Public spending as a percentage of GDP will return to the level seen in 2006-07, and in real terms it will return to around the level seen in 2008-09.
- The SR has increased the capital envelope by £2.3 billion a year by 2014-15 relative to the Budget plan.
- The SR has, for the first time, covered key areas of Annually Managed Expenditure (AME) in addition to Departmental Expenditure Limits (DELs) for each government department and for the devolved administrations.
- The Spending Review commits to:
  - Providing an NHS in England that is free at the point of use and available to everyone based on need, not the ability to pay. Total NHS spending will increase in real terms in each year of the Parliament; and,
  - Uprating the basic State Pension by a triple guarantee of earnings, prices or 2.5 per cent, whichever is highest from 2011, while bringing forward the date at which the State Pension Age will start to rise to 66 to 2020.

Spending Review Measures in Support of the Government's Priority of 'Growth'

- More than £10bn over the Spending Review to provide new road schemes / maintain existing roads; funding Crossrail and improvements to the London Underground network. £14bn for rail improvements including station upgrades in Birmingham, towns around Manchester, Yorkshire, etc;
- Rolling out superfast broadband access across the country; a Regional Growth Fund of £1.4 bn; investing £1bn with proceeds from sale of government-owned assets to provide incentives for investment in low-carbon economy through Green Investment Bank; and,
- £250m extra funding compared to previous Government for new adult apprenticeships; maintaining science budget in cash terms.

Spending Review Measures in Support of the Government's Priority of 'Fairness'

- Protecting schools spending, and introducing a new fairness premium worth £7.2bn in total, to support poorest in early years and at every stage of education;
- Improving sustainability of welfare state by ensuring the amount a household can receive from welfare does not exceed that earned by an average family that works; withdrawing Child Benefit from higher-rate tax payers;

- Making social housing more 'responsible, flexible and fair'; meeting Coalition Agreement's pledge to make in the region of £1.5bn available for the Equitable Life Payments Scheme; and,
- Maintaining commitment to spend 0.7 per cent of Gross National Income (GNI) on international development aid by 2013.

Spending Review Measures in Support of the Government's Priority of 'Reform'

- Localising power/funding, including removing ring-fencing resources to local authorities/extending the use of personal budgets for service users;
- Cutting burdens/regulations on frontline staff, including policing, education and procurement;
- Increasing diversity of provision in public services; and,
- Improving transparency, efficiency and accountability of services.

Major reforms announced in the Review include:

- A settlement for local government that increases local authorities' freedom to manage their budgets, but will require choices on how services are delivered within reduced allocations;
- Reforms to the sentencing framework so that it punishes/rehabilitates more effectively;
- Ensuring the effectiveness of frontline policing by reviewing terms/conditions of service and generating efficiencies in IT, procurement and back office;
- Accepting findings of interim Hutton Report on public service pensions, the UK Government will continue with a form of defined benefit pension and seek changes to employee contributions that will enable £1.8bn of savings a year by 2014-15 (the exact nature of benefits/level of contributions will be made upon receipt of Lord Hutton's final recommendations); and,
- Action to cut the cost of central government, with a 34 per cent cut in administration budgets across Whitehall and arms-length bodies, saving £5.9bn a year by 2014-15.

Table 1 HM Treasury Spending Review – Resource and Capital DEL

Departmental Expenditure - cumulative real growth over Spending Review period						
	Resource DEL less depreciation* (£bn)			Capital DEL (£bn)		
Department	2010-11 baseline	2014-15	Cumulative real growth (%)	2010-2011 baseline	2014-2015	Cumulative real growth (%)
Education	50.8	53.9	-3.4	7.6	3.4	-60
NHS (Health)	98.7	109.8	1.3	5.1	4.6	-17
Transport	5.1	4.4	-21	7.7	7.5	-11
CLG Communities	2.2	1.2	-51	6.8	2.0	-74
CLG Local Government	28.5	22.9	-27	0.0	0.0	-100
Business, Innovation and Skills	16.7	13.7	-25	1.8	1.0	-52
Home Office	9.3	7.8	-23	0.8	0.5	-49
Justice	8.3	7.0	-23	0.6	0.3	-50
Law Officers' Departments	0.7	0.6	-24	0.0	0.0	-46
Defence	24.3	24.7	-7.5	8.6	8.7	-7.5
Foreign and Commonwealth Office	1.4	1.2	-24	0.2	0.1	-55
International Development	6.3	9.4	37	1.6	2.0	20
Energy and Climate Change	1.2	1.0	-18	1.7	2.7	41
Environment, Food and Rural Affairs	2.3	1.8	-29	0.6	0.4	-34
Culture, Media and Sport	1.4	1.1	-24	0.2	0.1	-32
Olympics[1]	-	-	-	1.0	-0.1	-
Work and Pensions	6.8	7.6	2.3	0.2	0.2	-5.5
Scotland	24.8	25.4	-6.8	3.4	2.3	-38
Wales	13.3	13.5	-7.5	1.7	1.1	-41
Northern Ireland	9.3	9.5	-6.9	1.2	0.8	-37
HM Revenue and Customs	3.5	3.2	-15	0.2	0.1	-44
Treasury	0.2	0.1	-33	0.0	0.0	-30
Cabinet Office	0.3	0.4	28	0.0	0.0	-28
Single Intelligence Account	1.7	1.8	-7.3	0.3	0.3	-2.8

Small and Independent Bodies		1.8	1.4	-27		0.1	0.1	-52
Reserve		2.0	2.5	-		2.1	1.1	-
Special Reserve		3.4	2.8	-		0.7	0.8	-
* = depreciation is excluded because the depreciation figures reported in budget are currently not used in measurement of the fiscal aggregates by the Office for National Statistics.								

1 Depreciation in Resource DEL is drawn from departmental resource accounts and follows International Financial Reporting Standards. This currently differs from National Accounts depreciation, which is used in the calculation of PSCE by the Office for National Statistics.
2 As at all spending reviews, baselines exclude one-off and time-limited expenditure and therefore may not sum to 2010-11 total. Cumulative real growth is calculated using the 2010-11 baseline.
3 Includes the Office of the Qualifications and Examinations Regulator
4 If grants moving to local government are included then CLG Communities growth is -33%
5 LG DEL includes funding for police and fire authorities. Excluding these contributions LG DEL for councils will fall by 28%
6 If contributions to police are excluded then the Home Office growth is -30%
7 The DCMS baseline excludes £85m of broadcasting funding, which the BBC will fund from 2013-14.
8 Olympics is included in DCMS DEL.
9 The Government agreed that as part of the £6.2bn cuts to 2010-11 budgets the Devolved Administrations could defer their cuts to 2011-12. The settlements presented here assume the Northern Ireland Executive take their cuts in 2010-11, the Scottish Executive take their cuts in 2011-12, and the Welsh Assembly Government split their cuts equally between 2010-11 and 2011-12. These settlements are subject to change as the Devolved Administrations finalise their spending plans.
10 Includes one-off funding in 2014-15 for Individual Electoral Registration (£85m) and the costs of the 2014 election to the European Parliament (£120m). Excluding these, the core Cabinet Office settlement will be cut by 35%.
11 Includes SIA contribution to National Cyber Security Programme
12 A more detailed breakdown of small and independent bodies' is set out in Table A12
13 Values and profile based on indicative allocations from departments.
14 Includes the OBR's forecast for growth in council tax receipts

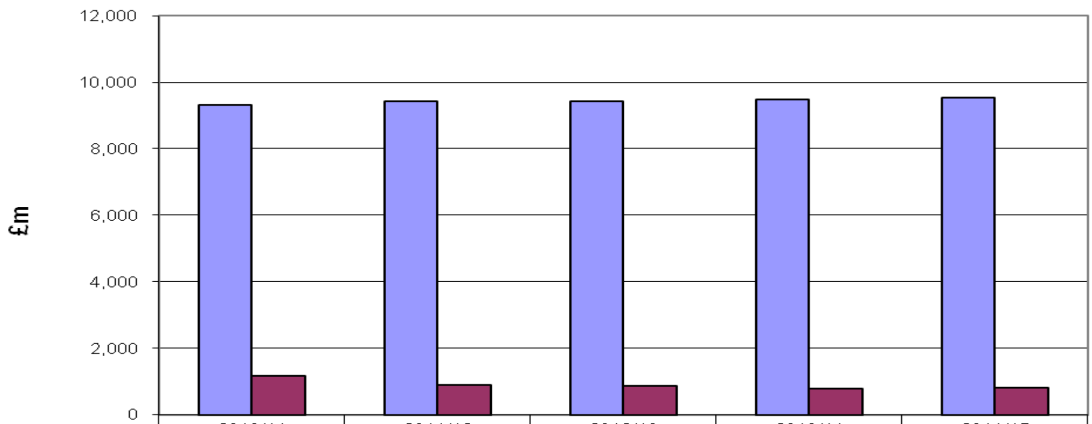
3. SR 2010: Northern Ireland's allocation.

Comparisons between the SR allocations for 2010/11-2014/15 with previous allocations are complicated by a number of factors, including:

- *The inclusion of Department of Justice funding in the 2010/11 baseline position reported in the Review document;*
- *The exclusion of depreciation and other non-cash items from the baseline figure outlined in the Review document.*

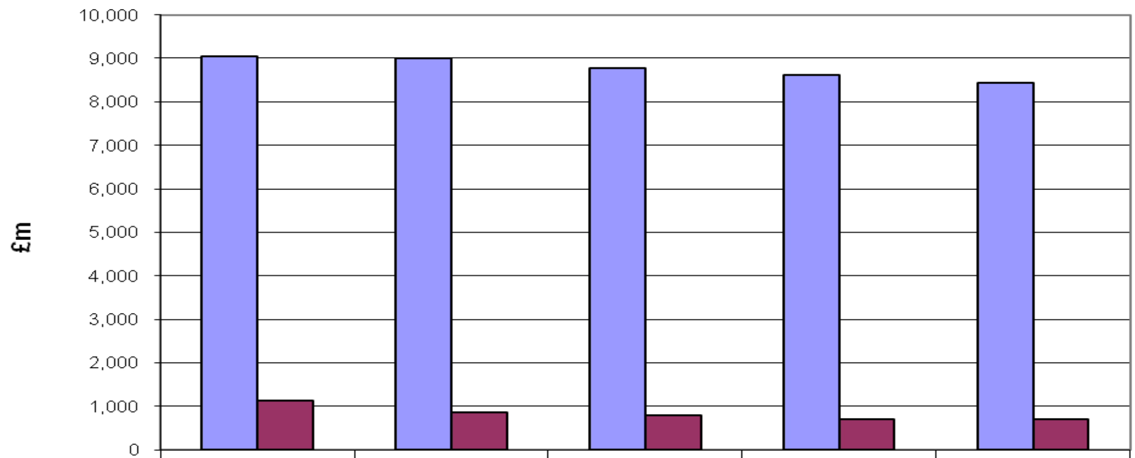
However, the Figures presented by HMT in the SR for resource and capital expenditure over the next four years are depicted in Figure 1 (nominal terms) and Figure 2 (real terms). (source HM Treasury)

Figure 1. DEL Provision for NI Executive



	2010/11	2011/12	2012/13	2013/14	2014/15
Resource	9315.0	9425.0	9420.0	9486.0	9529.0
Capital	1170.0	903.0	859.0	781.0	804.0

Figure 2. DEL Provision for NI Executive - Real Terms (2009/10 Prices)



	2010/11	2011/12	2012/13	2013/14	2014/15
Resource	9052.5	8988.6	8781.8	8619.2	8430.7
Capital	1137.0	861.2	800.8	709.6	711.3

Note: above figures derived using HM Treasury latest available GDP deflators.

Provision for Presbyterian Mutual Society

The SR announcement included scope for the Executive to borrow £175m **"**to ensure a fair and just resolution of issues arising from the collapse of the Presbyterian Mutual Society."[19] Provision for this borrowing appears to have been applied to Northern Ireland's AME through the Reinvestment and Reform Initiative (RRI) line.[20]

The RRI is the mechanism through which the Executive can borrow from the National Loans Fund (which is the UK Government's main borrowing and lending account) for the purposes of capital investment. Effectively then, the SR treats the resolution proposed for the Presbyterian Mutual Society as capital expenditure in order to allow for savers to have their savings returned to them.

It is not clear from the information currently available whether this £175m is taken from the Executive's annual £200m borrowing limit under RRI for 2011/12; an Executive press release from 16 April 2010 seems to imply that Treasury approval was needed to "**extend** the RRI borrowing facility."[21][emphasis added] This seems to suggest that the £175m loan is *in addition* to the current limit of £200m per annum.

The effect of this therefore would *not* be to reduce the Executive's ability to borrow to fund capital investment which would constrain further spending plans beyond the reductions in capital DEL.

What can be said with certainty is that if the £175m *is* additional to the £200m RRI ceiling then the Executive could potentially incur a much greater level of debt. Debt has to be serviced which will create pressure on the budget. Secondly, the SR has provided £25m towards the hardship fund. If the Executive is to make this up to the £50m figure announced in April, there is an additional funding pressure for 2011/12.

[19] http://cdn.hm-treasury.gov.uk/sr2010_completereport.pdf (page 70)

[20] http://cdn.hm-treasury.gov.uk/sr2010_completereport.pdf (Table 3, page 12)

[21] http://www.northernireland.gov.uk/executive-statements-index/content-newpage-150410-executive-agrees-_50.htm (final paragraph)

4. Impact of the SR on Northern Ireland.

This section briefly highlights some of the issues that face the Northern Ireland economy, focusing on those that make it particularly vulnerable to cuts in public spending. Some results of modelling of the potential economic impact of the SR announcement by PwC are then presented.

4.1 The Northern Ireland Economy

A Relative Vulnerability to Public Sector Cuts

There are a number of factors, specific to the NI economy, which could be argued to make us particularly vulnerable to the impending cuts in public expenditure.

- ***The Size of the Public Sector:*** The public sector in NI (including Reserved functions[22]) employs approximately 226,000 people; equating to 32.3% of all employee jobs. This is significantly higher than the equivalent figure in the rest of the UK (21.1%)[23]. The cuts to public expenditure and/or employment levels, implied by the CSR 2010, will thus have a disproportionate impact on the NI economy.
- ***Characteristics of the Private Sector:*** An additional difficulty that NI faces is that the ability of the local private sector to adequately 'pick up the slack' is questionable; productivity levels in NI remain below UK average levels (in fact the gap has widened over recent years). Whilst job creation took place during 1998-2008, boosting employment figures, this has tended to have been associated with low value-added jobs (for example in call centres).

  Companies in NI also have a limited export base; unless they become more 'outward looking'[24], declining levels of expenditure amongst consumers and by Government imply limited scope for growth.
- ***Local Banking Issues:*** Another impediment to economic recovery, which is relatively specific to Northern Ireland, is the remaining constraints on bank lending levels. NI has a relatively concentrated banking sector, with four leading local banks, two of which are Irish-owned (First Trust and Bank of Ireland). Thus in obtaining credit facilities, NI businesses are exposed to the issues associated with the Irish banking sector, including the outworking of the National Asset Management Agency (NAMA). For example, First Trust Bank is currently not actively seeking new

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[22] Reserved functions include the NI Office, PSNI, NI Prison Service, UK Central Government and UK Public Corporations

[23] This is, in part, due to the lower employment rate in NI and a higher requirement for public services due to demographic structure and socio-economic status.

http://www.dfpni.gov.uk/2010-11-pay-and-workforce-technical-annex.pdf

[24] However, there is the issue of where to export to: opportunities are constrained given the global economic climate.

customers, having recently been instructed by the Financial Services Authority (FSA) to reduce its loan to deposit ratio. NI has also had the lowest uptake rates of Government bank lending schemes (intended to enhance the accessibility of credit for businesses) in the UK[25]. These are significant issues, since restoring bank lending levels[26] is a necessary precondition for economic recovery.

- ***Relative Reliance on the Welfare System:*** The proposed scale of welfare reform in the UK may be particularly problematic for NI. Northern Ireland has comparatively high levels of deprivation, disadvantage and poverty; some of which is a legacy of years of conflict[27]. We also have a relatively high rate of economic inactivity in NI relative to other UK regions (28.5% as opposed to a UK average rate of 23.2%), and this is reflective, at least in part, of the proportion of individuals who currently claim Disability Living Allowance (28% of the economically inactive are sick/disabled)[28].
- ***Property Market/Construction Industry:*** Northern Ireland experienced an extreme spike in property prices in 2006-07, and the 'bursting of the bubble' has been accordingly painful. House prices have fallen by more in Northern Ireland than in any other UK region. This has clear implications for confidence levels and transaction levels are correspondingly low[29]. According to Ulster Bank, the re-adjustment in average house prices, since the peak in August 2007, has now reached 42% - this is illustrated, relative to other UK regions, in Figure 3 below[30]. Furthermore, leading forecasts indicate that this trend is set to continue for some time, (albeit at a slower rate), with a return to growth in average prices anticipated around 2013[31].

  The local construction industry has suffered accordingly; it is thus extremely vulnerable in the face of the planned cuts to capital expenditure.

[25] On a per head basis, the uptake of the Enterprise Finance Guarantee Scheme is lower in NI than in any other UK region

[26] This is not to say that credit should be as cheap and as accessible as it was prior to the credit crunch; this was reflective of a mispricing of risk.

[27] http://www.theyworkforyou.com/ni/?id=2010-09-13.8.1

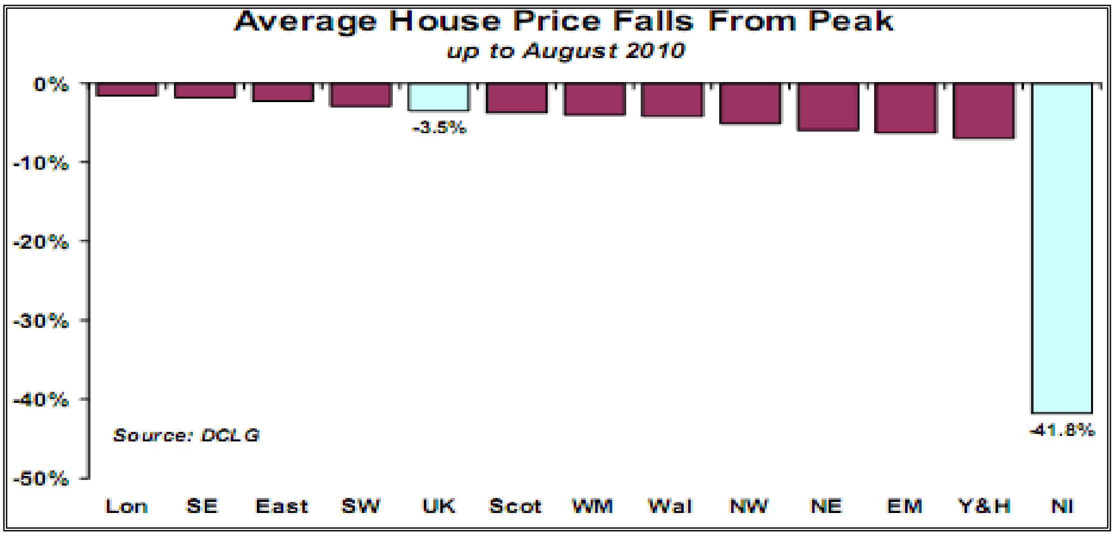
[28] http://www.detini.gov.uk/lmr_october_2010.pdf

[29] Refer to Northern Ireland's Housing Market Update*, Ulster Bank,* October 2010 available online at: http://www.ulsterbankcapitalmarkets.com/home/Economist/NI%20Economics%202/Housing.aspx

[30] According to the University of Ulster, the figure is slightly lower – 36%; relative regional trends are unchanged

[31] Refer to http://www.northernbank.co.uk/SiteCollectionDocuments/economic/QEO/quarterly-economic-overview-07-10.pdf

Figure 3 – Fall in Northern Ireland House Prices



Source: Northern Ireland's Housing Market Update, Ulster Bank, October 2010

Many of the factors outlined above are issues that other regions have also faced/continue to face; however, the point is one of proportionality. Northern Ireland is disproportionately exposed to a number of risks, which render it particularly vulnerable to the public sector cuts outlined in the SR. In the same way that *growth* in public expenditure has contributed significantly to economic growth in NI over recent years, the scale of the *spending reductions* present a considerable risk of a prolonged economic contraction.

Other General Features of the NI Economy

Other features of the Northern Ireland economy were highlighted by the Independent Review of Economic Policy in September 2009 (IREP - also known, somewhat confusingly in the context of this paper, as 'the Barnett Review'. For the avoidance of doubt, this review was not a review of the Barnett Formula).[32] Some of the headline findings of that Review were:

- Living standards in Northern Ireland are around 80% of the UK average;
- Labour productivity has weakened since 1997 and the gap with the UK average has widened;
- The sectoral mix of the Northern Ireland economy (measured by employment) shows higher than UK average reliance on sectors with typically lower productivity such as health, agriculture, construction, retail, manufacturing and education;

[32] Independent Review of Economic Policy (2009) available online at: http://www.irep.org.uk/Docs/report.pdf (see Chapter 2)

- The sectoral mix of the Northern Ireland economy (measured by employment) shows lower than UK average reliance on higher-end sectors such as business services, personal and financial services;
- Northern Ireland's employment rate is consistently below the UK average and correspondingly the level of economic inactivity is higher than in any other UK region;
- Business expenditure on research and development is lower than the UK average; and,
- A much higher proportion of those of working age has no academic qualification compared to the UK average (in 2008, 22% in Northern Ireland compared to UK average of 12%).

In addition to these structural weaknesses, the progress of economic recovery in Northern Ireland has been weaker than in the rest of the UK. In particular:

> *While private-sector activity has picked up a little in recent months, it remains fragile and does not look capable of replacing any significant contraction [in] public-sector activity.* [33]

Indeed, a recent report by Ulster Bank revealed that:

> *… the downturn in the Northern Ireland private sector economy continued in September. Business activity fell for the tenth month in a row, as the level of new work received posted a further marked decline.*[34]

In part, this is a reflection of low consumer confidence. A recent survey of confidence by the Northern Bank found that:

> *Of the 1,000 people surveyed, only 15 per cent believed that their household finances would improve over the next 12 months, while 28 per cent felt that their financial position would worsen. In addition, 35 per cent of households felt that their finances had already deteriorated relative to one year ago.*[35]

[33] First Trust Bank Northern Ireland Economic Outlook (2010) available online at: http://www.firsttrustbank.co.uk/servlet/BlobServer?blobkey=id&blobwhere=1044897680707&blobcol=urlfile&blobtable=FTB_Download&blobheader=application/pdf&blobheadername1=Content-Disposition&blobheadervalue1=document.pdf (see page 15)

[34] Ulster Bank Northern Ireland PMI September (11 October 2010) available online at: http://www.ulsterbankcapitalmarkets.com/home/Economist/NI%20Economics%202/Ulster%20Bank%20PMI%202.aspx (see page 1)

[35] Northern Bank (18 October 2010) 'Consumer Confidence October 2010' available online at: http://www.northernbank.co.uk/SiteCollectionDocuments/economic/2010/Northern-Bank-Consumer-Confidence-Oct-10.pdf

4.2 What does the outcome of the SR imply for Northern Ireland?

The ultimate economic impact of the SR will depend upon how the Northern Ireland Executive decides to allocate the cuts across the various departments, and whether, for example, health or education expenditure is ring-fenced. It will also depend on whether the Executive re-allocates any current expenditure in respect of capital spends. These decisions will be consulted upon, and ultimately presented in the Executive's Budget 2011-15.

In the absence of this detail, and to enable a broad quantification of the implications of the SR announcement on the local economy in the meantime, the Assembly Research Service has commissioned a piece of research by PwC to attempt to broadly quantify the economic impact of the cuts for Northern Ireland (for example, with respect to employment levels).

The key findings of their analysis are as follows:

- According to the SR total, Departmental Expenditure Limit (DEL) funding for all Northern Ireland departments (including the Department of Justice) will be £0.3bn less in 2014/15 than in 2010/11. In real terms, this is equivalent to a reduction of £1.4bn[36].
- This is equivalent to an average annual percentage decline, in real terms, of 2.0 per cent.
- With regards to the estimated impact on GVA, PwC estimates that a reduction in DEL of £1.4bn would be equivalent to -4.8% of Northern Ireland's GVA in 2014. However, a caveat on this estimate is that it does not account for cuts in welfare components of Annually Managed Expenditure (which are likely to be significant). Thus this is likely to understate the true scale of the effect.
- With regards to public sector jobs, PwC estimates that if the entire cut was offset against public sector employment (an unlikely situation, but useful in reflecting, in terms of jobs, the scale of the total cuts), this would result in a reduction in public sector employment of 41,200. Once again, this figure is intended to reflect the 'job equivalent' of the cuts, and is not a projection for job-losses.
- In respect of private sector jobs, PwC estimates that, when multiplier effects are accounted for, Northern Ireland could be facing the largest potential reduction in private sector jobs in the UK; with a potential 5% loss total employment (private and public sector) over the five year period.
- In terms of the potential welfare reform, this is likely to have particular significance for Northern Ireland. There is a relative reliance upon the welfare system in NI, with benefits representing 10% of household income here, compared to a UK average of

[36] As calculated by PwC on the basis of Treasury and DFP assumptions regarding inflation rate expectations

7%. Welfare recipients represent a 50% greater proportion of the population in NI, compared with the UK average. Furthermore, Northern Ireland's 60+ share of the population is projected to grow more rapidly than in GB over the next fifty years.

- Finally, with regards to the Investment Strategy for Northern Ireland (ISNI), the planned reduction of £500m in capital DEL (40% in real terms) over the next four years will have significant implications for the economy and upon the local construction sector.

5. Revenue Raising Options for the Executive

The scale of budgetary cuts might be mitigated should the Executive decide to implement increases in local taxation or revenue raising. There are a number of potential options in this regard; however, when considered within the context of the Executive's legislative competence, some may be more feasible than others.

The principle revenue raising mechanism available to the Executive is the regional rate.

Domestic regional rate

Domestic rates have been frozen in money terms for the last 3 years. The Department of Finance and Personnel's Land and Property Services has estimated the additional revenue that would have been raised by increasing the domestic rate by 3%, rather than freezing it as presented below in Table 2,

Table 2 - Estimated Revenue forgone by freezing the domestic regional rate rather than increasing by 3% per annum[37]

Financial year	Revenue forgone
2008/2009	£8.02 million
2009/2010	£19.8 million
2010/2011	£26.2 million
2011/2012	£35.9 million

This is a cumulative impact of over £90 million over the four-year period presented.

Note: the figures are based on projections of revenue rather than actual revenues. They also take account of increases in the tax base and changes in domestic rates reliefs over the period. The increasing revenue loss over time can be explained by the fact that the underlying tax base tends to increase in value over time, as well as a result of changes to the cost of reliefs.

Non-domestic regional rate.

For the year ending 31 March 2009, the non-domestic regional rate increased 2.7% on the preceding year. At the time this rate was announced by then Finance Minister Peter Robinson inflation was at 2.7% so this was - in effect - a real-terms freeze.[38]

[37] Source: figures provided to the Assembly Research Service by LPS

[38] http://www.northernireland.gov.uk/news/news-dfp/news-dfp-march-2008/news-dfp-030308-robinson-confirms-domestic.htm

For the year ending 31 March 2010, the non-domestic regional rate did not increase. This was – in effect – a real-terms cut.

For the year ending 31 March 2011, the non-domestic regional rate again increased 2.7% on the preceding year. At the time this rate was announced by Finance Minister Sammy Wilson inflation was again at 2.7% so this was again - in effect - a real-terms freeze.[39]

Both the domestic and the non-domestic regional rates could be increased to raise additional revenue, although the wider impact on economic recovery would have to be carefully considered.[40]

Other revenue-raising options

Other potential sources of additional revenue include:

- The introduction of water charges – it has been estimated that this would generate up to £200m per year[41].
- Abolishing free prescriptions – it is anticipated that this could generate up to £13m per year.
- Ending free travel for 60-64
- Following the Lord Browne report[42] recommendations on removing cap on university tuition fees

Other, less conventional, possibilities (for which legislative/authoritative feasibility would have to be more clearly established) include:

- A tax on mobile phone text messages;
- A car parking levy across the public sector;
- Northern Ireland Executive Bonds; or,
- An increased charge on MOT tests

[39] http://www.northernireland.gov.uk/news/news-dfp/news-dfp-february-2010/news-dfp-22022010-wilson-confirms-freeze.htm

[40] Whilst it might be argued that the economic impact would be restricted since the funds would remain within NI, and be spent therein, there is also the issue of confidence and whether increasing domestic/non-domestic rates could further constrain consumption/investment and increase precautionary saving.

[41] Northern Ireland Economic Outlook, *First Trust Bank Economic Outlook and Business Review,* 25 September 2010

[42] http://www.bis.gov.uk/assets/biscore/corporate/docs/s/10-1208-securing-sustainable-higher-education-browne-report.pdf

6. Conclusions

- There is a lack of consensus as to the exact scale of the cuts to total DEL in NI; this appears to be associated with issues around the exclusion of depreciation/other non-cash items, the savings which are to be incurred in the current year, and the inclusion of DoJ funding in the SR baseline.
- However, there is a consensus view that the real challenge for NI will be in respect of the significant cuts to capital expenditure over the Spending Review period.
- The Executive will need to consider alternative options, to ensure that these cuts do not leave a legacy impact in economic terms. These might include assessing alternative means of raising revenue (as outlined in section 5) or transferring resource allocations to capital spend. Given the existing constraints on current expenditure allocations, this would be a very difficult decision; however, it is important that the Budget is approached from a strategic, longer-term point of view to ensure economic sustainability in Northern Ireland.
- Finally, it is worth highlighting that the real-terms cuts in total DEL could be significantly larger should the rate of inflation exceed current forecasts (upon which 'real' cuts have been derived). This is a possibility, especially should the Bank of England vote on another round of Quantitative Easing in the UK (as is the current thinking in the US). However, this risk may be offset to some degree by public sector pay freezes.

7. Points for Further Clarification

The following issues may be worthy of further clarification with DFP, to assess their potential impact on Northern Ireland funding levels:

- ***Presbyterian Mutual Society:*** further details might be sought to establish whether the £175m borrowing allowance, granted to the Executive in respect of a resolution of the PMS situation, will be taken from the Executive's annual £200m borrowing limit under RRI for 2011/12. Furthermore, the SR provided £25m towards the hardship fund. If the Executive is to make this up to the £50m figure announced in April, there is an additional funding pressure for 2011/12.
- ***End-Year Flexibility:*** According to the UK Treasury's provisional outturn for 2009-10 the Northern Ireland Executive's total EYF stock was £624,478,000.[43] However, the SR indicated that the Government is abolishing the scheme at the end of 2010-11. It would be useful to clarify whether this implies that the existing stock will no longer be available to the Executive from the next financial year.
- ***Current Year Savings:*** Another point which might be worthy of clarification is whether the fact that the NI Executive has opted to incur current year savings in the

[43] http://www.hm-treasury.gov.uk/d/peowp200910.pdf (see Table 6, page 17)

region of £100m in the baseline year (2010/11) has had a negative impact upon subsequent spending allocations.

Appendix: Press Coverage

BBC Northern Ireland website

(accessed on 21st October 2010)

Gerry Adams says NI Spending Review cuts 'unacceptable'
http://www.bbc.co.uk/news/uk-northern-ireland-11595597

Cuts worse than feared - Peter Robinson
http://www.bbc.co.uk/news/uk-northern-ireland-11582887

Capital projects in NI 'will suffer' because of cuts
http://www.bbc.co.uk/news/uk-northern-ireland-11590423

Attwood urges Stormont maturity over Spending Review
http://www.bbc.co.uk/news/uk-northern-ireland-11594563

NI leaders accuse government of breaking promises
http://www.bbc.co.uk/news/uk-northern-ireland-11585961

NI's £4bn cutbacks 'a real test' warns Finance Minister
http://www.bbc.co.uk/news/uk-northern-ireland-11587394

How did Northern Ireland fare in the spending cuts?
http://www.bbc.co.uk/news/uk-northern-ireland-11590417

UTV website

(accessed on 21st October 2010)

Adams hits out at 'unacceptable' cuts
http://www.u.tv/News/Adams-hits-out-at-unacceptable-cuts/3abbee4c-b3c2-48be-9c31-0fbba113350f

NI leaders 'angry' at £4bn cuts
http://www.u.tv/News/NI-leaders-angry-at-£4bn-cuts/af35737d-1f61-4307-ba87-fe51d4e6543c

£200m for PMS rescue package
http://www.u.tv/News/%c2%a3200m-for-PMS-rescue-package/73d53993-c1c8-4328-83ac-e5ac53e83753

Belfast Telegraph

Website (accessed on 21st October 2010)

Osborne's spending review axe falls on Northern Ireland 21st October 2010
http://www.belfasttelegraph.co.uk/news/politics/osbornes-spending-review-axe-falls-on-northern-ireland-14982926.html

Osborne's £200m package for Presbyterian Mutual Society 20th October 2010
http://www.belfasttelegraph.co.uk/news/local-national/uk/osbornes-200m-package-for-presbyterian-mutual-society-14982484.html
Print Edition

Thousands of redundancies on the horizon by David Gordon Pg. 2

Now we know where we stand, it's up to Stormont to do more with less by David Gordon,
Pg. 2

It's a hell of a deal for Ulster: Paterson by Noel McAdam, Pg. 3

Hospitals, schools and new roads in doubt after savage cuts by David Gordon, Pg. 4

Attwood 'shocked' as the axe is wielded in benefits shake-up by Noel McAdam, Pgs 4 & 5

Presbyterian Mutual savers breathe a sigh of relief with £200m lifeline by Lesley-Anne Henry,
Pg. 5

Where the axe will fall: our experts give their opinions Pgs 6 & 7

News Letter

Website (accessed on 21st October 2010)

War of words over Ulster cuts 21st October 2010
http://www.newsletter.co.uk/news/War-of-words-over-Ulster.6592400.jp

Ministers left reeling by capital cutbacks 21st October 2010
http://www.newsletter.co.uk/news/Ministers-left-reeling-by-capital.6592459.jp

How cuts will impact Ulster 21st October 2010
http://www.newsletter.co.uk/news/How-cuts-will-impact-Ulster.6592497.jp

Jobs and pensions top the list of public fears 21st October 2010
http://www.newsletter.co.uk/news/Jobs-and-pensions-top-the.6592483.jp

PMS to benefit from £200 rescue plan 20th October 2010
http://www.newsletter.co.uk/news/PMS-to-benefit-from-200.6591321.jp

'Fairly good outcome' for PMS shareholders 20th October 2010
http://www.newsletter.co.uk/news/39Fairly-good-outcome39-for-PMS.6590389.jp

Print Edition 21st October 2010

The £4 billion war of words – angry clashes as cuts revealed by Gemma Murray, Pgs. 1 & 3

Businesses react to cuts Pg. 4

Pensioners 'winners' Pg. 4

Irish News

<u>Print Edition</u> 21st October 2010

Cuts leave air of uncertainty Editorial, Pg. 10
30,000 public sector jobs face the chop in 'Axe Wednesday' by Gary McDonald, Pg. 12

No-one really any wiser over how much will actually be cut by Gary McDonald, Pg. 14

Alliance explanation of discrepancy between figures by Stephen Farry MLA, Pg. 14

Rescue package announced for PMS savers by John Manley, Pg. 15

North gets its lower bill with a sting in the tail by Richard Ramsey, Pg. 15

Lots of work to do when ministers meet a day late by Diana Rusk, Pg 16

Tinkering about will not cut it in education by Simon Doyle, Pg 16

Hospitals to stay on waiting list by Seanin Graham, Pg 17

Leaders' mixed responses to budget 'massacre' by Claire Simpson, Pg. 18

Paterson insists first minister was 'relieved' by Diana Rusk, Pg 18

Note: print versions are available in the Assembly Library.