Northern Ireland
Assembly

COMMITTEE FOR FINANCE AND PERSONNEL

OFFICIAL REPORT
(Hansard)

Spending Review and Budget 2011-2015

24 November 2010

NORTHERN IRELAND ASSEMBLY

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Members present for all or part of the proceedings:
Ms Jennifer McCann (Chairperson)
Mr David McNarry (Deputy Chairperson)
Dr Stephen Farry
Mr Paul Frew
Mr Paul Girvan
Mr Simon Hamilton
Mr Daithí McKay
Mr Mitchel McLaughlin
Mr Adrian McQuillan
Mr Declan O'Loan
Ms Dawn Purvis

Witnesses:

Dr Esmond Birnie	) PricewaterhouseCoopers
Dr Graham Brownlow	) Queen's University, Belfast
Mr Colm McCarthy	)University College Dublin

The Chairperson of the Committee for Finance and Personnel (Ms J McCann): I welcome Dr Esmond Birnie from PricewaterhouseCoopers and Dr Graham Brownlow from Queen's University, Belfast. I ask you to make a few opening remarks, after which I will open up the floor for questions.

Dr Esmond Birnie (PricewaterhouseCoopers):
Thank you, Chairperson. The Assembly and Executive face a major challenge but also an opportunity. Ask yourselves what sort of Northern Ireland you wish to see in 10 years' time. Having done so, you can work back to the type of public spending — more, less or better — that you wish to see today. When talking about the future of Northern Ireland and the public sector, we need to focus on three issues: better definition of outcomes; assigning budgets specifically to those outcomes; and working out key performance indicators to track the progress of the public sector and public spending in the delivery of those outcomes.

It is not for me, as one engaged in the private sector, to tell elected representatives what those outcomes should be. However, they need to be informed by reading the record of the Northern Ireland economy from the foundation of the state in 1921. Performance has been disappointing. We have failed to achieve substantial and sustained economic convergence with the UK average, and relative GDP per capita has been stuck for at least three decades at about 80% of the UK average — despite 15 major reviews or Government economic strategies since the mid-1950s.

Therefore, we suggest that the following are likely to be priorities for spending, although it is for you politicians to make the choice: increasing productivity, particularly in the service sector; promoting foreign direct investment; and improving our transport and energy infrastructure. With special reference to Northern Ireland, we need to lower our dependence on fossil fuels and promote better internal balance east-west of the River Bann, North/South and east-west external links. We should encourage firms to cluster, particularly with respect to innovation; we should develop higher education and health, particularly their economic spin-offs; and encourage a longer productive working life.

The need for leadership and courage is an underlying theme. In England and here, PricewaterhouseCoopers has organised citizens' juries as deliberative research; each jury is a more advanced focus group. In that process, we take people through the challenges of the spending review in an informed way, either at a UK-wide or Northern Ireland level. It may surprise you to hear that when the public are given an explanation of the constraints facing Government, they are often more up for radical, courageous choices than we might expect, particularly on questions such as whether specific areas of public spending should be ring-fenced, welfare reform, and charging for some aspects of service delivery.

As a devolved institution, the Northern Ireland Assembly — and perhaps we should be grateful for this — is not directly under the cosh of the bond markets, in the way that counterparts in other parts of these islands and the continent are at this very moment. Notwithstanding that, the need to strike a Budget is urgent. Last week, Scotland and Wales did their Budgets for 2011-12. Uncertainty of any sort is bad for business. The private sector is appealing for a Budget to be struck as soon as possible, almost regardless of the content.

Dr Graham Brownlow (Queens University, Belfast):
Esmond summarised much of what I was going to say; indeed, I scribbled the word "opportunity" on my notes at the beginning. Despite our very serious problems, this is a moment for opportunity. You must think about the long-term ramifications of your decisions, as they will have major implications for decades.

We must pursue not merely equity but also efficiency. The bad news is that there is an efficiency/equity trade-off — economics is not called the dismal science for nothing. As an academic, my big theme is to look towards the economic evidence; and the good news is that there is evidence that we can avoid the equity/efficiency trade-off by having policies and strategies that reinforce both.

My briefing paper sets out the compelling evidence from the United States that early-years education and a pre-school environment are vital. The damage may already have been done by the time children go to school. Skills are important. When we think about skills, we think about an individual's lifetime earnings. However, if we do the right thing for skills now, we can send a signal to potential investors in the business community that Northern Ireland is open for business. That relates to Esmond's point about the kind of Northern Ireland that we are trying to create.

The essential problem with Northern Ireland is a long-run supply side; that has been the case for decades. I have just finished writing 'Business and Labour since 1945', which will come out next year in the Oxford history series. It is clear from the archival material that the long-run supply side problems are the root cause of Northern Ireland's financial problems. If we could improve the supply side and make people more productive, tax revenue would increase, public services would continue to grow, and there would be greater prosperity for all.

I will go through tax variation in more detail later, but those are main things that I want to say at this stage.

Mr McNarry:

Good morning, Esmond and Graham. Balancing job and wealth creation is some trick. We have to re-scope where we are. What opportunities lie ahead for doing that trick?

Dr Birnie:

That is a very good question. The Programme for Government, which was drawn up in 2008 but which will end soon, has targets for job creation and reducing the private-sector productivity gap between Northern Ireland and Great Britain, minus greater south-east England. You are right, Mr McNarry, that there is a trade-off in the short run. If we get very high-productivity jobs, we will have fewer of them. Economists and others would certainly say that, to ensure the long-run future of the Northern Ireland economy, we should not aim exclusively for low-productivity, low-wage jobs because they are not likely to endure. I am sure that Graham would second that.

I think that your question, more specifically, was what sectors may be capable of development. There are at least two considerations: first, we need to get a sense of what Northern Ireland's economy and businesses have been good at and build on it; secondly, you want a sense of future global growth. Such analysis is very difficult to do well.

One example is renewable energy, particularly heavy engineering related to it. Greater Belfast has several advantages: Harland and Wolff works at the seafront, where there is plenty of spare land; we have the growth of the wind turbine industry, particularly offshore. There are only a limited number of locations across Britain and Ireland where you can conceivably build the blades for an enormous 300ft wind turbine in a seafront dry dock, ship it out to sea and install it.

Harland and Wolff has expertise in that area, and our two universities also have expertise in renewables. I mentioned the idea of developing a cluster of firms that work together, supply one another and share expertise and skilled labour. That is one example, but there may be others.

Mr McNarry:

When I was canvassing last April, a lady came to the door and I was quite pleased that she knew me. She asked me a question, and I would be grateful if you could give me an answer to take back to her, because I am blowed if I can get an answer. She said: “David, what career should I be directing my young son towards?” I asked what age he was, and she said that he was four. That is a monstrous question, which somehow, within the realms of sanity, we have to address. She is obviously looking to the future.

I appreciate what you said about heavy engineering. The decrease in successful manufacturing — notably in light engineering — has greatly affected jobs and skills and the entrepreneurial spirit that lay behind them. Many firms were family firms. It is a bit like farming. The farmer’s son is not keen to go onto the farm nowadays; it seems that the manufacturer’s son is not keen to take on the family firm. What manufacturing projects should we be looking at to attract investment into and to rejuvenate a declining sector?

Dr Birnie:

Manufacturing in Northern Ireland, as part of the western world, will never again be a major employer. Several decades ago, 200,000 people were employed in manufacturing in Northern Ireland, perhaps a third of them in the linen industry; today, total employment in manufacturing is about 80,000 and falling. However, we should not write off manufacturing, which brings us back to the point about productivity. Far fewer people work in factories, but those who do produce a much greater value output per head. That is good, because it helps to underpin wealth across the economy, including the service sector.

On the issue of career choices, I am tempted to say that you should tell your constituent that it is not reasonable to plan for their sons’ or daughters’ future at the age of four.

Mr NcNarry:

We need the votes. *[Laughter.]* You know as well as I do that I cannot say that.

Dr Birnie:

I have children of my own aged six, seven and eight respectively, and, believe it or not, they talk about what they want to do when they grow up.

The labour market changes frequently, and the history of governments doing what used to be called, in non-pc terms, manpower planning — human resource planning, as it is now — has not been terribly good. However, there are some pointers in the Northern Ireland economy. The two most relevant Departments, the Department for Employment and Learning and the Department of Education, produced a new careers strategy about a year and a half ago. That strategy impinges on the issue of working with all the relevant stakeholders, particularly parents, who play a key role in determining what subjects their children study at ages 14 and 15, and if they go on to further study at 17 and 18 and at university.

The science, technology, engineering, mathematics (STEM) strategy was published in the last year to address the problem of A-level and university students not studying mathematics, physics or biochemistry. There is probably a range of deep explanations for that; it may be something to do with performance in mathematics and how it is taught in schools, which goes back even to the early-years stage that Graham referred to. It may also be a cultural thing and the result of a collective bias to the so-called professions. That is not unique to Northern Ireland; it also prevalent in England and the South and means that aspiring parents think that wee Johnny or wee Susie should become a lawyer, a doctor or — dare I say it?— an accountant rather than a mechanical engineer. The important thing is to provide opportunities and good information to parents and young people, and, broadly speaking, the market will probably produce the right outcomes.

Mr McKay:

Esmond, you outlined how renewable forms of energy have great potential here. Therefore, what is your view of the green new deal? Secondly, corporation tax is a big issue. I agree with the point in your paper about lower corporation tax and the potential for us to create a futile race to the bottom. The CBI expressed a view on corporation tax, and its chairman, Terence Brannigan, said that he prefers a rate of 10%. However, there is more to attracting inward investment than the headline corporation tax rate, and we need to look at things in a more holistic way. In the interests of long-term sustainability, should there be an all-island rate of corporation tax rather than North and South continually undercutting each other?

Dr Birnie:

Among other things, the green new deal includes the idea of putting a great deal of investment into upgrading the energy efficiency of homes in the private and public sectors. In principle, that is a good idea. It will deal with immediate unemployment in the construction sector, and we will end up with a socially useful addition to our capital housing stock with buildings that are more fuel efficient.

It is good for the individuals, in that such housing reduces reduce fuel poverty.

As with all such things, the challenge is how to pay for the upfront cost, which could be considerable. There may be ways of doing that by spreading the cost over a number of years rather than facing it upfront. However, in principle, green new deals should be given serious consideration, particularly in the current context of rising unemployment and Northern Ireland's traditional problems of depending on fossil fuel imports and not being particularly efficient at heating buildings.

Your second point, Mr McKay, was about corporation tax. PwC, the firm of which I am a member, has given evidence, along with others, to the current inquiry of the Westminster Northern Ireland Affairs Committee. Our position is that we do not believe that a reduction in the headline rate would be a panacea or silver bullet that would simply resolve everything overnight and result in the kind of performance in respect of foreign direct investment that the Irish Republic enjoyed for many years. Even in the current crisis, the Irish Republic still receives a disproportionate amount of the foreign direct investment that comes into Europe.

What the rate should be is a secondary issue. Obviously, it would be nice to have a lower rate, but it must be part of a much broader package. What the Republic has been very good at, particularly in recent years, is the provision of tax credits and allowances to encourage intellectual property. In other words, it encouraged people to patent new products, ideas or processes in Dublin as opposed to in California, Germany, Japan or South Korea. There have also been tax credits to encourage R&D. In the context of the paper that we await from the London Government on the enterprise zone and rebalancing the economy, I would like to see serious thought given to those sorts of powers. The question of whether the rate of corporation tax should be 12·5%, or 10% to make it slightly lower than the Southern Irish rate, would become somewhat secondary.

A couple of percentage points will not necessarily make that much impact on business. There would be a psychological effect, and you must make a political judgement on whether it is more important for Northern Ireland, given its current situation, to shine a beacon around the world saying that it is highly competitive and even more competitive than Southern Ireland, where Americans, Germans, and so forth, traditionally tended to put their plants, or simply to match the Republic's rate. Who knows? Notwithstanding all the denials, the fallout from the bailout could be that harmonisation occurs in the opposite direction should the Dublin Government be forced to increase their rate from 12·5% up towards 20%, which would bring it closer to the rate in Northern Ireland.

Dr Brownlow:

I return to the theme of academic evidence. I do not know whether the Committee has seen the evidence on corporation tax that the independent expert group for the Scottish Calman Commission examined. That evidence is overwhelmingly in support of Esmond's position. The evidence on corporation tax is that there are significant compliance costs to begin with, which, I am afraid, certain lobbyists in Northern Ireland have completely assumed away. There are all sorts of implicit assumptions that are fiendishly complicated — people have won Nobel prizes for trying to disentangle how specifically the physical capital is implicit in corporation tax and what the implications of that are. I could bore you with a lecture on confectionery manufacturers, how their physical capital operates and how differential corporation tax would affect the market for chocolate, but I will not put you through such an experience.

Mr McNarry:

Sweeties and politicians seem to go together.

Dr Brownlow:

It is incredibly difficult to model that, and it is also incredibly difficult to see how the assumptions could lead to some of the conclusions that people have suggested. The Economic Reform Group's report contains 10 or 12 pages of explicit empirical assumptions.

Dr Birnie:

The published work is not too lengthy.

Dr Brownlow:

Those are the explicit assumptions. In the report, a raft of implicit assumptions is made in order to come up with conclusions. Also, the payback is over a 20-year period, as is that of the Economic Research Institute of Northern Ireland (ERINI). The idea of crystal-ball gazing over a 20-year period makes that extremely hazardous.

I go back to Mr McNarry's question: economists, as you might have noticed, are not brilliant at crystal-ball gazing, despite the profession's —

Mr McNarry:

You economists are getting a reputation like that of lawyers. One says one thing, and another says another. It depends on who pays the most as to whether they get the right answer.

Dr Birnie:

We are not as well rewarded as lawyers.

Dr Brownlow:

I am an academic, and I am certainly not. I would like to identify three categories: entrepreneurship, products and export markets. All the evidence on entrepreneurship tells us that people's entrepreneurial abilities —I wrote about this when I lived and worked in New Zealand — are determined by incentives. Incentives, institutions and organisations are the rules of the game, if you will. They determine whether people become entrepreneurs and what kind of entrepreneurs they become. We should not regard entrepreneurship as an amorphous blob. It is far more subtle than that. Entrepreneurship can be socially beneficial or socially detrimental. We do not have to look too far to see socially detrimental entrepreneurship. That is the point to note on incentives. The rules of the game must be made conducive to the social good as well as to private gain.

I echo what Esmond said about picking winners when it comes to differential products. The record of picking winners is disastrously bad. However, we are able to say that certain trends in western economies will not be reversed. The ageing of the population is one such trend, and the shift towards environmental awareness is another. We should start with what we know, which is that western societies will become older, and they will have all the needs associated with that. By western societies, I mean the Organisation for Economic Co-operation and Development (OECD) economies, and so I include South Korea, Japan, New Zealand and Australia. From the economics of healthcare, we know that, as societies get older, the cost per patient rises. In other words, there is an increased need for medical technology, and there are pharmaceutical opportunities. If I had to pick a business in which to invest over the next 20 or 30 years, pharmaceuticals would be as good a bet as any. The environmental technology issue is as Esmond described. Those are the differential products.

On the subject of differential markets, one of the places where I plied my trade of teaching economics is China. The big opportunities are to be found in the BRIC economies: Brazil, Russia, India and China. I will give the Committee one statistic to show why. About a month ago, I attended a seminar in Queen's University when the Chinese Minister of Commerce at the Chinese Embassy in London was visiting. In the next 20 years, it is forecast that 300 million people will migrate within China's borders. That is a huge number of people moving from the west of the country to the east coast of China. They will need schools, airports, and so on. The list is endless. There are huge construction possibilities, and the huge possibilities that exist in China can be replicated when it comes to Brazil, Russia and India. There will be huge opportunities in the world economy.

I wish to make a historical point: the Ulster and Irish economy thrived best during what economists call the first era of globalisation. From 1871, when Germany's Zollverein, or modern Germany, was created, to the First World War, the major employers of modern day Northern Ireland thrived. If we are to have another era in which our economy thrives, we must move to an export orientation, and it is as good a bet as any other to think about high-growth economies over the next 20 years to 30 years.

Happily, I will never run for office, but if I were to tell your constituent anything —

Mr McNarry:
I will give you her phone number if you want.

Dr Brownlow:
No thanks. I would tell your constituent that she should, perhaps, be studying Mandarin.

Mr McNarry:
Perhaps we should all study Mandarin.

Mr Frew:
Better still, you could give her Graham's number.

Mr McNarry:
That would be far better than saying: "The number 53 with fried rice".

Mr McKay:
I want to tease out one point that Graham made in the paper about economic advice. He criticised the way in which that advice is developed and said that it is far from transparent. How should that issue be addressed?

Dr Brownlow:
Many of my comments arise from the fact that, although the Independent Review of Economic Policy 2009 had a very narrow remit, in that it reviewed only Invest NI and the Department of Enterprise, Trade and Investment, it made many extremely pertinent, germane points about the joining-up of economic policy throughout government. My comments were, therefore, based partly on that review and partly on my experience. I worked in the Government Economic Service (GES) in London, which is attached to the Treasury. Therefore, I know how the GES

operates in GB relative to here in Northern Ireland. In my three years at Queen's University, I have never once seen an official at one of the academic seminars. That is completely different culturally to what happens at Whitehall, where officials go to the London School of Economics (LSE), Birmingham and all over the shop. That is part of the culture, which is to tap into the brain power, such as it is, in universities, and vice versa. Unusually, however, that culture does not seem to exist in Northern Ireland. It exists in New Zealand and in Dublin. I do not have an explanation for why it does not exist here.

As far as I understand, because it is not transparent, government economists spend an awful lot of time working on evaluations. One of the basic insights of economics is the concept of opportunity cost. In other words, we cannot spend the same pound or the same minute twice. There are opportunity costs of money and time. My point is that I am not sure that such evaluations always make the best use of the time available.

If the longer-term strategic issues of the Northern Irish economy, such as those in the independent review, were more part of the bread and butter of the government's economic competence in Northern Ireland, I think that there would be a better policy framework. As far as I know, no formal mechanisms exist between the two universities and the Department of Finance and Personnel. The Invest NI group, on which both Esmond and I sit, is informal, and government economists are not to the fore of that. Rather, it is very much a place where business and academic economists give their views. The fact that there is no mechanism will be a problem.

Take the example of something as mundane as the website: I went on to the Department of Finance and Personnel website to look at the evaluation materials, and the website is not exactly transparent. Teachers of health economics explain that quality adjusted life years (QALYs) are used to make comparisons between cancer drugs, kidney dialysis, and so on. To make informed decisions, we need a common metric. However, as I do not know what metrics are being used, I cannot give an informed opinion on the wisdom or otherwise of the decisions that are being made. It is simply not transparent, which takes me back to my point on equity and efficiency. It is not enough to be equitable or efficient; rather, we have to be seen being equitable or efficient, and that means transparency. During my research on economic policymaking between 1945 and

1972, I found that a complete lack of transparency led to poor outcomes. More transparency is good because we cannot necessarily always have competition in the public sector. Sometimes we can, and sometimes we cannot, but transparency is a very good substitute for competition. When everything is out in the open, we can all decide on what makes sense and what does not. I hope that that answers the question.

Mr McKay:

I have no more questions, but Graham has made a good point. I propose that the Committee contact the Department on the issue of transparency and to ask how economists in the Department relate to academics, because, if there is a deficit in comparison with other countries internationally, we should at least look at that and see how great the problem is.

The Chairperson:

That issue was brought up at last week's evidence session by Mike Smyth. He said that there does not seem to be any mechanism for giving or receiving advice. We could, perhaps, look into that.

Dr Farry:

I want to reinforce that previous point. This matter goes far beyond the issue of economics and finance; it spans the ambit of policymaking. We have a lack of interaction between academics and policymakers, and we lack the infrastructure of think tanks that are the norm in many other national or regional capitals.

Before we look to the future, I want to go back slightly into the past. Graham and Esmond talked about our historical levels of low productivity relative to elsewhere. At the peak end of the nineteenth century or early twentieth century, were we one of the areas of higher productivity in the UK, or have we always been slightly below the UK average?

Dr Birnie:

Graham is probably a better economic historian that I am. I have dabbled in economic history over the years. Using the GDP per head of the population and living standards as measures had some flaws and were not perfect. In the 1920s, the level of GDP per capita in Northern Ireland was 60% of the UK average. It slumped a little during the great depression and jumped during the Second World War. That might seem surprising, but there is an explanation. There was a huge amount of government spending, employment went up, and Harland and Wolff and the linen industry boomed. However, GDP slumped again from the late 1940s onwards as that wartime boom ended, and it began to grow again, relative to the UK average, only in the 1970s. Again, that seems somewhat counter-intuitive because that was the worst phase of the Troubles. However, partly because of political factors, there was a huge growth in public spending and a push for parity in public services relative to those in Great Britain.

Therefore, the record has been one of a slow creep towards the UK average over the entire history of the state from 1921 onwards. We do not know for sure what the position was in 1900 or 1890, but it looks as though, even though we apparently had successful global exporting firms, the largest shipyard and the largest rope works and tobacco works — people in Belfast know about all that — their productivity was not particularly high compared with companies in America, Germany or even England.

Dr Farry:

I have two fairly broad questions. Graham, in particular, hinted in his remarks at the need for some level of tax-varying powers. I draw a distinction between tax-varying powers in the context of continued fiscal dependency on the UK and in the context of full fiscal autonomy. Is it fair to say that, when we try to address a productivity gap, our Executive are not properly incentivised to look to economic growth because, irrespective of how well or poorly we do, we still receive the same block grant? The determination of the block grant is not linked in any way to how well or otherwise we perform economically. Does that depress the level of innovation in government?

I appreciate fully the need for us to look 10 or 20 years into the future and to ask what we want to do and achieve. However, given our current position of having to strike the Budget for the next four years, and accepting that we are not simply asking ourselves how to make cuts most sensibly, but what we want to do during the next four years and using whatever resources are available to best effect, where are the major inefficiencies that we must tackle, and in which priorities must we invest? In essence, what key recommendations do you want to make today on what we should do differently to cope with the short-term and medium-term challenges?

Dr Brownlow:

I will kick off on that. It is only during recent research that I have begun to crystallise my thoughts on productivity. The essential point that explains the problem is the Schumpeterian notion of creative destruction. Schumpeter's point was that part of economic progress is that old industries and firms disappear as new firms appear and reappear. For a long time, that was extremely out of fashion because of the rise of Keynesianism. Its being out of fashion led to a misdiagnosis in economic policymaking in Northern Ireland, certainly after 1945. The misdiagnosis was to identify Northern Ireland's problem as that of declining industries. Of course, the problem was not that of declining industries; it was that new industries were not emerging. That was the misdiagnosis. When industries were created, which occurred late in the day for reasons that are far too esoteric for me to go into now, they produced synthetic fibres. We were what Americans would call, "Monday morning quarterbacks": we were wise after the event. Therefore, my general analysis is that we must understand that raising productivity will not be comfortable. I return to the point that I made earlier: economics is the dismal science, because it requires you to say things that will not win you any votes on the doorsteps.

It is pretty clear that, for the understandable reasons that Esmond mentioned, we have had policies that focused on equity to the detriment of efficiency and on stability to the detriment of flexibility. If we are to move forward on productivity, we must be honest with ourselves about the education system and about where we stand as a society. We must admit that ours is a classic low-wage, low-skill, low-productivity economy. In going forward, therefore, there will be problems, many of which are long-standing, and it will take a long time to put them right. In the meantime, there are things that we can do as Northern Ireland plc, and as the Assembly and the Executive, to signal to investors that we are serious about recognising that problem and doing something about it.

In a recent PwC report, Esmond made the point that there is no shortage of reports on your shelves. I have loads of old reports on my shelf, some of which are fine and others not so fine. However, that is another issue. The common denominator is the lack of implementation. That is a recurring theme. The first report sat on the shelf for two years before it was even published. Nothing was done for two years. There has been a culture, for want of a better word, of regarding a report as an end in itself — something pretty that can be stuck on a shelf. If you study Korea and how it goes about economic policymaking, you will see that engineers run the show and get things done.

Dr Farry:

China's past three or four leaders were all engineers. Engineering is the path to political power in China.

Dr Brownlow:

Does that answer your question?

Dr Farry:

Yes, to an extent. I am putting you on the spot now, Graham: what do we need to in the current Budget round?

Dr Brownlow:

As I am an academic economist, I do not have to be politically popular. You must signal to the electorate that you are serious about turning the economy round. A tax on mobile texts would be relatively painless and send out a good signal. Water charging is more controversial. The message that is being sent out is that the people of Northern Ireland are not supposed to pay for anything. The introduction of water charging would be a good signal. Any tax variation must start gradually. In that way, the Assembly and the Civil Service will learn and build up their confidence and develop that over a year. It is, I am afraid, inevitable that the cuts will balance the books in the short term. In the long term, we must think about tax variation to raise revenue.

I need much more information about exactly where the cuts are supposed to be made. The CBI has some interesting ideas. Other ideas, such as cutting public and school transport in rural areas are not necessarily sensible. That does not seem to make economic sense, because it would lead to traffic congestion, and time is money. Therefore, the businesspeople who, today, want rural public transport to be cut are the very people who, tomorrow, will say that their time to travel to work has increased at a cost to their business. I would need to examine a whole raft of issues in more detail than I have at my disposal.

Dr Birnie:

I will try to add to what Graham said in answer to Mr Farry. I have two general points about setting priorities. Later this morning, the Committee will hear evidence from Colm McCarthy from Dublin. The so-called special group on public sector numbers and expenditure is a holistic approach that is taken by independent economic experts who are considering the entire range of public spending and programmes, and so forth. That is something to which the Committee should give strong consideration. To me, looking at it from the outside, it seems that the experience in Dublin was that the Government did not accept all of the McCarthy report recommendations. However, the process was a valuable discipline, and it gathered information. That is one thing that I would say about setting priorities for the Budget for next year and even, perhaps, for the next four years.

A broad approach must be adopted to getting the most from the public spending that is available. We must try to ensure that we achieve desirable outcomes. Increasingly, that will require looking across Departments and agencies rather than taking — I know that it is a cliché — the silo approach. So many of the pressing social problems, such as crime and antisocial behaviour, alcoholism and mental health problems, which prove to be immensely damaging to society and, in the long run, immensely costly, are cross-cutting problems and, therefore, involve a range of agencies and Departments. We must try to take a holistic approach to those problems and, as a starting point, to benchmark how much money is being spent on issues such as alcohol abuse, mental health and early years education. When we know the total amount of money in all of the departmental pots, we should try better to join up that spending to achieve a better outcome.

Moreover, because so many of those problems develop over a lifecycle, we need to ensure that Government intervention occurs at the preventative stage rather than at the picking-up-the-pieces stage when so much of the human tragedy and harm has already been done and so much of the cost has been felt. For example, prevent people from getting into crime rather than spend immense amounts on keeping them in prison. If you can prevent criminal behaviour at the start of the life cycle process, the result is much better financially and is much more socially desirable.

The Chairperson:

It has come up in the Committee before that there is no measurement of the social outcomes of public services to determine whether they are working holistically.

Dr Birnie:

That is true. Estimates show that the return on the investment in preventing an adolescent from embarking on a life of crime and antisocial behaviour is enormous; whereas the cost of holding somebody in prison is about £80,000 a year.

The Chairperson:

The issue is not just the cost of people being in prison; there are health and other problems that people experience in later life.

Dr Birnie:

I agree.

Dr Brownlow:

Work to apply the quality adjusted life years (QALYs) health economic framework to the issue of crime, particularly violent crime, is at an early stage. Graham Loomes from the University of Warwick, who has just been made a fellow of the British Academy, has pioneered that work, although, as I say, it is at an early stage.

Mr O'Loan:

I agree that this is a time of potential opportunity, despite the difficulties; however, the issue is how we address it.

I want to ask about two areas in the economic arena that you touched on. I was very taken by your statement that we have had 15 major economic reviews but are still, essentially, in the same place. The business environment here seems in some ways very dynamic. You may know better than I the number of start-ups here compared with other places, but, on the face of it, there are many people with entrepreneurial instinct. Yet we do not grow or become as efficient as we need to.

There seems to be a glass ceiling, but what are its main causes? Why do our businesses not spontaneously take off? Is that, to any degree, due to regional inevitability related to the British Government's economic policy or to natural market forces? In any large nation, there will be a central point: the south-east of England is very wealthy, which condemns regions to being relatively poor. It also has to do with a lack of political direction, although I do not know whether you want to enter that arena.

Graham, you referred to "long-run supply side", which are big words that I do not fully understand. You talked about productivity. Is that a cause or a symptom?

Dr Brownlow:

I go back to the point that I made about incentives and entrepreneurship; although it is not presented as such, you can even seen that in 'Dragons' Den'. There is a phenomenon of the lifestyle business. That is an idea that economists kicked around in the 1960s to no great effect, but it is a convincing explanation of why, sometimes, you do not see the growth of businesses. People who have target incomes, such as a yacht or a BMW, for instance, might stop growing when they can comfortably maintain that lifestyle, because going to the next level is inherently risky.

Historically, Northern Ireland was a low-house cost society. Grammar schools were a huge middle-class subsidy, because people did not have to pay the huge fees that they would in Richmond in London, for instance. Many factors conspire to make people not ambitious to take their businesses to the next level. That might be part of the story; however, I do not think that it is regionally inevitable.

I will give an example from history. I do not pretend to have the answer to this; perhaps I should knock it around in future research. The textile networks in southern Italy created Benetton, while Northern Ireland, which had a much longer tradition, created linen firms that did nothing comparable to Benetton. That is puzzling. It is also puzzling that Northern Ireland did not develop a chemical industry, considering the chlorine that was used in bleaching linen. I do not have answers to those questions, but they suggest that there is something that is long-run institutional. I think that it is the long-run rules of the game, informal and formal. In other words, there are formal rules, regulations, institutions and laws, and there are cultural and informal norms.

Part of economics is unavoidably cultural. Often, economists do not like that, because we cannot make a nice equation, draw nice little curves that shift and tell students "The curve shifts left." I do not think that it is regionally inevitable to go through that. Is it market forces? Yes, but market forces never act in isolation from institutions and incentives. That is my best first stab.

Dr Birnie:

I agree with Graham. Often a firm founder or entrepreneur reaches a level that satisfies their lifestyle, which further growth may risk. They may lose control of the firm. Perhaps we have a cultural aversion to bringing in wider capital from the outside; our previous industrial policies and heavy grants may be factors. Firms were started; they grew to a certain extent; and, subsequently, the growth petered off, and they remained as small or medium-sized firms. They did not expand further, because they were doing OK.

Hopefully, that grant approach has gone. Moreover, from January of next year to 2013, Northern Ireland faces rules from Brussels with regard to the slashing of the maximum level of state aid that can be given across the European Union for the traditional payment of subsidies to buy machinery and so forth.

Mr O'Loan:

The second area that I want to ask about is corporation tax and, more particularly, foreign direct investment. I hear that the British Government are moving away from corporation tax. Do you know their thinking? How critical is foreign direct investment in breaking through? How will we get there? Peter Gregson at Queen's University suggests that it is very good to get firms to come here. However, another model may be advantageous: partnering arrangements between firms here and international firms and availing of research facilities in universities. Do you see significant potential in that idea?

Dr Birnie:

Foreign direct investment is critical. It is important to encourage indigenous or locally owned firms; however, foreign direct investment can bring sizeable additions to employment relatively quickly, whereas local start-offs can take years or decades to grow.

The traditional criticism of foreign direct investment firms has been that they take grants and stay only a short time. That is sometimes true, but we have to balance that with the fact that here, and in most countries across the western world where statistics are available for multinational firms, there is much higher productivity and much higher wages and salaries. They are more likely to spend on research and development and they are more likely to export. They tick all the boxes.

The joint venture approach could be a way of buying in expertise. Northern Ireland does not do much research and development — 99% of our manufacturing firms do not do research and development. A tiny minority do 90% or more of all research and development here.

The coalition Government are to reduce the corporation tax rate across the UK, including Northern Ireland; in four years' time, it will be reduced from 28% for larger firms to 24%. We are still awaiting the paper from the coalition Government on rebalancing the Northern Ireland economy and their proposals on our regional rate of research and development relative to the UK average.

Mr Girvan:

Thank you for your report. In the Senate Chamber three murals depict the three key industries of Northern Ireland: linen, shipbuilding and agriculture. However, little mention is made in any reports of our agricultural impact, and we do not think outside the box. However, part of the culture of people from Northern Ireland is that we do not necessarily think how we can export.

With regard to our agri-food industry, we hear that we lead the world in processes, but how can we influence globally? We are told that we have one of the best ways of producing milk in the world, and we produce some of the best beef, but we are not capitalising on our natural resources. We may be tied into the European agricultural policy, but we are not making the best use of it. The focus seems to be on the service industry, which does nothing to generate wealth; that is something that we should deal with. Do any reports identify the potential for employment? Could our agri-food industry gain a foothold in the growing markets in China and elsewhere?

Dr Birnie:

I agree with you about food processing and agri-food, which is a significant employer and the largest component of our manufacturing sector. Surely, we must have certain natural advantages, or, as an economist would put it, competitive or comparative advantages. For example, we get a great deal of rain and we have a great deal of grass and can therefore produce dairy and beef products.

It is also significant that during the downturn, from roughly 2008 to the middle of this year, when so many other parts of the manufacturing sector here shed employment, agri-food and food processing remained fairly flat. The sector beat the downturn, and its exporting performance was impressive.

As Mr Girvan hinted in his question, the sector faces many difficulties, one being that we are a small player. So many of our firms in that sector are now part, at the very least, of a supply chain that probably operates across the island. In some cases, firms are linked to Great Britain or have ownership outside the Province, and there has been considerable investment from the Republic. I am not saying that that is necessarily good or bad, as it has advantages, such as bringing in outside capital and managerial expertise. However, those advantages have to be weighed against loss of control. For example, the marketing of a product may not be locally controlled. Whether that is good or bad depends on how well the firm markets the dairy or beef product in question.

The sector has potential, especially when we put it in a global perspective. Graham referred to the Bric economies. As if we do not have enough economic problems to think about, a long-running concern is food security, or, less euphemistically, whether there will be enough food to feed a growing world population. Until the downturn in 2008, global food prices for beef and wheat were rising. That was due partly, as Graham said, to a huge growth in incomes in China and the beginnings of a more affluent lifestyle and diet in parts of east and south Asia. That has a knock-on effect in Europe.

We have been blessed with a climate that is appropriate for many parts of food processing. There are global opportunities. We have the challenges of a relatively small-firm sector. However, some companies are owned by wider firms. In principle, something can certainly be done through that sector. It should continue to grow.

Mr Girvan:

Farmers receive grant aid funding to set land aside, for want of a better way of putting it, in order not to contribute. Grants from the European agricultural policy are having an impact.

I know from my engineering background that many engineering firms were bought over by multinationals that pulled out of Northern Ireland. One of their reasons for pulling out was that they got fed up with red tape and bureaucracy and because of the previous culture in which the unions took control of many firms. That has had a major impact on the engineering industry here. An example is FG Wilson, which trades under its original name but which is globally owned by the Caterpillar group. Kraft Foods has a major involvement in the buying of milk products; however, it has pulled all operations back to its base. If there are problems anywhere in the world, it will protect its home base. Unfortunately, we sold much of our home industry.

We talked about the sweet industry and what is going on with Cadbury. That is another thing that affected our economy and may have a still greater impact on it. We are allowing it to happen. People may be happy that they are getting big pay-outs and are thinking, “I am OK Jack; I can forget about the future.” However, we have sold off the family silver without thinking that we may need it further down the road. We need to re-educate people that wealth is not necessarily what they have today and that we should hold on to what we have and make the best use of it.

Dr Birnie:

I agree. We need balance and a strong, locally owned business sector in manufacturing and in some parts of the service sector. Certain activities in the service sector can be exported, and although financial services are not a good example at the moment, hopefully that sector will recover in due course. Tourism is a service that is provided here, but it will be exported as we increase the number of visitors to Northern Ireland, as we surely will.

Alongside a strong indigenous sector, there is value in having inward investment, but you are right to be realistic: some firms will leave after a relatively short period. There will always be turnover, and it is a constant battle to encourage more firms to come here as well as growing our locally owned firms.

The Chairperson:
I thank the witnesses for their attendance. The Committee will take on board the issue that Daithí raised about asking for information from DFP.

The Chairperson:
I welcome Mr McCarthy to the meeting. Members have a copy of his presentation. Perhaps you would make a few opening remarks, after which I will open the floor to members for questions.

Mr Colm McCarthy (University College Dublin):
I thought that it might be helpful to give an outline of how we got into the mess that we are in, which is still unfolding, its implications for public spending and for the review of public spending. I am well aware that the situation in Northern Ireland, and I suppose in Scotland and Wales, is a little bit different, in that taxation policy is in London, so it is really the expenditure consequences that have to be dealt with.

What has happened in the Republic is, in a way, a more difficult micro-economic crisis than the one that occurred in the 1980s. Some of you will remember that; some of you will not. However, there was a big public finance crisis in the South in the 1980s, which was eventually dealt with without external financial support through controlling expenditure and raising taxes, and with a little bit of good luck at the end of the 1980s.

This crisis is more difficult, mainly because the banks are bust. The banks did not go bust in the 1980s. The banks in the Republic had a bigger crisis than the banks in the UK. I am aware that some of those banks operate here and that people have concerns about that. Some of the UK banks had to be substantively nationalised and a few of them compulsorily merged, and the UK

Government had to insure certain bank liabilities, so there was and remains a banking crisis in the UK, but it is of smaller dimension relative to the size of the economy. Many countries have had bank crises. However, the Republic has experienced one of the biggest banking collapses anywhere since the Second World War relative to the size of the economy and to the capacity of the Exchequer to solve it.

There are further complications. One of them is that, being in the euro zone, there is no flexibility on exchange-rate policy, and, moreover, through the construction bubble over the past seven or eight years, the traded sector of the economy got squeezed and the economy's resources were shifted into public services and construction. The cost base of the traded sector of the economy got squeezed quite badly, so there is now a competitiveness problem as well. Neither the competitiveness problem nor the exchange rate constraint is present in the UK, and although the UK's banks are a little bit bust, they are not seriously bust, if you know what I mean. Therefore the Republic is in a worse place than Britain.

However, that is not to say that Britain does not have a big budget deficit — the ongoing budget deficits in the UK and in Ireland are similar. The Chancellor started taking measures in the emergency budget in June, I think; measures that, arguably, should have been commenced earlier. In the Republic, the budget measures commenced in July 2008, so it was one of the first of the European countries to begin to address the budget deficit. However, it has been overwhelmed by the banking problem, and the efforts made to address the huge loan losses in the banking system have not succeeded. The result is the International Monetary Fund (IMF) and the EU bailout.

To be a bit technical, what happened was that the budget deficit problem became a debt crisis; a debt crisis happens when you simply cannot roll over the amounts that have been borrowed. Governments finance themselves, as do banks, with a series of term loans. It is worse for banks because they have zero-notice accounts and people can withdraw their money; they also sell bonds. Governments finance themselves mainly with bonds, which are like term loans; these mature every now and again and have to be re-financed.

There is a continuing requirement to refinance, and fresh money must be borrowed to meet a

Budget deficit, if there is one.

What happened is that a deficit crisis became a debt crisis. In Greece, that happened last May because of the Treasury position. In Ireland, it was more because of the banks than the Government, because the Government are pre-funded. It is very disappointing that it has worked out this way. We will have to wait and see exactly what arrangement will be arrived at with the International Monetary Fund and the new European fund.

I expect that you are most interested in what is being done about public expenditure. The Government began to make expenditure cuts in July 2008. A Budget was brought forward to October 2008, and more expenditure measures were taken in January or February 2009. There was an emergency Budget in April 2009 and, subsequently, an ordinary Budget in December 2009. Many of the measures that have been taken were tax increases. That is not on your agenda in Belfast, although it may be on someone else's in London.

Many of the measures that were taken were on the expenditure side. An expenditure review, which I chaired, was established in December 2008. It reported in July 2009 and made extensive proposals about various cuts that could be made. Some of those were implemented in the Budget of December 2009. A four-year fiscal plan will be released in Dublin at 2.00 pm today. You can expect to see more of those proposals included in that plan.

The exercise that was undertaken in that spending review did not include rates of pay in the public sector. We suggested cuts in public service numbers and much more besides; I will come back to that in a minute. Nor did it include the public capital programme, which had been quite sizeable in the South. The public capital programme was reviewed separately, and it has been cut. Indeed, it will probably be cut further, which may have consequences for cross-border projects, road projects, and so on. We will see the details later today.

One difference between the public spending review in the Republic and the comprehensive spending programme that the Chancellor of the Exchequer revealed a month or six weeks ago is that we did not exclude any areas of spending. I think that I am right in saying that the new Government in the UK red-lined health and overseas development assistance. Without too much difficulty, we managed to persuade the Minister not to red-line anything. Every element of current spending was considered. It was the same in the capital spending review, which was carried out separately by officials in the Department of Finance: there were no red lines.

Given the current situation, there will have to be a multi-year adjustment. It will be serious, and it will be politically difficult for everyone. Politicians always regret red-lining and end up trying to wriggle out of it. I predict that, if health is left completely untouched in the UK, it will become unsustainable to cut education in a few years' time. It will create industrial relations problems, such as issues of fairness, and so on. It is always a mistake to red-line any substantial item of expenditure.

I am sure that, in Northern Ireland, as in most European countries, health, education and welfare dominate Government spending. Those three areas typically account for 70% of all Government expenditure. I am not familiar with the figures here, but I would be very surprised if they differed that much. The drawing of a red line around one of those three areas would make adjusting another area much more difficult technically. Given that we are talking about four- or five-year programmes, it would also be more difficult to sustain further down the line.

Notwithstanding the cuts that have been made in current spending in the South, the total amount of Government spending on current account this year will not be much different from what it was three years ago. There are two reasons for that. Once in a fiscal trap, unemployment pay and all the other social expenditures that are linked to it start to go up. Someone who is unemployed qualifies for rent subsidies, a medical card and all sorts of other things. If no action is taken, social expenditure will rise.

The other reason, which you do not have to worry about in Northern Ireland, is debt service. When one starts to borrow, the interest bill comes in the following year. Therefore, the two components of public spending in the South that have risen rapidly in the past three years are social welfare spending and debt service.

To prevent the total from rising, something else must be cut. That is one of the frustrations of fiscal adjustment, and it is one reason why people try to take a four- or five-year view. In the early years, it is hard to prevent the expenditure totals from rising because of that build-up of debt service and social spending. Unemployment may have plateaued, so perhaps the worst of that side of it is over.

I have not had time to study carefully the detailed spending review in Northern Ireland. Even if I had, I would not be familiar enough with the Northern Ireland economy to draw conclusions. What we tried to do down South was, first of all, to take a multi-year view from the beginning. This is not an immediate panic or something that will be sorted out in six months. It will take three, four or five years to get through this.

Secondly, do not red-line anything. If I may presume, as a humble economist, to offer advice to professional politicians, I caution you that, if you red-line anything significant, you will regret it in due course.

Finally, you must pursue social fairness when deciding what sort of medicine has to be dished out, and you must try to protect those who are least able to carry the burden. It is also important to try to design expenditure control policies in such a way that they will not inhibit the economic recovery in due course. That is quite hard to do because, in a crisis situation, people begin to think in the short term. The tendency is to think that they must get the next Budget through or that they must comply with something with which they have been asked to comply. People tend to get forced into a six-month time horizon.

It is important, in so far as you can, to stick with a time horizon of three, four or five years and to think through the exit strategy from the crisis — there will be an exit. People will be pretty sour and fed up, but, in due course, it will be over, and it is important that, when it is over, a platform is in place for a sustainable economic recovery.

It is possible to cut the wrong things, make the wrong taxation decisions, or be tempted into book-keeping-type accountancy tricks with national debt figures, and so on. That is always a mistake. What matters is to make the public finance adjustment and to leave behind, at the end of the crisis, an economy that is structured for recovery and growth.

The Chairperson:

Thank you very much. Several members have indicated that they have questions.

Mr McLaughlin:

You are very welcome. I am tempted to say that you are almost a household name in the North as well.

Mr C McCarthy:

I do not know about that.

Mr McLaughlin:

I found your comments extremely interesting. You referred to our limited fiscal powers in respect of red-lining. What are the implications of the International Monetary Fund (IMF) and European Union bailout and the announcement that is due later this afternoon on the work of NAMA? We have to consider how those issues impact on our planning.

Mr C McCarthy:

I am aware that NAMA is an issue in Northern Ireland because it now owns a bunch of assets up here. The lending policies of the banks are also relevant. There are four banks here: the Ulster Bank, the Northern Bank, Allied Irish, which calls itself First Trust in the North, and the Bank of Ireland. Clearly, the Ulster Bank and the Northern Bank have also had their problems. The Ulster Bank belongs to the Royal Bank of Scotland, which went wallop, and the UK Government now own 80% of it. The Northern Bank in the South belongs to Danske Bank, which also owns it up here, and Danske Bank had to bail it out.

Taxpayers in the South are whingeing that they had to bail out the Bank of Ireland and the Allied Irish Bank, including, unfortunately, those banks in England. However, shareholders in the Royal Bank of Scotland and, ultimately, the UK Government, picked up the tab for the Ulster Bank. Under the Danish bank guarantee scheme, the Danish shareholders in Danske Bank picked up the tab for the Northern Bank. The good people of Scotland, had they voted for the Scottish National Party, would have had the pleasure of bailing out the Royal Bank of Scotland and the Bank of Scotland, but they managed to get the Sassenachs to deal with that for them.

How NAMA operates in Northern Ireland is an issue. I am not that familiar with the details of it. As you can imagine, NAMA has not been proactively disposing of property up to now, but that must be addressed at some stage. There is a sunset clause hanging over NAMA, and it is not meant to exist in seven, eight or 10 years' time. In due course, whatever property NAMA owns in Northern Ireland will have to be put on the market or developed; something must be done with it. The NAMA legislation includes a provision for Ministers in the North to have a consultative role, and I hope that that will work.

I am not familiar with the details, but NAMA's approach appears to have been not to sell off assets in the Republic for the time being. I presume that it has not sold much in Northern Ireland either. I would be surprised if it had, because the market here is pretty depressed, too. Banks here are not in lending mode. A large property portfolio cannot be liquidated into any market in which the banks are not lending, because deals have to be financed.

NAMA has begun to look at disposals in the United States and the UK. It may have some strategy of starting with those assets that it considers are the most liquid and can be disposed of most readily. At some stage, it will have to dispose of property. If NAMA has not been wound up in 10 years' time, I will be astonished. That is what was always envisaged, and it might be wound up sooner. Over the years, it will dispose of everything.

You asked me about the IMF and the deal that is currently being negotiated. There must come a point at which the banking collapse is resolved. "Bank resolution" is a technical term, which means that through compromising some categories or creditors, or through recapitalisation by the state, or some other way, banks are placed in a financial condition whereby they can finance themselves without resort to Government guarantees or anything similar. We are still a long, long way from that. In Ireland, we are far further away from it than we should be. We should have dealt with the situation faster.

However, that is a Europe-level problem now. There has been a failure to address the scale of the bank problems. Many other countries have problems with their banks, and, in a funny sort of way, the Republic may have owned up to its problems a bit faster than some of the others. Some people think that there are hidden problems in the banks of some continental European countries.

Until those issues are resolved, you cannot expect banks to lend aggressively. How aggressively do you want them to lend? Would you like to go back to the lending of 2005 and 2006? I certainly would not. There is nostalgia in some quarters for the credit bubble, but I hope that there will not be another credit bubble in your lifetime or mine.

Mr McLaughlin:
Or ever again?

Mr C McCarthy:
Yes. We do not want the banks to start undisciplined lending. No one would finance that anyway, so it will not happen. The concern is that viable small businesses are having their overdrafts pulled and are unable to finance projects. However, I am always slightly sceptical about the extent to which that is happening. The demand for credit has collapsed. It is not just that supply credit has collapsed. The demand for credit is way down, and the economy has slowed down.

There have been huge reductions in inventories, for example. Inventory financing was a big part of capital demand, but that demand has fallen. Therefore, there may be bank branches around Northern Ireland that would not be able to lend a whole lot of money, even if they had it. I am not saying that that is universally the case, but we must be conscious that the supply of credit is constrained and that the demand for credit is way down. Furthermore, many people who looked like good credit risks a few years ago do not look like such good credit risks now.

Mr McLaughlin:
We are attempting to observe, and to learn from, your expertise on the Southern economy. The Assembly has been engaged with the British Government in the examination of how we can rebalance the economy, perhaps introduce some relaxations and achieve a more flexible fiscal policy. The issue that gets all the headlines is corporation tax and rationalising or harmonising it with the existing level in the South. Media speculation is that one of the conditions of the IMF/EU intervention is pressure on the Irish Government to raise the Republic's level of

corporation tax. What do you expect to happen?

Mr C McCarthy:

That pressure will be resisted.

Mr McLaughlin:

Is corporation tax red-lined?

Mr C McCarthy:

None of the treaties provide for a harmonised taxation policy across Europe. There was a ludicrous piece in yesterday's 'Guardian' about the Irish Exchequer raiding everybody else's Exchequer, tax revenue being nicked, and so on. Any of you who shopped in Newry over the past few Christmases will have seen lots of Southern tax revenue being nicked by Her Majesty's Treasury.

A surprising number of Irish companies have branches in the Isle of Man and Jersey. Tax competition is the name of the game. All the member states in the European Union have complete autonomy under the treaties to fix whatever rates of tax they like. There has been some harmonisation of tax bases, which is different, and there has been an attempt recently to bully the Irish Government over the 12·5% corporation tax rate. I would like to make a provocative observation: in all of the international economic diplomacy that goes on, there is more hypocrisy about corporation tax and tax competition than about anything else. Some continental European countries have headline corporation tax rates of 30% and 40%, but if you look at their fiscal accounts, you will notice that the gross revenue from corporation tax is not as high as you would expect.

The reason is that businesses, especially if they have smart accountants working for them, can deduct fast depreciation allowances, capital allowances, R&D or something fashionable related to the green economy or whatever and end up not paying as much as they appear to pay. The system in the South has been infected a little by smart accountants and lawyers, but the intention was always that the rate would be 12·5% and that businesses would have to pay it. Some continental European countries have rates of 30% or 40%, but businesses do not have to pay that.

There is wholesale hypocrisy.

The rate of corporation tax in the UK is coming down. I think that the Government announced that they were cutting it to 28%. There are more deductibles in the UK system than there are in the South. Years ago, the corporation tax rate in the South was, I think, 40% for non-exporting companies. The Government then decided to make the rate 12·5% for everybody. However, at the same time, they got rid of many of the deductibles. There were all sorts of bizarre peculiarities. Section 84 of some finance Act or other, for example, meant that, if businesses juggled around with bank debt, they could write off their interest twice or some flipping thing — I cannot remember. There were stunts connected with leasing and all sorts of things like that. Putatively, people were liable for a 40% rate, but they did not pay it. When the Government got rid of the deductibles, there was meant to be a clean, simple, low rate of tax, with the snag that businesses had to pay it. That is not what happens in many of the continental European countries.

There has been a campaign in Northern Ireland to have a 12·5% rate as against what will now be 28% in the rest of the UK, but I am not sure how practical that is. There are some precedents for differential rates of tax in different parts of the UK. I remember the selective employment tax. It was high in the south-east and lower elsewhere, but that was a long time ago. The Government persevered with that for a few years and then gave up. It did not survive. It would be extremely difficult to operate differential rates of corporation tax in different parts of the same fiscal jurisdiction. It would lead to all sorts of tax avoidance, and the smart accountants would have an absolute field day. Therefore, I do not know how realistic it is to push for the 12·5% rate.

Mr O'Loan:

You are very welcome, and thanks very much indeed for coming. When you look back to when the big bank crisis started in the South, could anything have been done differently? Were the Government too generous at that point, particularly in relation to the Anglo Irish Bank?

Mr C McCarthy:

Are you talking about in September 2008?

Mr O'Loan:
Yes.

Mr C McCarthy:
The balloon went up in September 2008, and the Government introduced a loan guarantee that I felt at the time was far too broad and too risky. Unfortunately, that is what has done for us rather than the public finance crisis. However, the fire brigade cannot be blamed for failing to put out a fire that somebody started. The fire was set by the failure of the banks and their regulators and supervisors, which had gone on for five or six years previously.

The first line of defence against a credit bubble is the banks. The conditions for credit bubbles arise quite often — the economy gets a good run, asset prices are strong and people feel buoyant, and so on. However, those are the ingredients for a credit bubble, provided that banks that are too careless are added to the mix. When the banks are run by sober, granite-faced, tedious people who do not want to lose money, the credit bubble does not happen. The first line of defence, the banks, failed, and, subsequently, the regulatory and supervisory system failed. However, it did not just fail in Ireland; it failed in lots of countries, as we know. It failed spectacularly in Ireland.

Mr O'Loan:
In the longer run, the future discussion that Angela Merkel is mooting is about shifting the burden on to the banks. Is that the right future?

Mr C McCarthy:
On 16 October, after that meeting in Deauville, Angela Merkel made a statement on a Friday after the markets had closed. She envisaged that, from 2013 onwards, European sovereign debt could take a haircut. Her statement was all about the sovereign bonds of Governments. On the Monday morning, not surprisingly, the bond markets in the peripheral countries, such as Portugal, Greece, Ireland and a few others, took a huge hit. There are two possibilities: either she made a mistake in saying that or she did not. If she did not, it was an attempt to bring the crisis to some form of resolution. I am not sure whether that is the case.

One potential outcome of the crisis in the euro zone is that the Governments that have very high debt ratios and are struggling to deal with them will eventually have to compromise with their creditors through restructuring their sovereign bond debt. However, nobody has thought that through, because more Italian bonds are issued in Europe than from any other country. Italy is a big country, and its debt ratio is very high. The Italian Government's bond market is bigger than the German Government's bond market because the Germans have not printed quite so many. The Spanish bond market is pretty big. It is all very well to talk about hair-cutting Greek debt into the balance sheets of lots of other banks. It is a different story to talk about hair-cutting Italian debt or Spanish debt.

There is no worked-out strategy to do that on any comprehensive basis in 2013. In the absence of a worked-out strategy, the opportunity to say nothing should have been taken. What was said precipitated the bond market crash that happened last Friday week. The lender of last resort, which is the European Central Bank, began to brief to the effect that it was unhappy about the extension of bank credit to the Irish banks. I do not blame it for being unhappy, but it is not possible to impart stability to the system via a lender of last resort that gets windy.

Mr O'Loan:
Will the euro zone hold together?

Mr C McCarthy:
I think that it probably will. However, the policy response to date has involved kicking the can down the road, and that is what the resolution of the Greek situation achieved. Some deal will be done in Dublin, and it will be difficult to negotiate. That will kick the can down the road a bit further, and there will be trouble in Portugal in due course. The source of the difficulty is the infestation of bank balance sheets with various kinds of toxic assets. That has not been fully acknowledged, and there has been no full workout of the European banking system. Ultimately, I think I am right in saying that Greece, Portugal and Ireland account for 5% of the balance sheets of the European banking system. Therefore, at some stage, somebody will have to give some serious thought to the other 95%.

Mr O'Loan:

Provided that a major problem does not arise in the euro zone, once the election is out of the way in the South and the financial rescue plan has been implemented, has enough been done to stabilise the situation and to give confidence to the system to ensure that everything will be worked through over the next three to five years?

Mr C McCarthy:

I think that the answer to that is no. Two things are needed to get out of the situation. First, we need a credible medium-term programme to address the Budget deficit. That will be announced this afternoon. That has been tackled reasonably well since the middle of 2008. However, on the banking side, the resolution of the banking crisis requires that, if the banks have lost a huge pile of money, we have to quantify that as acutely as possible and decide who will pick up the tab. From that must emerge a clean banking system that does not have any unexploded bombs in the basement and is able to finance itself credibly in the markets. Until that has been done fully, the banking problem will not be resolved. It is not enough to continue to provide liquidity to those banks and to reassure depositors that small deposits are guaranteed. Of course, that all has to happen, but, eventually, the banks must have adequate capital, all the bad debts must be cleaned out, and some category of creditor will be hit with the consequences.

The reluctance to do that has resulted in a kicking-the-can-down-the-road policy. That is where we are.

Mr O'Loan:

Your work in an Bord Snip Nua focused on numbers, headcount and expenditure. Is anyone looking at whether the Government are using that money for reform and ensuring that their business is done better?

Mr C McCarthy:

One of the features of fiscal consolidation is that people see it as an opportunity for reform. There are phrases such as, "Never waste a good crisis", for example, and a notion that things that were not normally politically possible become so for the period of the adjustment programme. However, there is a funny feature to that. We in the South have ended up with a cluttered public administration system, too many quangos, odd methods of financing and multi-stream funding for the same organisation. You would not tolerate that in a well-run business. It is an opportunity to clear them up.

However, the opportunity is often not taken in fiscal adjustment, as it does not save much money. Politicians say that they have to save £1 billion, a zillion or other enormous sum, and they begin to focus on whether they can cut social welfare benefits or get rid of X number of public servants. However, the political energy needed to do those things is so great that it is very hard to get them to say that the "national mushroom council", for instance, was not needed. However, if getting rid of that council saved only €100,000, they would not bother. The spring cleaning of the public administration system sometimes gets lost, because you cannot tell Ministers that doing something will make a big contribution to the fiscal adjustment. It will not; it is small change. We had experience of that in Dublin last year. Of course, the folks who work for the mushroom council will leak information to the papers, hire a PR firm and battle for their jobs.

Mr O'Loan:
It might not make a saving, but you might get a better service.

Mr C McCarthy:
It might not save anything, but that does not mean that it is not worth doing. There is a whole agenda of essential rationalisations in enterprise promotion in the South that will probably not save money, but now is a good time to do them. Yet it is hard to get them done.

After the Budget, about three or four months ago, I spoke at a meeting of a think tank in London. There were lots of people there from the Treasury who said that they have had a similar experience, especially with Ministers in a new Administration talking about reform and restructuring. However, when they realise that they have to put up income tax and cut social welfare they do not see it through.

They did something interesting in the UK. Francis Maude, the Paymaster General and a Minister in the Cabinet Office, has been charged with the exclusive task of pushing through those measures. It will be interesting to see if he succeeds. However, even if Governments have the political capital and they expend it on unthinkable big-picture things to save money, it is hard to push through a reform programme. It should not be, but it is. You would think that a terrible crisis would be a great time to get things done, but it does not always work out like that.

Dr Farry:

Welcome, Colm. You mentioned the potential risk to the money that the Southern Government has committed to Northern Ireland for infrastructure. I want to widen that out. Do you see any interest in Dublin to do more on a North/South basis, particularly since Dublin and Belfast will each have its own separate financial crises to deal with over the next few years?

This is not a political point and must be kept separate from politics, but there are opportunities for economies of scale in service provision or distortions that are caused by the border. Is there any recognition of that? Is there any interest, or are things so inward-looking at the moment that that it is not on the agenda?

Mr C McCarthy:

I did not say that I have any reason to believe that such commitments will be dropped. I do not know; I am not privy to those discussions. I am not an expert on economies of scale, but you do not need top-notch hospital in Enniskillen and another in Sligo. I do not get that, although the people who work in them may think otherwise.

A programme has been under way in the South recently to create a network of 10 or 12 top-notch hospitals with other, smaller ones that would not have all the specialisms. There is phenomenal political resistance to that. One of the places chosen was Limerick, which is a pretty big city about the size of Derry. It will have a top-notch hospital, which is fine. There are two towns, each of them no more than 20 or 30 miles away — Ennis and Nenagh — both of which have had hospitals for a long time. There are huge campaigns in both places. Coincidentally, the motorways down there have just been finished, so you can now get from Nenagh to the hospital in Limerick in about 20 or 25 minutes. I cannot get to my local hospital through the Dublin traffic in 25 minutes. There is always scope for such rationalisation. I am sure that that is true of the border counties, although I am not familiar with the data.

It needs to be pushed through. If there is money to be saved, let us do it. There are other nuts-and-bolts areas of North/South co-operation, one of which I benefited from this morning. I may never see Newry again. I will try to, just not so often. The cross-border roads programme has been carried out in a good and practical way with local authorities. I suspect that there are other areas, including electricity transmission system across the frontier. A great deal of money has been wasted, but that can be stopped now with better cross-border connections. I am not really familiar enough with the nuts and bolts to say much more.

Dr Farry:
One of the positive lessons from the first Bord Snip related to how public support was generated for what had to be done and how it was carried through. It happened without too much controversy. That is not the case now. Can you expand on that? You also said that, with hindsight, too much money was taken out of capital at the expense of revenue and that there is a danger of short-termism.

Mr C McCarthy:
Those are good points. First, preparing the public for the fiscal correction at the end of the 1980s was easy because it had been ducked for 10 years; everyone knew that it was coming and that it was necessary. Everyone felt that politicians were ducking and diving and not facing up to it so that when it eventually came it was almost a relief.

Secondly, the capital programme was cut too much; however, it is much bigger now than it was then in relation to the size of the economy. It is still too big in the South and was way overblown a few years back. It is fine to build a motorway from Dublin to Cork, but it need only be done once. There is no need to over-design and over-build roads, which we did a little bit. Some parts of the motorway network in the South were over-specified. That happened here in the 1960s, the MI to Dungannon being a case in point. Guys used to bring over Grand Prix racing cars from Britain to try them out at 6 o'clock in the morning. It was a test road; there were 2,000 vehicles a day on it. I am sure that it is much busier now, but it was over-specified when it was built. We have done the same south of Carlow with the M9, which eventually goes to Waterford.

Mr McLaughlin:

It was future-proofed.

Mr C McCarthy:

It certainly was. According to the figures, it did not need to be specified to motorway level south of Carlow, but some politicians wanted it, so it happened.

The Chairperson:

Dawn had to leave, but she left a question about what will happen to the toxic debt in the banks.

Mr C McCarthy:

Some of the toxic assets have been discounted heavily and taken into the National Asset Management Agency (NAMA). The UK Government did something that was meant to have a similar effect, which it sort of did. They insured toxic assets. They did not set up an asset recovery agency as such in the UK, but they have taken liability for some of the rubbish off the banks' balance sheets. They also took shares in Royal Bank of Scotland and Lloyds TSB.

The banks just acquired assets that turned out to be worth half of what they had lent on them; they will not get paid back. The banks' balance sheet is inadequate to take that hit, which has to be imposed elsewhere. It could be on other categories of bank creditors, such as bond holders, or on the unfortunate taxpayer.

You will not have a normal banking system until you have owned up and done some of those things, one way or another. The approach to bank resolution in Europe generally has shown up weaknesses in the design of the euro system. It has been jusst too slow.

It is salutary to remind you that there was a great, big Europe-wide stress test of the 91 biggest banks in Europe in June or July. The two Irish banks passed; some continental ones failed. However, the Irish have had to go to the IMF; that tells you how stringent the test was. The Allied Irish and the Bank of Ireland passed but have brought down the creditworthiness of the Irish Exchequer since. The banking crisis in Europe is not over by any means.

The Chairperson:

Is there more to come?

Mr C McCarthy:

Yes; I think so.

Mr McLaughlin:

I am not sure whether anyone has a figure, but you hear that bond holders may control €30 trillion. You cannot begin to imagine such figures. The debt for the Southern system is some 0·002%. Is there a point, given that this could have a European dimension, when the bond holders will start to take some of the pain? You do not want to go back to the taxpayers too often.

Mr C McCarthy:

No European bank has been allowed to go bust. The US Treasury and the Fed bailed out Bear Sterns, which was the first big bank to get into serious trouble, by marrying it off to, I think, J P Morgan, with taxpayers' money. They slithered taxpayers' money around, although we were not supposed to know that it was happening.

The US Treasury got fed up with that, and when Lehman Brothers went under, they let it go. No one knew just how interconnected and fragile the system had become.

As a good capitalist, I think that it was a good idea to let Lehmans go. Losses are important in capitalism as well as profits. Lehmans screwed up; let it bloody well go. Shareholders will lose, but that is tough. However, once people saw the mayhem that ensued when Lehmans had been let go, a decision was made in Europe that that would not happen here. Once it was decided that significant banks would not be allowed to go under anywhere in the euro system, the rest unfolded.

Mr McLaughlin:

You describe very well how we arrived here, but what of the taxpayer?

Mr C McCarthy:

Decisions to let significant banks go wallop, in Ireland or anywhere else, have to be thought through very carefully. It is the unplanned bank collapses that create mayhem rather than orderly resolutions, such as there have been in the United States. I should explain that there are two kinds of bank in the United States: those that are regulated by the Fed and those that are not. The five New York investment banks were not regulated by the Fed, because they used to be broker-dealers but became big investment banks over the past 20 years or so.

The United States Government have terrific bank resolution powers; interestingly, the UK does not have such powers. The UK passed the Banking Act 2009, but the South has still not done anything similar. The South has powers, but it does not want to put them in place because that would frighten the horses. However, it is a bit late for that. The US has terrific bank resolution powers: banks go bust all the time, the Fed arrives, takes over the place, haircuts the bond holders and fires the management, who are given a black plastic bag and told to pack up the photographs of their children and get out.

However, in a systemic crisis, such as that in Europe, there is no such process, and it is too late to start one. Europe is locked into inching its way towards some ultimate EU-led solution of a problem that is not going to go away. Moreover, there are hidden loan losses.

Mr McLaughlin:

You say that there is infection in the other 95%. Europe will get to the point at which there is a quantum that just cannot be borne at individual state level.

Mr C McCarthy:

There is no such quantum. The destruction of value has occurred, and the people who own the bonds are other banks, central banks, pension funds and life insurance companies. Ultimately, many bonds belong to the public not to a handful of fellas hiding in a cave in Switzerland. Losses have occurred, but we cannot decide how to share them: they cannot be avoided by refusing to crystallise them. The Irish banks were bust in September 2008, and the loans on which they lost money had all been made at that stage. The Irish banks did not go bust when we decided to look at the figures properly. Crystallising bank losses does not cause them; they are already there.

Mr Frew:

I apologise for not hearing all your evidence, although I caught some of it on TV; therefore perhaps you will forgive me if this question has already been asked. We know that in the Republic the problem has been banking issues and the property market. However, if Ireland had not entered the euro zone, where would it be today?

Mr C McCarthy:

Such counter-factual hypotheses are good fun, but you can never be definitive about them. I think that we would have had a smaller bubble, because the availability of credit would have been less. There would have been some exchange risks, so Irish banks would not have gone as mad as they did. However, it is salutary that there have been serious bubbles in countries outside the euro zone; you do not need to be in the euro zone to have had a bubble.

What has happened with bank resolution has shown up weaknesses in the design of the euro system. One of those weaknesses, often commented on, is that there are no automatic fiscal-transfer mechanisms in it. I am not a big fan of that argument. There are no automatic fiscal-transfer mechanisms in the dollar zone either; a city in Texas is allowed to go wallop if it feels like it. Federal government usually helps with a bail-out in such instances, but there is no automaticity.

We have seen some other design flaws, including the selective behaviour of the lender of last resort. In the sterling area, it would not be accepted if the Bank of England suddenly said that it would not provide emergency support to banks in Newcastle; such a stance would not go down well in Birmingham or Manchester either. The lender of last resort must be non-arbitrary and predictable. The absence of that has been a flaw in the design of the Euro system.

The Chairperson:

That was very interesting. You have given us much food for thought, although the subject matter is a bit depressing. Thank you for taking the time to speak to us. Can we write to you if we have any questions?

Mr C McCarthy:

Yes, of course.

The Chairperson:

Thank you.