Group Economics

UK Budget 2013

Ulster Bank

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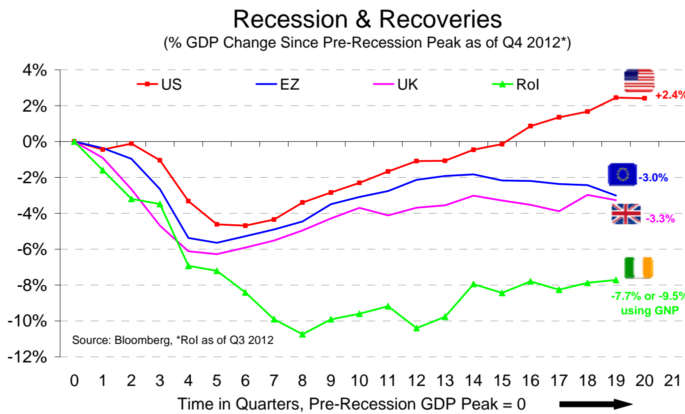
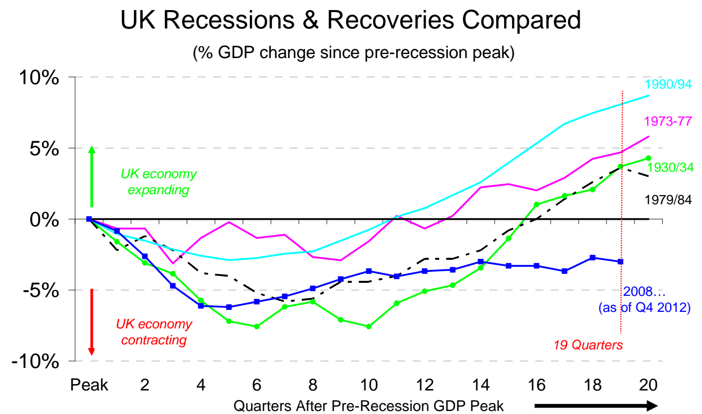
Background

The UK Coalition government has just over two years to go before the next election. When the Chancellor announced his master plan in the summer of 2010, he must have hoped that the worst of the fiscal pain would be behind him by now and he would still hold his coveted 'Triple A' credit rating. Economic growth was supposed to be just shy of 3% in 2012 with a similar outturn anticipated in 2013. Meanwhile, it was projected that by 2014/15 the cyclically adjusted current budget *(the day-to-day public spending not linked to the downturn of the economic cycle)* was set to be in surplus and public sector net debt *(the overall stock of national debt)* would be falling as a share of GDP. Back in 2010, the Chancellor also unveiled a new set of fiscal rules that were supposed to be superior to the old set. The UK was proclaimed a safe haven.

Fast forward to the present day and the picture looks less rosy with a significant part of the UK's fiscal adjustment still to come. Last month saw Moody's strip the UK of its *'Triple A'* credit rating. The charts below highlight that the depth of the UK recession has been deeper than both the US and Eurozone recessions and the recovery much weaker. Furthermore, the UK recovery has been much weaker and longer than that which occurred during the Great Depression.





This is the context within which Budget 2013 and the policy response *(or lack of)* is set. The economic and fiscal forecasts presented in the various reports released today are sobering. Furthermore, the last few years has taught us that there is no guarantee that these will be met. Whilst the UK economy recovery in output terms has been much weaker than expected, the labour market has been much more encouraging. Since the first quarter of 2010 there has been a net gain of over 1 million private sector jobs. To date, however, Northern Ireland has not experienced such an employment recovery. Indeed, today we learned that almost 1 in 4 of our 18-24 year olds looking for work cannot find employment. Within the UK context one of the key reasons why the economy has lacked a meaningful recovery in output is due to the consumer. There has been a lack of a consumer led recovery and this is linked to the sustained squeeze on disposable incomes. The persistent rise in inflation is largely responsible for this.

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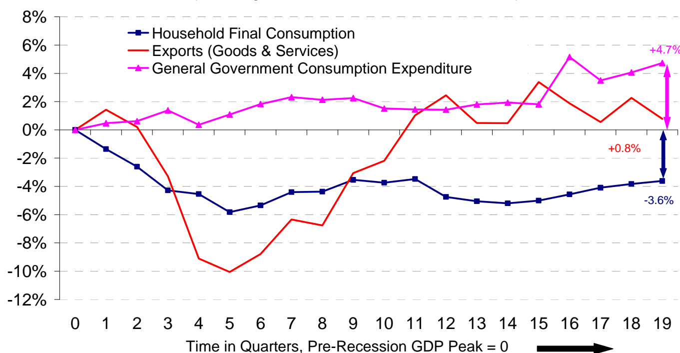
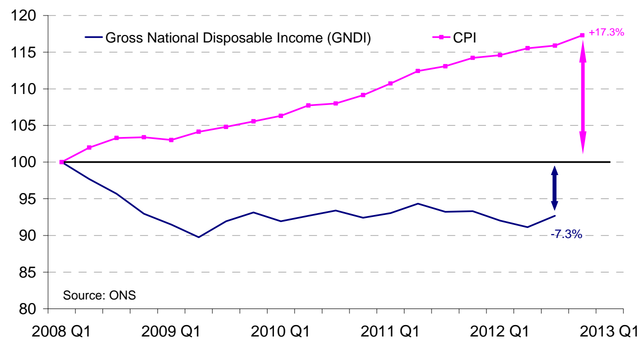
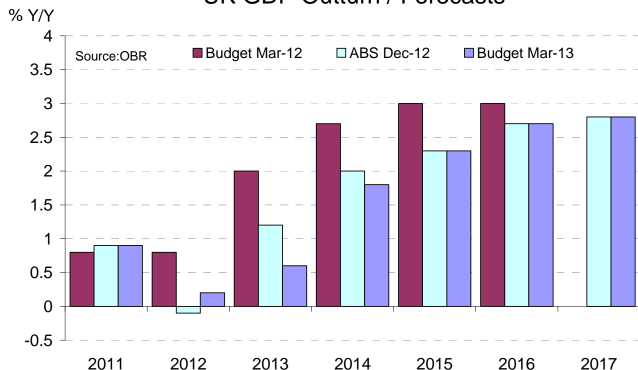
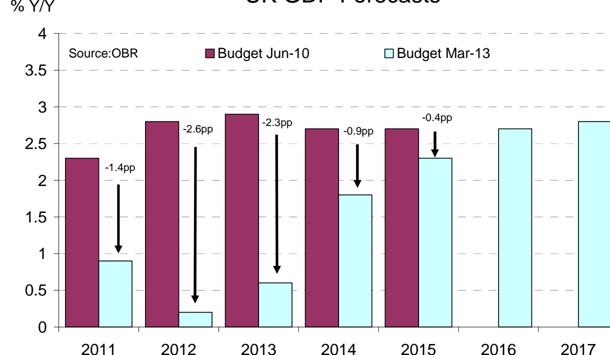




Budget 2013 Economic Forecasts

The UK economy recorded marginal positive growth (+0.2%) last year which compared with an expected decline (-0.1%) at the time of the Autumn Budget Statement. Once again, however, there have been further downgrades to GDP growth for 2013 and 2014. The 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. The growth forecasts for 2015 (+2.3%), 2016 (+2.7%) and 2017 (+2.8%) remain unchanged relative to the Autumn Budget Statement projections. 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.

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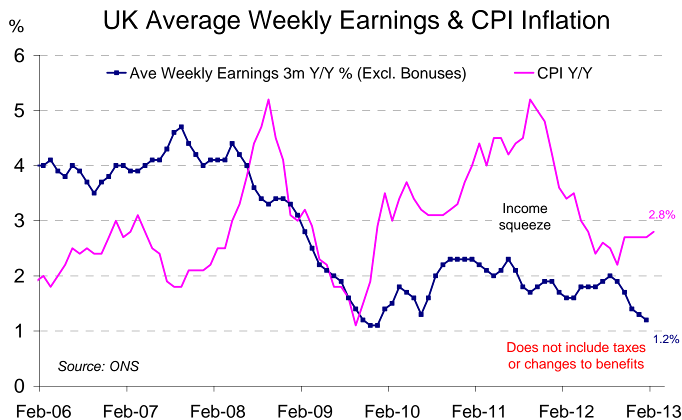
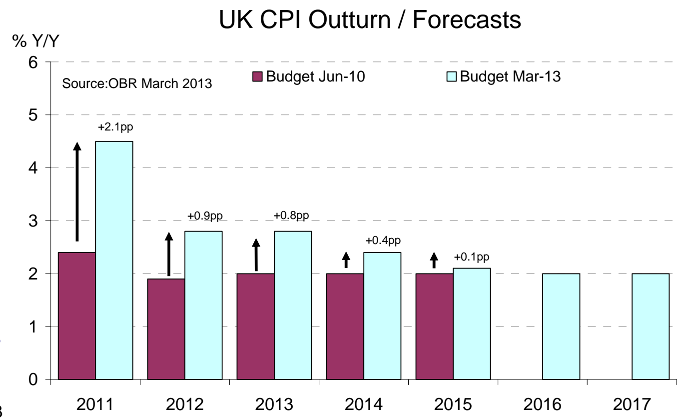




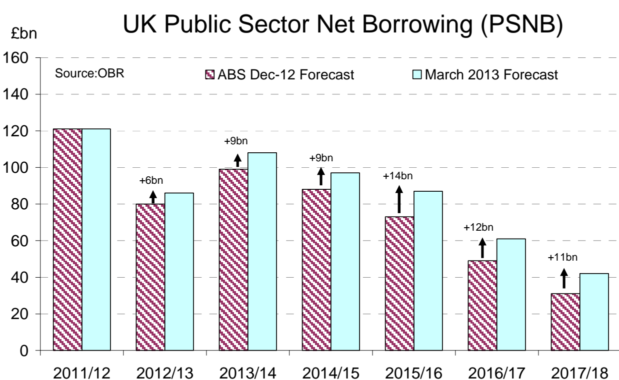
Public Finances

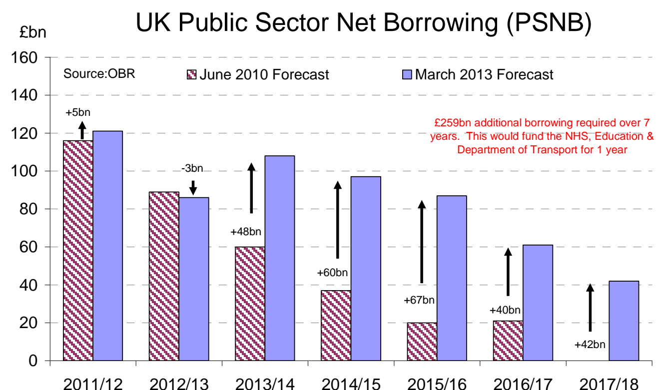
Fiscal consolidation – two thirds of planned spending cuts have taken place

The Chancellor reiterated the coalition's commitment in tackling the deficit. Budget 2013 highlights that by the end of 2012/13 around 70% of the annual fiscal consolidation planned for the Spending Review 2010 period *(2011/12 to 2014/15)* had been achieved, with around 65% of spending and 90% of the tax consolidation in place. This highlights that one third of the public spending cuts have still to take place. The government will publish departmental budgets for 2015/16 on 26 June 2013. Northern Ireland will get its Barnett consequential relating to this settlement.

Borrowing continues to rise with £602bn in just 7 years

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 which will be clarified below. 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 £61bn 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. The chart below highlights that an additional £259bn of government borrowing is now required over the 7-year period 2011/12 to 2017/18. This would run the NHS, Education and Department of Transport for 1 year. Meanwhile the overall level of borrowing throughout the 7-year period comes to £602bn or £0.6 trillion! This borrowing is equivalent to over four years of running the NHS.





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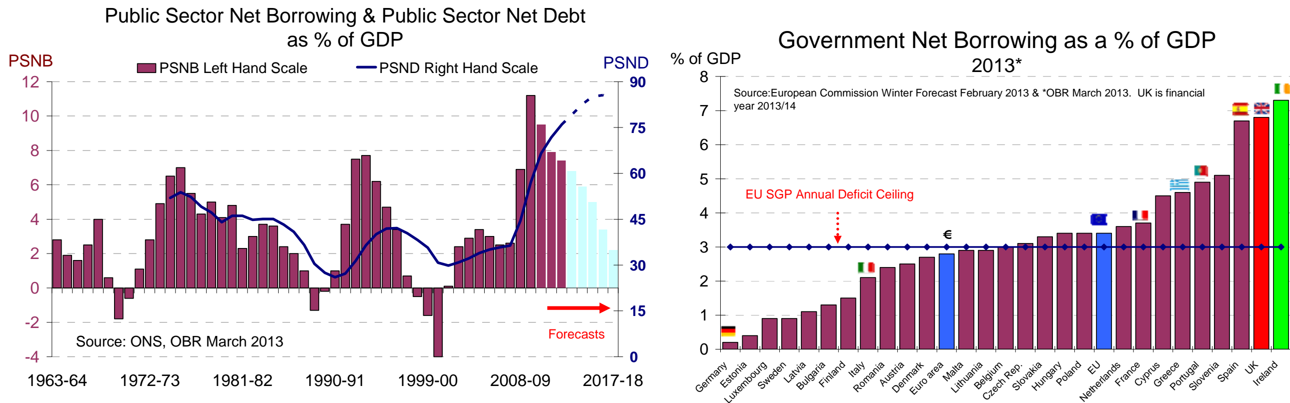
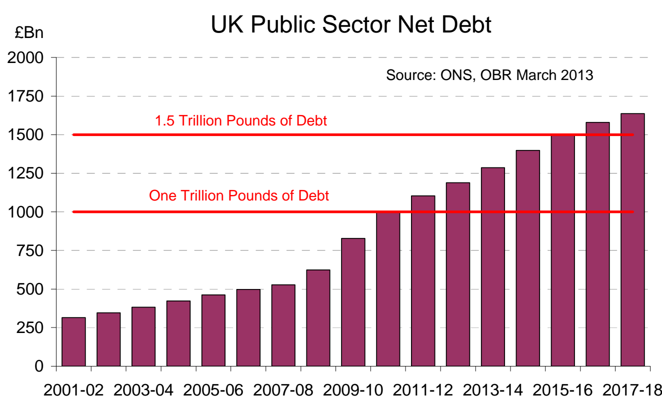
Public Sector Net Debt as a share of GDP is falling

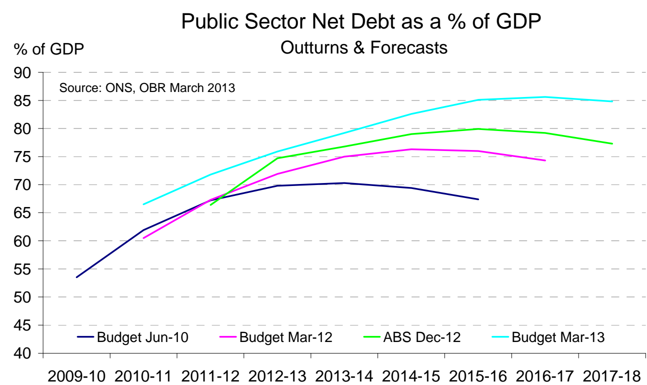
Deficit reduction has been the central plank of the Coalition government's fiscal strategy. *'Bringing the deficit down'* is often incorrectly viewed as reducing the level of overall debt. That is not the case. Instead what we are talking about is reducing the rate of growth in the annual deficit. The OBR expect the UK's PSNB to continue to fall from its Post World War II peak of 11.2% of GDP in 2009/10 to 7.4% in 2012/13. The EU Stability & Growth Pact target for annual deficits of 3% will not be achieved until 2017/18 when the annual deficit is set to fall to 2.2%. This is one year later than was forecast three months ago and three years later than was projected in June 2010. The Chart below highlights the UK's annual fiscal deficit relative to its EU counterparts. It illustrates that for 2013 *(2013/14 financial year for the UK)*, the Republic off Ireland is the only EU economy expected to have a higher annual fiscal deficit (7.3%) than the UK (6.8%). Spain is hot on the UK's heels with 6.7%.



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, or Public Sector Net Debt (PSND), breached the £1 trillion 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 *(assuming no population growth).* In the seven years between 2011/12 and 2017/18, UK Public Sector Net Borrowing is projected be a total of £602billion – 20 times the annual output of the Northern Ireland economy, or the cost of running the UK NHS for over four years!





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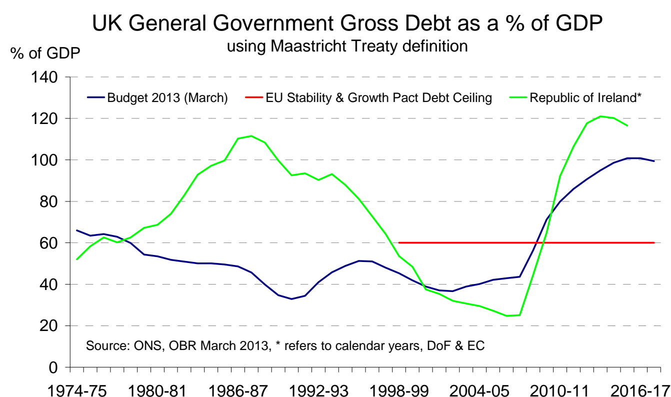
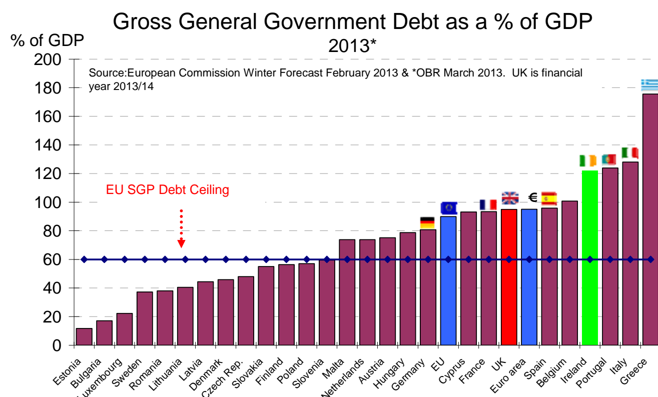
The UK's overall stock of national debt, as a share of the economy, is also continuing to rise. According to the OBR's latest forecasts the UK's PSND as a percentage of GDP is set to peak at 85.6% in 2016/17. This is 11.3 percentage points above the level forecast in March 2012. Looking at the last year (2015/16) of the June 2010 Budget forecast, the UK's PSND as a percentage of GDP was projected to hit 67.4%. Now, the same year is expected to see overall debt levels as a percentage of GDP almost 18 percentage points higher. The UK government will therefore miss its target for public sector net debt to be falling by 2015/16. However, the OBR still believes there is roughly a 70% chance that the Chancellor will meet his fiscal mandate of balancing the budget *(adjusted for swings in the economy)* in the next five years. A cyclically-adjusted budget surplus of 0.1% of GDP is now forecast in 2016/17. This means the deficit has taken two additional years to close relative to the Coalition's first budget in June 2010.





The UK figures quoted above focussed on net debt levels as opposed to gross. The charts above highlight the UK's Gross General Government Debt as a percentage of GDP relative to other EU economies. Using the Maastricht Treaty definition for gross government debt highlights that the Republic of Ireland will reach a peak of 121.2 in 2013/14. This is double the EU stability and Growth Pact threshold of 60%. Under the same measure the UK is currently at 90.7% (2012/13) and peaks at 100.8% in both 2015/16 & 2016/17. Comparisons with other EU countries highlights that the UK is moving towards the wrong end of the chart.

Fiscally neutral budget offers some encouragement for business & households

Given the state of the public finances the Chancellor had limited scope for pro-enterprise policies. Nevertheless there were a number of measures that are to be welcomed.

Capital investment boost – The Chancellor unveiled plans to increase capital investment by £3bn a year from 2015/16. However, this increase remains relatively modest. Northern Ireland will also receive an additional £94m of capital investment over the next two years. This will provide a much needed boost to the construction sector. It should also be noted that the huge falls in capital investment projected in 2010 have not been as bad as originally projected.

Annual Investment Allowance – As announced in the Autumn Budget Statement, the Government will increase the AIA from £25,000 to £250,000 for qualifying investment on plant and machinery for 2 years from 1 January 2013. This will further incentivise business investment amongst SMEs.

Corporation tax rate to fall to 20% by 2015 - Next month sees the UK's headline corporation tax rate fall to 23% with a further cut to 21% in April 2014. These reductions were already announced. In addition to these, however, the Chancellor announced a further reduction to 20% in April 2015 which will unify the small profits rate and the main rate. This will narrow the corporation tax differential between Northern Ireland and the Republic of Ireland from 15.5 percentage points (pp) to 7.5pp in just five years. This would also reduce the potential cost of cutting Northern Ireland's block grant in order to match the Republic of Ireland's 12.5% corporation tax rate. **There was**

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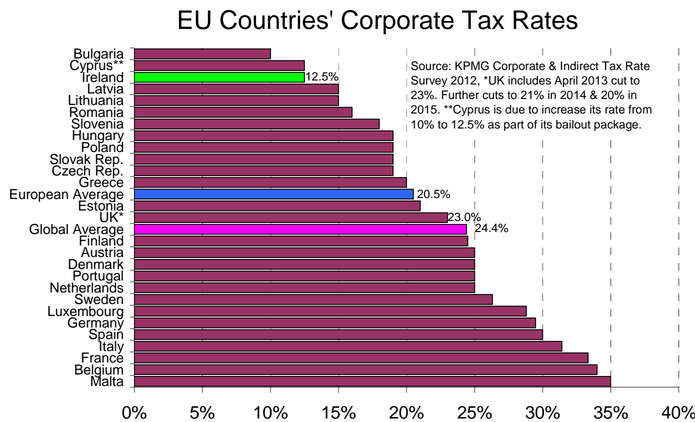
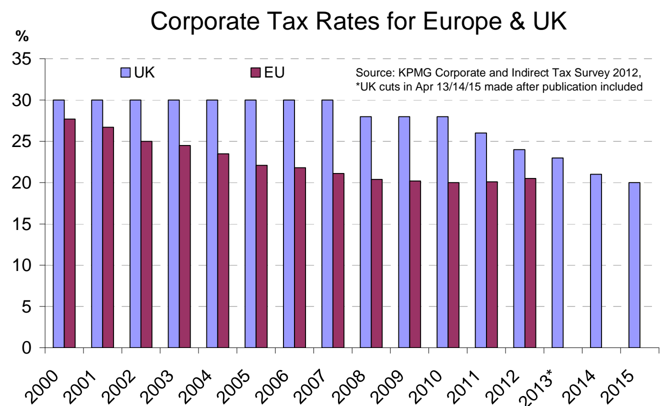
no update on Northern Ireland's call for it to be granted a 12.5% corporation tax rate. The reduction in corporation tax to 20% will bring the UK rate to the joint-lowest in the G20. According to the latest KPMG Corporate and Indirect Tax Survey 2012, the average corporation tax rate in the EU was 20.5%. To take account of the additional reductions in corporation tax, the rate of the Bank Levy will increase to 0.142% from 1 January 2014.





Improvements to R&D tax credit – A new *'above the line'* credit for large company R&D investment will be introduced next month. Whilst this was already announced the credit will be for 10% as opposed to 9.1%. Larger firms will benefit from the improved R&D tax credit with Northern Ireland's R&D intensive aerospace industry also set to benefit from access to a £2.1bn UK Aerospace Technology Institute.

New Employment Allowance – Budget 2013 announced that from April 2014 every business and charity will be entitled to a £2,000 Employment Allowance towards their National Insurance Contributions bill. In Northern Ireland, this new measure will allow 25,000 local businesses to offset £2,000 against their National Insurance bill. This will lead to a saving of £35m and will take 10,000 businesses out of employer NICs altogether.

Carbon Price Floor exemption – It was confirmed that Northern Ireland is to be exempted from the carbon price floor from the 1st April 2013. This exemption levels the playing field with competitors in the Republic of Ireland. This means businesses and households will not see a rise in energy costs emanating from this policy. Furthermore, without this exemption Northern Ireland's electricity generators would have been made uncompetitive vis-à-vis their Republic of Ireland counterparts. As a result, this move protects jobs and security of energy supply.

Aggregates levy remains unchanged – The aggregates levy will remain at £2.00 per tonne from 1 April 2013. This benefits the Northern Ireland quarrying / aggregates industry which has been vulnerable to the levy rate.

A new tax relief on social enterprise in the pipeline – Budget 2013 announced that a formal consultation on a relief will begin this summer and will be introduced in Finance Bill 2014. This will be designed to encourage investment in social enterprises.

Alcohol, tobacco and other duties - Budget 2013 announced that general beer duty will be reduced by 2% from 25 March 2013. The government will then cancel the beer duty escalator which was 2% plus the rate of inflation. Instead, it will rise by inflation (RPI) only going forward. Meanwhile all other alcoholic drinks will continue to increase by 2% plus RPI. This dates back to the alcohol escalator announced in the March 2010 Budget. Similarly, tobacco duties will increase by the same margin as of 6pm 20 March 2013. The government will abolish stamp tax on shares for companies listed on growth markets including the Alternative Investment Market (AIM) from April 2014.

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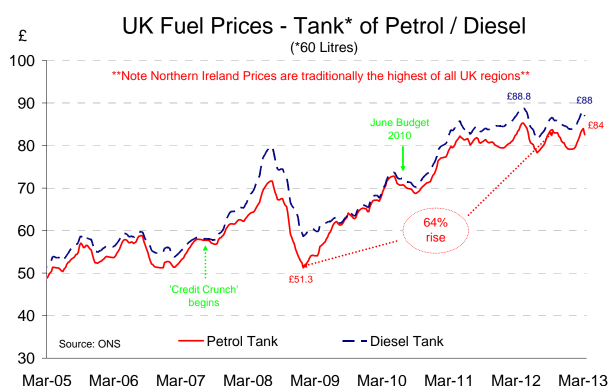
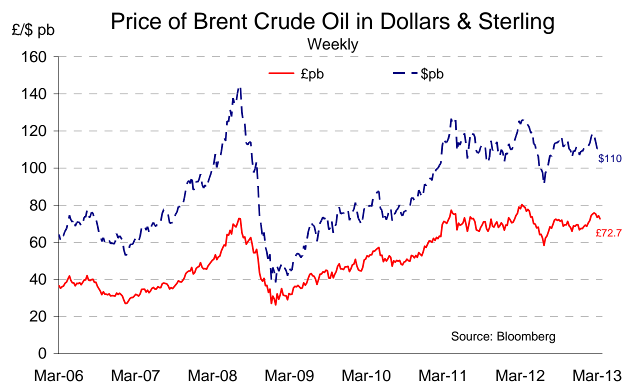
CGT & IHT thresholds – As announced in the Autumn Statement 2012, the annual exempt amount (AEA) will rise by 1% to £11,000 in April 2014 and to £11,100 in April 2015. The Seed Enterprise Investment Scheme (SEIS), launched at Budget 2012, offers 50% income tax relief on investments made into small, early-stage companies. The government has announced an extension of the capital gains tax holiday. Any investors making capital gains in 2013/14 will receive a 50% capital gains tax relief when they reinvest those gains into seed companies in either 2013/14 or 2014/15. The inheritance tax nil-rate band has been frozen at £325,000 since 2009. This freeze is set to be extended to 2017/18. Clearly more estates will be liable for IHT as the threshold fails to rise in line with inflation. Part of the rationale for freezing the IHT threshold is to help fund social care costs. There will be a £72,000 cap on reasonable social care costs for people in residential care from April 2016.

Income tax thresholds – One of the biggest announcements of the day was the increase in the income tax personal allowance to £10,000 by April 2014. This represents an increase of £560 on the 2013/14 allowance (£9,440) and a £1,895 increase on the current 2012/13 figure. It should be noted that by April 2014 the personal allowance will have increased by 54% since 2010/11 ((£6,475). By April 2014, 2.7 million low income individuals will be lifted out of income tax altogether. In Northern Ireland, the tax change will benefit 618,000 people and lift another 7,000 out of income tax *(but not National Insurance!)* altogether. Overall, changes to the personal allowance will have taken 75,000 people out of income tax in Northern Ireland.

New tax-free childcare scheme - 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. This will be the equivalent to basic tax relief (20%) on childcare costs of up to £6,000 p.a. All households in which both parents work, but do not receive support through tax credits will be eligible, providing neither parent does not earn over £150,000 p.a. However, they will have to wait until autumn 2015 for that one. This will help 80,000 families in Northern Ireland with 130,000 children aged under 12.

September fuel duty rise shelved - The Government has cancelled the 1.89 pence rise in fuel duty planned for September 2013. This now means that fuel duty has been frozen for nearly three and half years. Or as the Budget flags, the longest duty freeze for over 20 years. There is still one further rise planned *(which dates back to the previous government)* for September 2014 *(previously April 2014)*. The cancellation of the fuel duty rise planned for September 2013 will save the typical Northern Ireland motorist £25 per year. Cancelling the duty rise will save Northern Ireland van drivers and hauliers around £50 and £750 per annum respectively. Whilst today's announcement is welcome it must be put in the context of where petrol prices currently are. The oil price has been stronger than the Chancellor had previously anticipated. This is due to the international price of oil and the weakness of sterling. It is also worth noting that Northern Ireland has the highest petrol prices within the UK.





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Housing measures – A raft of measures were announced with a view to stimulating demand within the housing market. These include the government providing a mortgage guarantee for lenders who offer mortgages to people with a deposit of between 5% to 20% of the value of a home up to £600,000. Clearly this applies to both first-time buyers and home movers.

Public sector pay – Public sector pay *(excluding annual increments)* will be limited to an average of up to 1%. Significantly, however, the Chancellor signalled that further savings would be required by reforming pay progression. This will effectively act as a brake on public sector pay growth going forward.

Richard Ramsey
20 March 2013

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