Group Economics

Ulster Bank

Beneath the Budget: Debt, Debt and More Debt

Contact: Richard Ramsey
Chief Economist, Northern Ireland
02890 276354 or 07881 930955

Richard.ramsey@ulsterbankcm.com

www.ulsterbank.com/economics

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Was the Budget good or bad? That is usually the most popular question asked when the Chancellor sits down afterwards.

For the man or woman on the street, the Budget has a number of attention-grabbing elements that will be widely welcomed, including a cut in beer duty, a scrapping of the planned rise in fuel duty and an increase in the personal income tax allowance to £10,000. The latter, due to take effect in April next year, will take another 7,000 individuals out of income tax altogether *(but not National Insurance Contributions).*

On the other hand, small firms will gain some relief from their National Insurance Contributions. From April next year, a new employment allowance will allow 25,000 local firms to offset £2,000 against their National Insurance bill. Larger firms will benefit from the improved R&D tax credit with NI's R&D intensive aerospace industry set to benefit from access to a £2.1bn UK Aerospace Technology Institute. Meanwhile, the headline corporation tax rate is set to fall by another percentage point to 20% in April 2015. This will narrow the corporation tax differential between Northern Ireland and the Republic of Ireland from 15.5 percentage points (pp) to 7.5 pp in just five years.

Households feeling the inflation induced squeeze on incomes will welcome news that new tax relief for childcare costs of up to £1,200 per child will be introduced. However, they will have to wait until autumn 2015 for that one.

Stormont will also benefit from an additional £94m of capital spending over the next two years. This will provide a much needed boost for the construction industry. A sector that has seen output plummet by over 40% and employment fall by 36% over the last 5 years. Northern Ireland's beleaguered housing market will also welcome measures to stimulate demand amongst both first-time buyers and home movers.

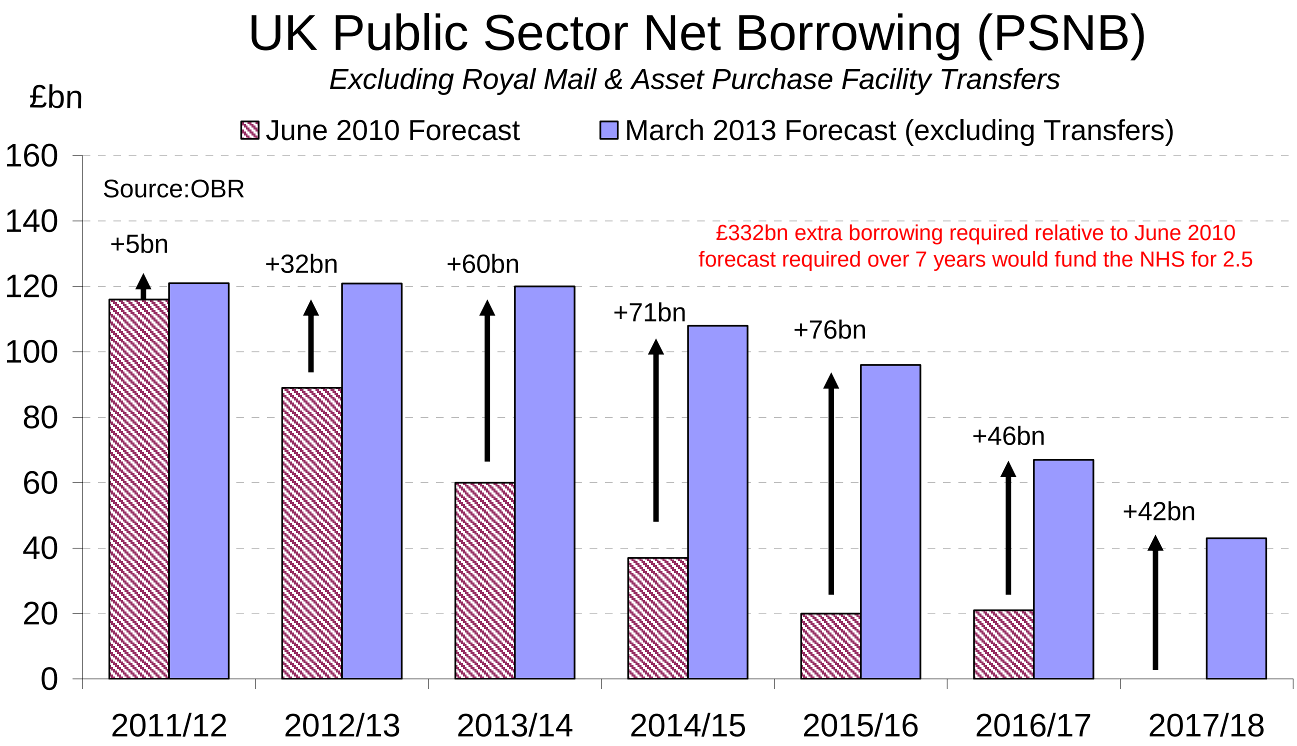
In another upside, things are not as bad in capital spending terms as they looked as if they might be. Back in June 2010, one of the biggest fears for the Northern Ireland economy was the planned 39% real terms cut in capital investment between 2010/11 and 2014/15. However, a series of budgetary allocations within the intervening years have significantly limited this cut to 22%. As a result, Northern Ireland's capital expenditure profile from 2011/12 to 2014/15 is some £408m higher in cash terms *(£382m after inflation)* than was projected almost three years ago.

But this is one of the few upside surprises in terms of forecasting. Elsewhere it is largely a case of things turning out much worse than expected.

Once again, there have been further downgrades to GDP growth for 2013 and 2014. The Office for Budget Responsibility (OBR) now expects the UK economy to expand by just 0.6% in 2013. This is just half the rate of growth it projected just three months ago and compares with +2.9% back in the Coalition government's first Budget in June 2010. Economic growth is expected to accelerate to 1.8% in 2014 which is slightly below the 2.0% growth rate forecast in December and will below the 2.7% forecast less than three years ago.

As the Chancellor noted, the economic recovery has taken much longer than anyone hoped with a slowdown in global growth and the Eurozone back in recession not helping matters. The health of the UK economy is the most important driver of economic growth in Northern Ireland. In addition, Northern Ireland remains over-exposed to the ongoing economic difficulties within the Republic of Ireland. We expect the Northern Ireland economy to remain flat in 2013 with growth of 1% in 2014 and 1.3% in 2015. Thereafter we expect the Northern Ireland economy to lag behind that of the UK.

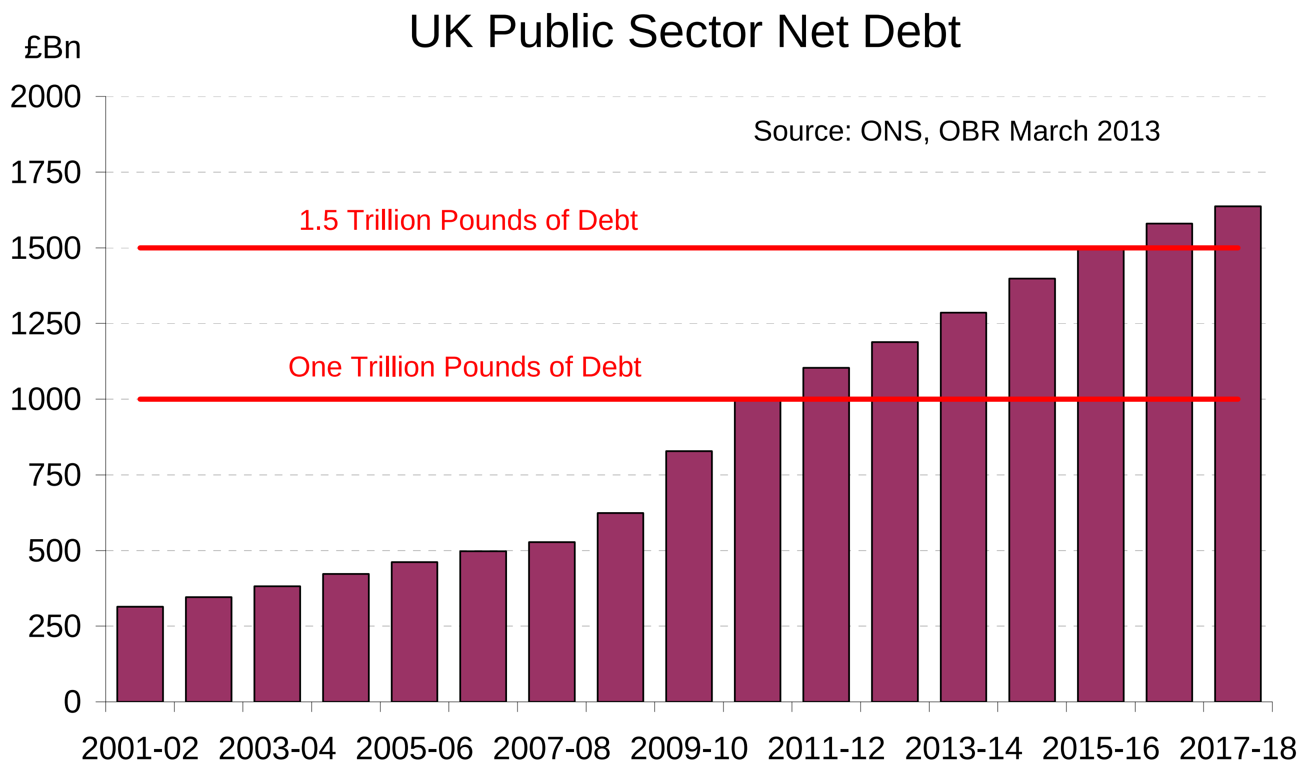
While the OBR have over-estimated UK economic growth, they have also underestimated inflation. It is noted that since the credit crunch began (August 2007), UK CPI has risen cumulatively by almost 20%. Looking beneath this headline measure it is noted that food prices have risen by 35% over this same period. Clearly those individuals on lower incomes spend a disproportionate amount of their income on food and fuel. Both of which have rocketed in recent years. A significant risk is that the current growth and inflation forecasts are overly optimistic. If this risk is realised it will cause even more havoc with the UK's battered public finances.



Within the wider public there is a lot of misunderstanding surrounding the public finances. Indeed, there remains the perception that the UK's debt is actually falling. It is not. There is particular confusion between debt and deficits. The annual amount of public sector borrowing required to fund an annual deficit is called the *Public Sector Net Borrowing* or *PSNB*. With UK economic growth much weaker than expected, government revenues have failed to recover in line with what was expected. As a result, the public finances are starting to look pretty horrendous with borrowing on the rise. The OBR now forecast an additional £130bn of government borrowing over the six years from 2012/13–2017/18, relative to the forecast made just three months ago. The overall level of UK borrowing is quite staggering when compared with what was envisaged in June 2010 in the Coalition government's first Budget. An additional £332bn of government borrowing is now required over the 7-year period 2011/12 to 2017/18. This would run the NHS for 2.5 years.

Meanwhile the overall level of borrowing throughout the 7-year period, after allowing for transfers of Royal Mail pension assets and revenue from the Bank of England's quantitative easing, comes to £602bn or £0.6 trillion. This borrowing is equivalent to running the NHS for over 4 years, and is 20 times the annual output of the Northern Ireland economy. It is worth noting that the UK's debt interest payments for the current year amount to £51bn, which is more than half of what the UK currently spends on education.

It should be noted that while the annual PSNB or deficit is falling, the overall stock of debt, and that stock of debt as proportion of GDP, is still rising. The overall stock of debt breached the £1trillion mark in 2010/11. This compares with just under £500bn in 2006/07 prior to the credit crunch. The UK's PSND is set to breach the £1.5 trillion by 2015/16 which is two years earlier than previously forecast. The OBR only forecasts as far as 2017/18 when the total stock of UK debt is set to hit £1.63 trillion or £1,637 billion. Therefore it should be stressed the UK's overall stock of debt will continue to rise as far is currently projected.



It is worth putting this scale of debt, which has interest payments associated with it too, into some sort of perspective. The current stock of UK debt (2012/13) is equivalent to £19,000 for each man, woman and child in the UK, and will rise to £26,276 per person by 2017/18.

We said at the start that the question normally asked when the Chancellor sits down after his Budget speech is 'was it good or bad?' This time around, this was probably the wrong question. A more realistic and fairer question might have been 'was it bad or horrendous?' given the context in which the Chancellor was operating in and also the fact that Budget 2013 can't be viewed in isolation - it is the cumulative effect of past Budgets and this one, plus issues such as inflation, that have created a very gloomy picture. And, given this cumulative effect, the picture is unlikely to change much in the Budgets that are to come. So whilst some will be toasting the cut in beer duty, those who look more closely at the figures will more likely be drowning their sorrows.

Richard Ramsey,
2nd April 2013