North's public-sector pay bill the new elephant in the room

Contact: Richard Ramsey
Group Economics
02890 276354 or 07881 930955

richard.ramsey@ulsterbankcm.com

www.ulsterbank.com/economics

Article appeared in the Irish News on 6 October 2009

In July 1957, Harold Macmillan famously remarked that *"most of our people have never had it so good".* In July 2007, some 50 years later, those words were as applicable to the people of NI. The only problem was we didn't realise it. NI was on the crest of a wave, having experienced simultaneous booms on a number of fronts such as property, employment and public expenditure.

The north's property market experienced a bubble, resulting in the region experiencing the UK's biggest house-price correction on record. Similarly, major improvements in the labour market were unsustainable. Unemployment hit a record low in 2007 due to what we now know were freak economic conditions. Since then, the labour market has undergone a significant correction.

The property and labour markets were not the only ones that had never had it so good. Public expenditure growth was booming and Northern Ireland was benefiting more than any other UK region in this respect. However, while the north's property and labour markets have undergone significant corrections to date, the public expenditure bubble has yet to burst.

As with the property boom, similar factors were at play with the UK public expenditure bubble. Gordon Brown believed that he had brought an end to boom and bust. This fuelled an expectation that economic growth could only go up and therefore so too would future government revenues. The UK's, and ultimately Northern Ireland's, future public expenditure plans were based on this premise. However, with the UK experiencing a recession on a par with the 1980s, the public expenditure outlook has been radically altered.

Last week the Independent Review into Economic Policy (IREP) restated that the north's widening productivity gap, within the private sector, is the biggest challenge facing the economy. However, within the context of the worst set of UK public finances on record, the public sector productivity challenge has rocketed up the political and economic agenda in Britain, and more recently in Northern Ireland.

Talking about public expenditure cuts had been taboo until relatively recently, but this is now being freely discussed at both Northern Ireland & UK levels. Indeed, the Finance Minister has stated that cuts totalling some £370m have to be made by Christmas. These short-term public expenditure pressures will be compounded by further reductions in public spending from 2011 onwards. It is vital for all stakeholders in the economy to appreciate the seriousness of the current UK fiscal problem and how this will impact at a local level. Managing expectations will be crucial in paving the way for some difficult, unpopular but unavoidable decisions.

While the vast majority of citizens are well versed in our local politics, they have much less understanding of public finances. Arguably, this has fuelled unrealistic expectations of what Northern Ireland can afford and how far current revenues can be stretched. As a result, the local electorate is ill prepared for the sizeable public expenditure correction that will occur.

A first step in addressing this could be greater transparency regarding expenditures and revenues. The Scottish Administration, for example, produces a set of public sector accounts providing details of all the revenues and expenditures relating to the region. And the annual Government Expenditure and Revenues Scotland (GERS) report estimates the annual fiscal deficit.

A similar exercise would be useful in Northern Ireland, which has the largest fiscal deficit of all the UK regions, due to lower revenues and higher expenditure. At a time when the UK is facing a record fiscal deficit of 13% of GDP, it should be remembered that NI receives an annual subvention of around £7 billion to balance its annual deficit. This works out at twice the deficit of the UK as a whole, at 25% - and, this figure actually underestimates NI's true fiscal deficit by a number of billions.

More transparency with Northern Ireland's public finances would facilitate a greater understanding by the public of the challenges the economy faces. Ultimately if this message is communicated well, this will make it easier to sell difficult but unavoidable decisions.

It is now widely accepted by experts that it is not a question of if there will be cuts but rather what size will they be. In the short-term, the Executive has to navigate its way through current pressures which include the water charges subsidy (£240m per annum), an NICS back pay claim (@£200m) and a capital receipts shortfall running into several hundred million. These are some but by no means all of the current expenditure pressures.

Looking further ahead, it is clear that NI is about to experience its biggest public expenditure correction on record. The scale will be greatly influenced by whether UK health expenditure is protected or not. According to recent estimates from ERINI, which incorporates forecasts by the Institute of Fiscal Studies, Northern Ireland will face sizeable cuts when UK cuts are translated through the population-based Barnett formula. If Health expenditure is protected, and held constant in real terms, Northern Ireland is expected to experience cuts of £560m. Alternatively, if all Departmental expenditure, including health is held flat in cash terms, this will reduce the Executive's Departmental spending by £730m over the period 2011-2014. Such a reduction is almost equivalent to eliminating the 2010/11 budgets of the Office of the First & Deputy First Minister, the Department of Finance & Personnel, Department of Culture Arts & Leisure and the Department of Agriculture & Rural Development.

In the short term, capital budgets are likely to bear the brunt of the initial cuts. However, current expenditure levels, which include wages and salaries, will not escape the cuts. In 2007, Northern Ireland's house price growth was the elephant in the room that no one dared talk about. In recent years, the other elephant in the room has been public sector pay and conditions. However, there is now growing debate over the numbers and remuneration of public-sector workers in the UK and RoI economies. Indeed, a recent study by the RoI's think tank, the ESRI, published a study which highlighted that public sector wages in 2006 were some 22% above the private sector average, when adjusted for skills and age. Public finance pressures have forced the RoI Government into a proactive approach in addressing this imbalance with the introduction of pension levies for public sector workers.

In Northern Ireland, the wage premium is even more marked at 25% and this does not include favourable public sector pension provision. Indeed, NI currently enjoys the largest public sector wage premium of all the UK regions. In this regard, whilst private sector workers have already borne the brunt of a significant labour market correction, public sector workers, by comparison, continue to have it relatively good.

However, whilst the labour market and property corrections were, with the benefit of hindsight, inevitable, it's very hard to envisage a scenario where the public sector wage premium does not also have to fall into line with Northern Ireland's economic fundamentals. Indeed, many are now arguing that such an outcome is essential.

Richard Ramsey
05 October 2009