Outlook: Spring 2014

Northern Ireland
Centre for Economic Policy

Will the recovery last?

Since the last NICEP Outlook in Winter 2013, the economic news has been almost universally positive. The labour market has been improving, UK economic growth accelerated to 1.8% in 2013 and all measures of business and consumer confidence have increased. Following these improvements, the 2014 UK growth forecast has been revised upwards to 3.3%, which would be the fastest rate of growth recorded since 2007 and above the OBR forecast of 2.7%. Northern Ireland's economic growth is forecast to accelerate to 2.8% this year, an encouraging rise but still lower than the UK rate.

The short term outlook is positive, but the NICEP medium term forecast is more cautious. In particular, interest rates are almost certain to rise during 2015 (if not sooner) and further UK Government fiscal restraint is likely to follow the 2015 Westminster General Election. This will have the effect of constraining expenditure by both the consumer and Government, the two largest spending groups in the economy. Lower Government expenditure would be a particular issue in Northern Ireland where the business base is of an insufficient scale to fully offset reductions in public sector spending.

Job growth beginning to gather momentum

Northern Ireland has trailed the UK labour market recovery, but over the last 18 months the local economy has enjoyed accelerating jobs growth. This recovery has been broadly based and since 2012, 11 out of the 19 industry sectors showed an increase in employee jobs. NICEP forecasts 13,600 net new jobs in 2014 followed by a further 9,600 in 2015. Thereafter, increased pressure on consumer and Government spending will likely exert downward pressure on job creation. Consequently, longer term economic growth can only be maintained if business investment and trade performance accelerate at a sufficient pace to offset the spending reductions elsewhere.

Key forecasts

United Kingdom

	2014	2015	2016	2017	2018
GVA[1] growth rate	3.3%	3.3%	3.0%	2.2%	1.9%
Unemployment rate[2]	3.3%	3.0%	2.9%	2.8%	2.8%
Employment growth	1.6%	1.1%	0.8%	0.8%	0.4%
House price growth	4.6%	9.6%	8.4%	8.0%	7.0%
Base rates	0.5%	1.0%	1.8%	2.0%	2.0%
Inflation (CPI %)	1.7%	1.5%	1.1%	1.1%	1.3%
World trade growth	4.5%	5.7%	5.6%	5.4%	5.2%

Northern Ireland

	2014	2015	2016	2017	2018
GVA[1] growth rate	2.8%	2.9%	2.6%	1.8%	1.5%
Unemployment rate[2]	5.4%	4.9%	4.4%	3.7%	3.6%
Employment growth	1.7%	1.2%	0.8%	0.9%	0.4%
House price growth	6.7%	8.5%	8.4%	8.0%	7.0%

Note 1: Gross Value Added (GVA) is the preferred method of measuring economic activity. It is similar to Gross Domestic Product (GDP) but excludes the impact of taxes and subsidies (most notably VAT).
Note 2: Claimant count rate as a % of 16 – 64 population

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In this Edition

- **Sustainability of the recovery:** as economic recovery gains traction, economists are now seeking to determine if this recovery is sustainable or just another false dawn. This edition explores the factors driving recent growth and those needed to sustain growth in the longer term.
- **The Northern Ireland fiscal deficit – supporting the need for reform:** in most countries there is a lively debate about the need to manage budget deficits. This is a central theme of the UK Government's economic strategy, but this is not often considered in a Northern Ireland context. This edition examines some of the reasons why the scale of the Northern Ireland fiscal deficit is such that the Assembly must embrace reform of our local public services.
- **Growing our Knowledge Economy:** a bright spark in the economic landscape is the growth of the local Knowledge Economy. NICEP has been working with NISP Connect to monitor progress and this edition sets out the initial results of the work undertaken.

Sustainability of the recovery

Consumers lead the way
An improving local labour market is increasing consumer confidence and this is driving the current phase of economic recovery. Employment numbers have been rising since 2012 thereby increasing the amount of money in the economy and giving many an increased sense of job security.

House prices are finally increasing again and transaction volumes are on the rise. Taken together, this will act as a catalyst for growth in the Construction sector and lift confidence in the economy more generally. Northern Ireland is now seeing an increase in the number of mortgage offers being made and the turning point in the housing market has now been passed (as we forecast in our last Outlook).

The central risk to the NICEP medium term outlook remains the consumer's ability to continue driving growth. Although pay rises are beginning to align with inflation, there is no evidence in the data indicating real wage growth across the public and private sectors as a whole. Furthermore, whilst consumer debt has fallen from its pre-recession peak, it remains high by historic levels and is increasing again. Combining these factors with an interest rate environment which is certain to increase in the medium term, it is difficult to see longevity in a consumer-led recovery.

Business growth needed to lock in the recovery
Interestingly, at a national level, increased business investment was the anticipated catalyst for economic recovery rather than rising consumer spending. The investment and export/trade led recovery, evident in countries such as Germany, has been missing in the UK. The large multi-national corporates have retained significant cash balances over the last number of years and have not significantly increased their levels of investment. The primary reason for this is a lack of confidence in their customer base (why build a factory to make more goods, if you are not sure your customers will buy them?). Therefore the return in consumer confidence levels may now create the environment for increased business investment moving forward.

If the UK Government remains committed to further reductions in public sector spending, as looks likely, then the 'baton of recovery' must be taken on by the business sector if economic growth is to be sustainable. The uncertainty around future business investment levels and trade performance has resulted in NICEP forecasting a recovery that 'runs out of steam'. In contrast, most economic models assume an economy that returns to its long term growth trend within a defined period of time with consumer expenditure continuing to contribute positively to growth.

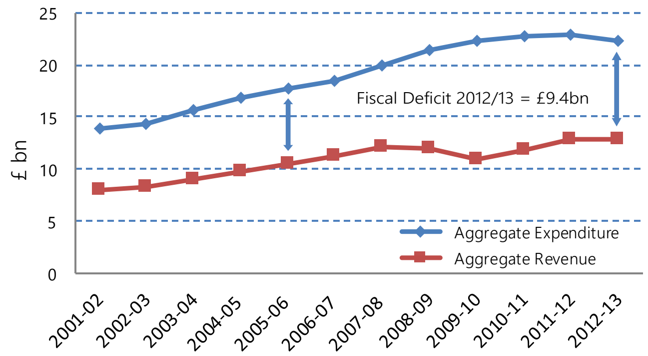
The NICEP forecast also has important political implications for Northern Ireland. It is likely that the forthcoming Programme for Government (PfG) could be drafted at a time when the short term economic outlook is strong but, if attention is not paid to the potential risks identified, the PfG priorities and targets could be misaligned from the economic reality which may follow.

It may seem pessimistic to be warning of longer term risks just as an improved economic forecast is being made for 2014, but with potential economic challenges already visible on the horizon, it is important that both businesses and Government develop the appropriate strategies and economic policy plans.

The Northern Ireland fiscal deficit – supporting the need for reform

A fiscal deficit represents the amount by which Government expenditure exceeds tax receipts in any given year. Until recently this has only been calculated at a national level, however in the last few months both HM Treasury (HMT) and HM Revenue and Customs (HMRC) have published information on tax receipts and Government expenditure in Northern Ireland as well as each of the other devolved regions). Using this information NICEP has estimated the Northern Ireland fiscal deficit for 2012/13 at circa £9.4 billion, or approximately one third of GVA. Whilst Northern Ireland is not required to 'finance' this deficit, it is a vulnerable position for an economy to be reliant on Great Britain to maintain its standard of living to this extent.

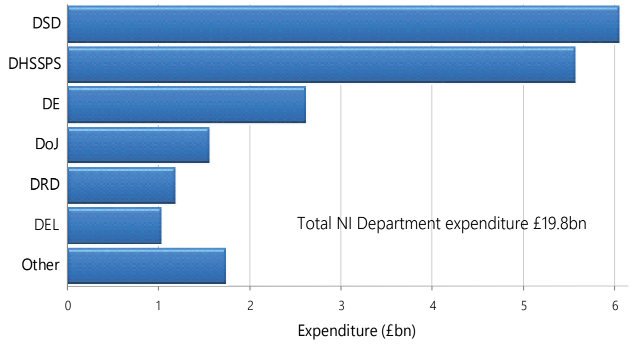
Northern Ireland's Fiscal Position[2]



Source: HMT, HMRC and NICEP analysis

To set the current deficit in context, it is approximately equivalent to the entire GVA of the Manufacturing, Construction and Wholesale & Retail sectors combined. Or put another way, if Northern Ireland had to pay for its own public services out of its tax base it could only afford to fund activities equivalent to the budget of Social Development, Education and Justice.

Northern Ireland Projected Expenditure by Department 2012/13

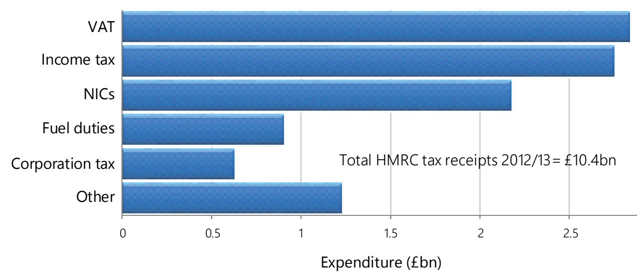


Source: NI Executive

Note 1: This represents expenditure by Northern Ireland Departments only. The UK Government also allocates expenditure across the regions on items such as Defence, Foreign Affairs and the Monarchy These additional items have been excluded from the analysis.
Note 2: 'Other' includes: DFP, DETI, DARD, DCAL, DoE and OFMDFM.

The detailed breakdown of receipts across taxation type is also relevant to the debate on the devolution of Corporation Tax. This decision is scheduled to be taken after the Scottish independence referendum in September 2014. The 2012/13 Treasury estimate of Northern Ireland generated Corporation Tax is £476 million (a further £137 million of receipts from offshore sources, most notably North Sea Oil, is allocated to NI on a per capita basis). Therefore on the basis of a UK Corporation Tax rate of 20% in 2015 (the year in which power would be devolved), a reduction to the Republic of Ireland rate of 12.5% would incur a cost of approximately £180 million. Importantly, the full cost would likely be higher because of charges for the administration and monitoring of a separate tax regime along with other considerations such as the impact of transfer pricing. However, the scale of this additional 'cost' remains a contentious issue.

Northern Ireland HMRC Tax Receipts 2012/13



Source: HMRC

Is it really a deficit?
There is a strong view that the net transfer from Westminster to Stormont should not be considered as a deficit, because there is no requirement for Northern Ireland to 'balance the books' or to finance the annual shortfall. It is also argued that the large deficit reflects a greater 'need' in Northern Ireland and that in any fiscal union, transfers across regions are normal. In return for a fiscal transfer, less prosperous regions provide a range of goods and services that could not be provided efficiently in higher cost locations, such as agricultural produce and the provision of administration services (e.g. call centres). Furthermore, highly trained labour is supplied by all regions which then migrates to wealthier areas for employment, for example, many young people are educated in Northern Ireland and then move to work in London.

However, if we wish to reduce our dependency on Westminster, understanding the scale of the deficit is the first step in addressing the issue and delivering a stronger economy in future.

Does the current funding arrangement stifle reform?
The scale of public funding from Westminster to Stormont also potentially creates perverse incentives in terms of policy making. In particular, it can have the effect of supporting the status quo and counter efforts to reform. For example, the payment of social security benefits is demand driven with no direct impact on local budgets, as a result the Northern Ireland Assembly may have a social incentive to reduce the number of people on welfare but the fiscal incentive is limited.

Time for a mature debate about reform
Analysis of the scale of the deficit focuses the mind or at least it should). Conversations about welfare reform, public sector service reform or public sector pay and conditions cannot and should not be avoided. It is recognised that many reforms are unpopular, but the economic balance sheet is such that Northern Ireland cannot continue to ignore these issues.

The current experience of welfare reform sets a worrying precedent in terms of Northern Ireland's inability

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[1]*The Department of Finance and Personnel (DFP) has also undertaken analysis of the Northern Ireland fiscal deficit. Although the DFP work was not completed at the time of publication, NICEP has consulted with the Department and understands their estimate is broadly similar.*

[2]*Aggregate Expenditure includes both expenditure through NI Departments plus a share of national expenditure on items such as Defence and Foreign Affairs. Similarly, Aggregate Revenue includes both locally generated revenues plus a share of national receipts on items such as North Sea Oil. The chart is expressed in nominal terms.*

to implement a new programme or to develop an appropriate alternative. Clearly, any reduction in the level of funding coming into Northern Ireland (whether that is wages, benefits or an HMT financial penalty) has an economic impact. However, failure to reach agreement on a key policy initiative raises concerns about Northern Ireland's ability to implement other reforms, whether they are imposed by Westminster or developed locally.

It is in this context that NICEP welcomes DFP's work in understanding the local fiscal position and more importantly the reform agenda being taken forward in several Government Departments. Reform cannot be considered as a pejorative term that triggers political gridlock, but rather embraced as a key part of the journey towards a more successful and fiscally sustainable economy.

Growing our Knowledge Economy - in partnership with NISPCONNECT

The Knowledge Economy is an important and growing component of the local economy, within which companies invest in research, development, skills, innovation, creativity and sales and marketing. Recent announcements such as the Research & Development investment made by Automated Intelligence, SiSaf's development of highly efficient drug delivery systems and the innovative work undertaken by Wrightbus in the development of composites and propulsion systems for their buses are just a snapshot of the exciting work that is taking place within the Knowledge Economy in Northern Ireland.

Over the last year NICEP has been working closely with NISP Connect and Oxford Economics to track the progress of the sector, develop a composite Knowledge Economy Index and encourage the development of policies that will help to grow this sector.

The Knowledge Economy includes a broad range of sectors including:

- IT services and telecommunications;
- Creative content and digital media;
- Computing and advanced electronics;
- Software and digital content;
- Pharmaceuticals, biotechnology and medical devices; and
- Aerospace and other transport equipment.

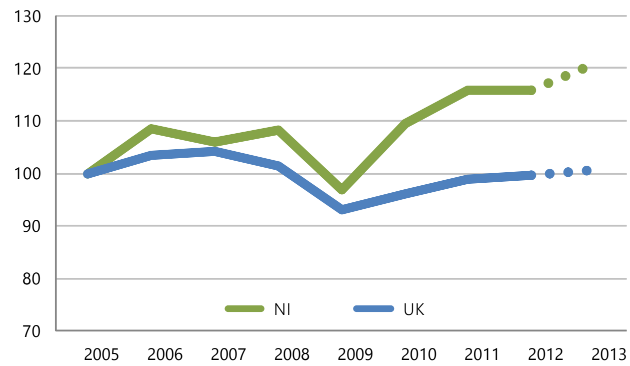
The Knowledge Economy Index (KEI) tracks progress across a total of 21 indicators which are grouped under four broad themes:

- levels of employment, wages and business stock;
- investment activity;
- research & development activity; and
- innovation and patent activity.

The index acts as a barometer of the health of the sector and in recent years has been moving in a positive direction. In 2013, fourteen of the twenty one indicators monitored registered an increase on the previous year, which is a laudable performance in a challenging macroeconomic environment.

The chart below shows the improvements made in the Northern Ireland Knowledge Economy against UK performance particularly in the last four years.

Northern Ireland Knowledge Economy Index (2005 = 100)



Source: NISP Connect and NICEP

The major driving factors behind this recent growth are:

- Business starts;
- Private equity and Venture Capital investments;
- Market capitalisation of PLCs; and
- The number of patent applications filed and granted.

These four specific areas have all grown by more than thirty per cent between 2009 and 2012. The analysis therefore shows that the Northern Ireland Knowledge Economy is becoming a more significant component of the overall economy.

A major challenge remains however, because despite the improvements recorded in recent years, comparisons show that Northern Ireland is still ranked tenth across the twelve UK regions and would need to double in size across a wide range of indicators to match the UK average.

Meeting this challenge must be set against an economic development context where all UK regions are striving to grow their own Knowledge Economy. The conclusion therefore must be that a concerted effort is needed from relevant players in the sector including local entrepreneurs, the research community, Government Departments, economic development agencies and advisory bodies to identify and grasp the opportunities available. To that end, NICEP will be working with NISP Connect and Oxford Economics over the next two years to track this progress and work with the sector and policy makers to maintain and boost the momentum achieved in recent years.

The detailed Knowledge Economy Index research report is published on the NICEP website: www.business.ulster.ac.uk/nicep

Northern Ireland sectoral outlook

Production and Manufacturing

The manufacturing sector has continued its recent upturn and employment levels are at their highest since early 2009. External sales to GB are performing well, with the latest DETI Manufacturing Sales Export Survey showing an increase of 6.2% (in 2012-2013). However exports (sales outside the UK) were disappointing, recording a fall of 1.2% largely on the back of steep reductions in exports to the European Union.

Construction

The construction sector is finally beginning to enjoy some growth after a very difficult six years in which the workforce fell by over a third. A small increase in employee jobs recorded in Q3 2013 was only the second quarter of employment growth for the sector since December 2007. GVA (i.e. economic activity) for the construction sector is 42% lower in real terms than in 2008 but growth is projected at a healthy 5.6% for 2014. As the housing market improves and levels of business investment increases, employment in the sector will continue to recover.

Private sector services

Whilst private sector services have been the key driver of economic growth in the UK, the sector in Northern Ireland continues to underperform, both in terms of employment levels and overall GVA. Fortunately, moving forward the forecast is positive and recent inward investment announcements suggest this should be reflected in the official data in 2014. The significant growth in administration services reflects a likely increase in the use of agency workers as more employers avail of the flexibility that short term employment contracts offer. Other service sector industries, such as retailing and entertainment will also show growth in response to improved consumer confidence.

Public sector services

Overall employment levels in the public sector have decreased marginally between 2008 and 2013, however within the sector a shift in employment has occurred. Public administration (which includes all elements of the public sector excluding health and education) has recorded a decline of 5,600 jobs and Education has lost a further 2,100, but the Health sector has increased employment levels by 7,300 over the same period. The current UK Government is projecting further spending constraints and this poses a significant risk to the longer term outlook for the Northern Ireland economy as the private sector is not of a sufficient scale to absorb losses on the public sector side.

Sectoral employment actual and forecast ('000s)

Industry:	2008-12 Actual	2013 Actual	2014-18 Forecast
Agriculture	0.8	5.0	2.0
Mining and quarrying	0.0	-0.3	0.1
Manufacturing	-10.8	7.5	3.0
Utilities	-0.5	1.0	0.1
Water supply & waste	0.0	-0.3	0.8
Construction	-25.5	-2.3	3.3
Retail	-12.3	1.0	3.7
Transportation	-0.5	-2.8	2.1
Accommodation	-1.0	1.8	2.4
ICT	-0.8	0.5	2.0
Financial activities	-1.5	0.0	0.7
Real estate	0.5	-0.5	0.5
Professional & scientific	-0.5	-2.3	3.1
Administration services	-4.0	0.3	4.2
Public Admin' & defence	-4.3	-1.3	-3.5
Education	-1.8	-0.3	-0.5
Health	1.5	5.8	2.4
Arts and entertainment	0.8	0.8	1.0
Other services	-0.3	0.0	1.0
Total	**-60.0**	**13.8**	**28.4**

Headline sectoral GVA forecasts (% p.a.)

	2014	2015	2016	2017	2018
Production and Manufacturing	4.5%	4.4%	4.0%	3.1%	2.9%
Construction	5.6%	2.1%	2.1%	1.6%	0.8%
Private sector services	2.3%	3.4%	3.0%	2.2%	2.0%
Public sector services	2.1%	1.6%	1.2%	0.2%	0.0%
Total	**2.8%**	**2.9%**	**2.6%**	**1.8%**	**1.5%**

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Outlining the research agenda

The NICEP research agenda is focused on the strategic economic priorities of the Northern Ireland economy and in consultation with Government, the Centre is taking forward the following research projects in addition to a range of commercial activities, teaching and media work):

- **NICEP Core Model development** – this is being developed to provide the framework and empirical test bed to explore a wide range of policy options and measure impacts. As the development of the model progresses, interest and applications for its use across both the public and private sectors has increased and we look forward to reporting on these in due course.

- **Corporation Tax** – NICEP is updating forecasts of the potential economic impact of a reduction in Corporation Tax in Northern Ireland. This is a priority piece of research given the decision on devolving this power will be taken by the UK Government after the Scottish independence referendum in September 2014. The final outcome of this decision could have significant implications for the Northern Ireland economy and NICEP is pleased to inform this important process.

- **Air Connectivity** – as a peripheral regional economy it is essential that Northern Ireland is well served with air connections nationally and internationally. This review is currently being undertaken in partnership with York Aviation and will explore the economic impact of changes to air fares.

- **Small Business Rate Relief scheme** – this project will evaluate the performance of DFP's Small Business Rate Relief scheme and consider how the scheme may operate in the future. Rates are a vital source of revenue for the NI Executive and a cost to those within the small business base in Northern Ireland. This important research will help to inform the future direction of policy in this area.

- **Knowledge Economy Index (KEI)** – the first stage of the KEI research has been completed as outlined in this edition of the Outlook. Moving forward, the longitudinal nature of the Knowledge Economy research will track progress and NICEP will work with the sector and policy makers to maintain the momentum achieved in recent years.

About NICEP

NICEP is an independent economic research centre focused on producing evidence based research to inform policy development and implementation. It engages with all organisations that have an interest in enhancing the Northern Ireland economy. The Centre's work is relevant to Government, business and the wider general public with the aim of engaging those who may previously have been disengaged from economic debate. In addition, staff from the Centre equip students with practical skills required in the workplace, which complements the existing provision of economics teaching at the University of Ulster.

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