Northern Ireland Assembly

COMMITTEE FOR FINANCE AND PERSONNEL

OFFICIAL REPORT
(Hansard)

Spending Review and Budget 2011-2015

1 December 2010

NORTHERN IRELAND ASSEMBLY

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

Witnesses:

Mr Victor Hewitt	)	Economist
Mr John Simpson	)	Economist

The Deputy Chairperson (Mr McNarry):

I welcome two familiar faces to the Committee. Which of you gentlemen would like to go first?

Mr John Simpson (Economist):

The young apprentice deserves his scene.

The Deputy Chairperson:

Victor, you are in the driving seat.

Mr Victor Hewitt (Economist):

I will kick off then.

There may be a tendency to downplay some of the implications of the comprehensive spending review (CSR) now that the dust has settled. People see, for example, that current expenditure is dropping by roughly 2% per annum over four years and that, unfortunately, capital expenditure is dropping by closer to 40% over the same period. However, it would be wrong not to recognise this as something of a watershed in our financial relationships. One of the major engines of the economy's growth over many decades is starting to go into reverse. Although it looks like 2% against a flat baseline, the longer-term trend in public expenditure has been upwards. Therefore, we are seeing a break-point in the trend lines and a widening gap.

I will deal with the minutiae of the CSR. It is gradually becoming known that there was a bit of jiggery-pokery around the baseline. My calculations are that the Treasury essentially removed certain things from the baseline, some of which were perfectly justified. Depreciation and impairment are ring-fenced in the departmental expenditure limit and, therefore, could not be used for anything other than that purpose. However, the £128 million of in-year cuts were a little bit naughty. There was a dispute about that, and I have tried to lay out the basis of it.

The issue of the £18 billion was possibly a little overdone. We had an investment programme running for 10 years that covered £18 billion of expenditure. The naughty bit was the incorporation of law-and-order capital spend into that £18 billion even when it was not actually transferred. It was not a great ploy to base your major plank to the Treasury and the Prime Minister on the restoration of the £18 billion. Statements were made that the £18 billon was somehow free-standing and did not include the reinvestment and reform initiative and so on, but I am afraid that that is simply wrong; the £18 billion did include that.

Another thing that may have slipped below the radar is the ending of the end-year flexibility (EYF) scheme in the UK as a whole. We had built up a substantial EYF stock of nominally more than £600 million but drawable of about £312 million. That has vanished. There may be some restoration, because, in multi-year schemes, some smoothing mechanism is needed to carry money from one period to another; however, whatever replaces EYF will be a good deal tougher.

The other issue is access to the reserve. That is particularly important for areas such as law and order, which has a way of forcing itself to the top of the priority list whether one wants it to or not. The assumption seems to have been that we had a more or less automatic right of access to the reserve; that was probably a false interpretation. We would have had access to the UK reserve in appropriate circumstances, but, as far as the Treasury is concerned, appropriate circumstances are after every spare penny has been stripped from every other programme to maintain the position.

Overall, the outcome of the CSR is quite tough, but it is probably also an opportunity to rethink our priorities and how we will balance our expenditures against our income over the next four years. It is starting to bring out some new ideas, some of which will take time to crystallise. In the short term, if you were to look to replace income, you would have only the regional rate to turn to. The regional domestic rate has been frozen in nominal terms, so it has been decreasing in real terms.

There is also the issue of prioritising in the various programmes. A Budget has not been struck yet, but I would not be a bit surprised to find that we also provide some protection for health. It may not involve protection for the entire health, social services and public safety programme, but at least the health elements of it. We will possibly look at moving some current expenditure to capital expenditure.

In his evidence to the Committee, Colm McCarthy emphasised that it is probably not a good idea to have red lines. Drawing a red line on a huge programme will paint you into a corner when anything goes wrong over the next four years. Health is a huge programme, so if you were to protect the health budget to any great extent, your room for manoeuvre would be seriously diminished. McCarthy carried out an exercise for the Irish Government over some six months looking at the numbers in the Irish Civil Service and at public expenditure. That was a valuable exercise, and I regret that it was not replicated here. To some degree, we are entering unchartered territory without a great deal of information about what works and what does not and how to prioritise. An interesting period is ahead.

The Deputy Chairperson:
We will try to deal with a couple of points arising from what each of the witnesses says and then members can comment generally. Having listened to Victor, the issue of access to the reserve comes to my mind. The Chief Constable made a concerted bid in London to have access to £200 million from the reserve. I know that it is not a bottomless pit, but he thinks that he needs it for security issues. Could that access be at risk?

Mr Hewitt:
When there was a wave of dissident activity, especially after the murders at Massereene, there was an agreement with the previous Government to access a reserve of some £72 million. At least some of that has been drawn down, but I imagine that all bets are off with the new Administration. As I said, you would get access to the reserve if you really needed it. However, you would have to prove that you needed it; it will not be automatic in future. One bit of good news is that I believe that the Northern Ireland Office's EYF element will be carried over, so that will give you some leeway.

I see the coalition regularising the financial relationships between Northern Ireland and the Treasury rather than creating new spatial arrangements.

Mr O'Loan:
Thank you, Victor, for your introduction and paper. I agree with your endorsing Colm McCarthy on not red-lining an area, and on not protecting any area from scrutiny that it should be ring-fencing. I do not see how we can simultaneously call for better use of resources while at the same time protecting spend in one particular area. The two do not go together.

You addressed those issues in your sections on zero-based review and public-sector costs. Colm McCarthy said that although people often talk about doing that when they hit a crisis, the tendency is, in fact, to deal with the crisis and keep your head above water rather than act strategically. It is imperative that we look not just at how much money we have and where we allocate it but how we use it better. Do you see much scope for doing that over the four-year period?

Mr Hewitt:

I agree with the Finance Minister in that, before turning to exotic revenue-raising measures, you really should check whether you are using the money that you have to the best possible advantage. One benefit of what economists call a hard budget constraint, as opposed to a fairly elastic budget constraint, is that it smokes out one's true priorities.

The stated priority of the Administration is the economy. That is a bit of a fiction. The real priority will come to be seen as maintaining health, because that is what the people on the doorstep want, and you, as good politicians, tend to take notice of that. It would be useful to have clarity on exactly what the true priorities are to get a sense of what gives you the best value for money.

Despite programmes running for many years, we do not know how valuable their outcomes are. That is why McCarthy 's exercise, although not perfect, was nonetheless a good catalyst for debate about the value of certain exercises, including things that we have always taken for granted, such as research and development expenditure. He questioned whether some of that was as valuable as was claimed. A great many lobby and interest groups have an interest in maintaining their position.

Dr Farry:

We may return to Victor after we hear from John to see whether there are any discrepancies between the two opinions.

Mr Hewitt:

Three opinions, at least.

Dr Farry:

Victor, you speculated that there may be a shift from current to capital when we finally agree a Budget. What should we be doing about that? That is something that we ourselves called for.

However, Colm McCarthy also said that you can go too far with capital and that in the Republic of Ireland they perhaps over-built motorways and gave them more capacity than was needed. How can we ensure that we find the right balance between current and capital?

Mr Hewitt:
Be cautious on transfer — there are no free lunches in economics. You may transfer money from current to capital to preserve construction jobs, for example. However, you should not fool yourselves that removing current expenditure to help the construction industry will not have job implications: you may kill off jobs that were either directly or indirectly supported by that money.

Some construction is specialised. If you put money into road building, you may have to import labour from across the water because we do not have those skills here. It is a very delicate balance and it must be looked at in the round. An economist should never look at things in isolation; there are always implications.

Dr Farry:
Opportunity costs.

Mr Hewitt:
Indeed; there are always opportunity costs and reverberations for the rest of the economy. By all means look at moving recurrent capital, but look carefully when doing so.

Mr John Simpson (Economist):
I have a few brief words. First, I have no exception to take at the — *[Interruption.]*

Dr Farry:
That is different from agreeing.

The Deputy Chairperson:
That is very disappointing.

Mr Simpson:

I have approached what the Committee asked for in a slightly different way. I hope that you have a two- or three-page summary of the points.

The Deputy Chairperson:

We have, thank you.

Mr Simpson:

I looked at the questions posed on the Committee's behalf. A large number of suggestions is available for this year and indeed for the four-year horizon. In preparing this list, I have considered what various business organisations have been saying. The quality of what the Confederation of British Industry (CBI) has been saying commands very careful reflection, to a better standard than previous years, and poses problems that link to what Victor said.

I also took the liberty of reading the proposed Scottish Budget that was tabled about 10 days ago. It contains suggestions, some of which match what the CBI is saying, so there is some reinforcement there through their both saying the same thing. Perhaps we should consider that. Having looked through your questions, I have highlighted the issues on which I commend the Committee's particular attention.

We share a belief that it would be desirable to have a four-year Budget or a Budget that is divided into the four years and that it would be desirable to have a clear head about the essential elements of matching resources to that four-year Budget. As Victor said, a Budget reduction of 2% a year in real terms may not sound difficult; the usual language in the public sector has been annual efficiency savings of 3%. Therefore some might say that you have not really been set a difficulty. However, added up, those figures become approximately 8% over four years; that is much more fundamental. Looking at the comments in paragraph 3 on page 3 of my submission, "Achieving longer-term efficiency savings", we should be going down the road that the Committee has already signposted on Victor's evidence.

We need annual efficiency savings, and we need a careful review of how we deliver public services, or what I call the operational delivery of public services. We could use the McCarthy model, which is standing the test as people say that it has been a useful exercise; they may say that not everything was acceptable, but that it was, nevertheless, a useful exercise.

Interestingly, the Scots are going to do the same thing and have asked Campbell Christie, a senior retired trades unionist from the Scottish TUC, to conduct a review. I am sure that Campbell Christie will be employ specialists; he will not do it on his own. However, the operational delivery review — and I intend no disrespect by saying the following — should not be conducted from within. Colm McCarthy did not examine the public sector from the inside. Would you ask the permanent secretary of a Department to carry out an operational review of the efficiency of his Department? Whatever regard one might have for him, my answer would be no; you would bring in outside evidence. I suggest that we learn the lessons of the McCarthy project or the Christie review.

On efficiency savings, I am surprised that Northern Ireland does not seem to have made any progress on the review of non-departmental public bodies; there is certainly capacity to reduce the numbers and to review critically the services that they say they provide. This is not the forum for putting the first victim on the scaffold. However, some will need complete change.

Is the Committee prepared to commend the freezing of public sector pay, as I recommend, on the same formula as is adopted by London and Edinburgh? Over two or three years that could give 40% of total savings. The basic question is whether it is better to continue to employ 95 people at slightly lower pay or to employ only 90 at the continuing rate. That is the trade-off. It involves 4% or 5% of the labour force. When it looks at longer-term efficiency, I hope that the Committee pays attention to those issues.

As Victor said, “protecting the economy” is the phrased used. However, the Northern Ireland Executive have chosen to protect social, not economic, issues, and they are allowed to do so. Social issues took us down the road of prescription charges, the change in transport arrangements and the regional rate. We are heading for a shortage of revenue, and giving away part of the regional rate is not consistent with making the economy the number-one priority. Therefore, I put in paragraph 1 that we should remember to give training and skills priority, and I argue for prioritising further education in particular.

We both have a background in higher education and we do not want to take anything away from that; however, comparing North and South, we need to learn that we need to be more ambitious. I do not know whether the Committee agrees. However, that is my assessment and I am working on a couple of projects that will bring that very forcibly to bear.

Consistent with what Victor said, the other priority is rethinking infrastructure investment. I hear the comment that perhaps we have too many roads and motorways. That may now nearly be true for the Republic of Ireland, but I do not feel that way as I travel around Northern Ireland. I would not back off from tackling any major structural problems in roads. In the interests of good all-island communications, and forgive me if I use a trite phrase, I would remove the only set of traffic lights on the road between Dublin and Larne harbour: the one at York Street. Those of you who come in from the north of the city will appreciate what I am saying.

I move on to the revenue question. Victor emphasizes that the regional rate is the most obvious source of extra revenue, perhaps £50 million or £60 million a year. That is worth having, but it is not the be all and end all.

I know that there are other tensions, but I have highlighted water charges. I would like to see water charges introduced in some way; on a hypothecated basis against the regional rate if necessary. I want to see water revenue directed to a trading company called Northern Ireland Water, which would then stand separate from central Exchequer finances and would be in a position — as the water company in Wales is — to borrow from financial markets for its capital programme so that water would not be using capital that would otherwise be available to the rest of the public sector. I would like to see movement in that direction, but I realise that the issue is not uncontroversial.

You asked me about potential savings from outsourcing. There are several of those, but one of the most conspicuous is market-testing the Rate Collection Agency or Land and Property Services. You can think of others, and the CBI has identified some. You need to open the door to that possibility. You asked about possible capital assets realisation. I do not know whether the Committee has seen Ed Vernon's reports on the capital assets of the public sector. He did a report two or three years ago, which he has since updated. At the time it was initiated, the intention was to publish it but, to the best of my knowledge, it has not been published. It should be available for assessment when the market improves — I do not suggest that we sell now when the market is down.

I have a couple of other points. You asked about the impact of annually managed expenditure cuts. I am not much encouraged by the idea that we should break parity on social security spending. I have heard that argued in recent days, and I want to record my preference for holding parity. If, nationally, welfare spending is changing in uncomfortable ways, it may be the greater good to say that we have to live with it.

In paragraph 6 of my briefing paper I introduce my only suggestion for improving capital spending. First, there may be capital spending from carrying funds from current to capital, but we would be lucky if that were more than a one-off £100 million or £150 million. I found the Scottish example interesting. The Scots have developed a little formula stating that they do not wish to expand public-private partnerships in an unlimited way, as it puts commitments on the next generation. They say that, in the four-year period, there is a need to build up and protect capital spending. Therefore, for that period, they are prepared to go for capital projects that might add 1% to the annual cost from government revenue expenditure. They have converted that 1% into what it might mean in potential capital spending, and, for Scotland, it could mean £500 million per year for the four years. On a pro rata formula, that must mean about £200 million per year if we decided on the same formula.

That is not open sesame; it is a controlled, four-year, targeted, unusual step. I will go further and look at the Scottish ways of containing the impact. They now want to see the use of the phrase "non-profit-distributing organisations". They are trying to protect against the argument that PPP can mean a very handsome, unexpectedly large profit to the organisations that do it. They have tried to invent methods of putting a ceiling on that, and that is their formula. It is worth reading in detail.

That takes me to an institutional point. Northern Ireland used to have a Strategic Investment Board (SIB). You may recall the fanfare when it was set up, but you may have some difficulty in recalling its most recent actions. It still exists.

Nevertheless, now might be the occasion to look at the way in which the Scots have invented the Scottish Futures Trust, which I consider to be the SIB's equivalent. It has a nice, enticing title, but when you boil it down, it is their method of having a strategic investment board, making it real and giving it real challenges. That is interesting for Northern Ireland in its longer-term implications and in its being a vehicle to allow for some increase in capital spending.

The Deputy Chairperson:
Thank you very much, John. Just before we go into questions, I welcome Adrian. There was an apology on your behalf, Adrian, so I am just pointing out that you are here.

Mr McQuillan:
Thank you very much.

The Deputy Chairperson:
I welcome Dawn as well.

We have taken a couple of questions to Victor. If members are happy to do so, we will take a couple of questions to John, and we will then open it up wider.

John, you mentioned that the Ed Vernon report is very timely. We are hoping to address that and return to it in a couple of weeks' time, and we will let you know how we get on.

You also mentioned CBI and other business representative bodies and spoke about their inputs and what they are doing. Most of us would concur that there has been a somewhat refreshing contribution from the unions. Certainly, the whole debate has opened wide. Do you have an insight as to whether Departments, particularly the Department of Finance and Personnel (DFP), are embracing outside opinion, including the respected opinions of both gentlemen here, and those of people like yourselves? Although those opinions are getting attention, it seems to be media attention. It would seem to be a bit wasteful if there are good ideas and nobody is taking them up.

Mr Simpson:

Mr Chairman, I share the concern behind your question. As someone outside the official system, I am not privy to the way in which particular proposals, for example, those from the CBI, are assessed in DFP, and I do not know to what extent your individual members are privy to that. When I was a very young civil servant, not going very far, I recall that when outside documents came in, we would go through them and say that some were good and some were rubbish. By and large, and forgive the implied reference, there is a tendency in Departments, such as DFP, to say, "Actually, they do not really understand our problems, do they?"

That is why we need a forum that puts strain on the senior officials in an informal, intelligent way, to say which of the proposals command some interest and which they have looked at but established that Treasury rules would forbid them. Victor is in a privileged position in that sense. The degree to which officials come clean with the pros and cons of arguments is very limited, and that is a great pity.

The Deputy Chairperson:

That is alarming. I think that this Committee would ask how the hell do you break through the brick wall that is up, and who is listening? However, I thank you for the answer.

Mr Girvan:

I thank John and Victor for their presentations. You mentioned a pay freeze and how that could help us through part of this hiatus. The underlying inflation rate is controlled by the Bank of England. Or perhaps it is not being controlled; that might be one way of looking at the situation. It is probably a fact that inflation is rising, irrespective of us supposedly being in recession. Indications are that it is costing people more to fill their oil tank and a lot more for the food that they have on their table, because of transportation costs. How can you compensate for that factor if you put a freeze on public sector pay?

Mr Simpson:

The short answer is that if you put a freeze on, you will probably not be able to compensate. The purpose of the exercise is that real living standards will be reduced.

Mr Girvan:

What fiscal controls can be put in to control inflation at any stage?

Mr Simpson:

In recent times, the Bank of England has been more professional at assessing what has happened to inflation. At the moment, it is assessing that inflation will come back to 2% late in 2011. It may well be right. Look at the past performance. For the moment, they are off course, due, largely, to international events. I would not be too depressed about getting inflation back to between 2% and 3%, but, equally, I acknowledge that I have no answer to the question of how to maintain living standards for people who have had a ceiling put on their salaries. Nobody can answer that question.

The short answer is that if the public sector lives through a period when salaries have a ceiling, it will also live through a period when pension contributions are going up. We cannot avoid that. We can compare it with the private sector. The private sector is doing this in different ways. It has had pay freezes for the past couple of years; in fact, it was first to adopt them. We do not know how many, where or who, but we know that it has been happening. There is a rough justice about it. One piece of comparative evidence that we can use is the events in the Republic of Ireland; this sort of step is mild compared with what they have to do, although their crisis is bigger.

Mr Girvan:

I know that a number of members sit on other Committees. What has been demonstrated is what you alluded to earlier, that Departments are coming back with their own figures, irrespective of any external expertise. I have a difficulty with that, because I always have had a theory that, if you interrogate statistics enough, they will confess whatever you want them to. To be truthful, that is exactly what is happening, because we are being told that there was £50 million of savings on management from one Department. However, when the Committee interrogated the figures, it looked like quite a bit less. It did not look as much as £10 million; it was quite a bit less. How on earth is so much wriggle room being given to the Departments to make those adjustments in their own figures? I feel that we are not getting down to the detail where we are seeing the full picture.

Mr Simpson:

If I may make an assumption: the illustration that is being used happens to be a very large-spending Department, concerned with our health. I will not name it, though. *[Laughter.]* The difficulty is that it took out elements of management, but, within a very short time, and for what it saw as good reason, other things came in. That is the sort of thing that can happen; you have to be sympathetic when they have unforeseen problems.

The other area in which that is waiting to be done is education, where we have a scheme to reduce management costs. The introduction of the education and skills authority would reduce management costs, but we are stuck. From my perspective, my view is: for goodness' sake, make it work. There is a little political difficulty, but make it work.

Mr Hewitt:

Being slightly cynical, a little bit of inflation when a country is hugely in debt is no bad thing because the debt can be inflated away. The UK economy has had an enormous shock. Probably the best analogy is to go back to the oil crisis of the 1970s, when the oil price quadrupled in a short space of time. We fooled ourselves into thinking that it was a passing difficulty and that we should simply spend our way out of it. However, people's living standards had to drop; there was no way around that. There is no way around living standards dropping to try to cope with this debt. It is a big shock to the system and to people when they suddenly realise that they will be poor. There is no way out of being poor; it is just a question of who will be poor and how the pain will be spread.

As regards interrogating numbers and so on, you have a pretty hopeless task. The complications of the system are such that virtually no one outside the system will ever be able to penetrate it to the required degree.

The Deputy Chairperson:

Is there no code or anything?

Mr Hewitt:

It is like entering into the priesthood. Outsiders cannot —

The Deputy Chairperson:

We had better not go there, but I understand what you mean.

Mr O'Loan:

I will direct one question to John and then I have two general ones. John, regarding your endorsement, or, certainly, interest, in the Scottish capital scheme, do you envisage that a similar system here could create a £200 million pot, for which Departments could then bid? I have heard at least one Minister saying that they will not touch PPP schemes. If that is a ministerial decision, that is fair enough. It seems to me that any other Department could go for it. Is that how you see it operating?

Mr Simpson:

That would be one of the things that a reshaped investment strategy could do. Ministers could say that they want bids for how to use the sum of money in the priorities. The people who devise that could bring something well up the list. If a Department says that it does not want something to be put on that list, the public would be entitled to know that a project was rejected on grounds of financial principle.

Mr O'Loan:

I am interested in your point about achieving efficiency through a McCarthy exercise. You said that it should be above all, not from within. Getting culture change is very significant here. I do not believe that it is possible for that to be achieved by somebody from outside cracking a big whip. Therefore, some exercise that, in a very deep way, involves activity from within to create change from within has to be part of the action. I offer that as my own corrective to what you said; it at least has to be thought about.

Mr Simpson:

That would be the skill of the person who was told to bring forward proposals but, insofar as they can, bring them forward with some empathy from within. An outsider in a senior position is needed to look at an organisation and say what should be stripped out or what they should stop doing. There will be a private stage in which the outsider will propose x or y and that can be argued about.

Mr O'Loan:

There is quite a high level of natural wastage in staffing, and, on its own, a freeze in recruitment would create gaps in the wrong places. However, managers may then have the opportunity to redeploy staff and so on. Does that mechanism have the power to force that kind of efficiency change, or is that too optimistic?

Mr Simpson:

I would treat the suggestion as something that has to happen, but it is optimistic to think that it is a very sensible restructuring mechanism. You put your finger on the real weakness, which is that vacancies tend to build up in areas in which there are skills shortages. An organisation does not adapt readily to casual vacancies in one place when there are skills shortages in another. For example, when vacancies have not been filled in the Health Service previously, it has tended to leave a lack of nurses but plenty of clerks. Clearly, that is a silly answer. That method may be part of the package, but it should not be relied on to be a useful restructuring mechanism.

Mr O'Loan:

We are about to write a Budget before we have seen or considered the paper on rebalancing the economy. If we start coming up with ideas about how we might rebalance the economy after the Budget is in place, how would those be married retrospectively? More broadly, how will we use the four-year Budget as part of achieving some longer-term vision when we have not written the long-term vision? I see that as a big problem.

Mr Simpson:

As an Executive and a community, we want to live within our public sector resources, and we want, as far as possible, to rebalance the economy. I caution about the scale of what rebalancing would mean. I know that you have all heard statements that it will take some time. If the private sector were to grow by 2% a year over the four-year period or a bit a longer, we would bring the proportion of employment in Northern Ireland that is in the private sector roughly into line with the average outside London and the south-east. The private sector is not small; 70% of our employment is in the private sector. It is dependent on the public sector for a lot of its business, but, if the Northern Ireland economy were to begin to grow by a couple of per cent a year and the public sector was not growing, it would be almost inevitable that the balance between the private sector and the public sector would change.

You have not opened the door more widely and I do not particularly want to do that in this forum. If rebalancing the economy were to become centrally about changing the behaviour of businesses because of the way that the tax system works — I will not use the word beginning with “c” that describes the name of the tax — and that system were to work as effectively as some of my friends hope that it would, your question would not be so difficult to deal with, because that would be happening in parallel rather than in competition with what is happening here.

Mr Hewitt:

It would be foolish to stop everything entirely until a paper on rebalancing the economy comes from the Treasury. Whatever comes is likely to be a consultation paper, so it will pose questions rather than give answers. You may have noticed that the proposed White Paper on promoting growth in the rest of the UK has had to be put on hold because no one could think of any ideas to put into it, so I would not hold my breath in the hope that the Treasury will solve your problems.

John is quite right that this CSR may take 6% of our gross value added (GVA) out of commission. Where will that be replaced from? The construction industry is on its back, and retail is not too far behind. The only sectors that have any growth in them are manufacturing and exports, which are very small. They have been aided by an almost deliberate devaluation of sterling, but, given the structure, it is an impossible task for that sector alone to make up 6% of GVA. In all probability, the economy will be flat for the next four years, and we will be lucky to have any growth in it at all. However, the labour market is not flat. People are joining it all the time. Therefore, there will inevitably be enormous pressure from unemployment and inactivity over the next four years. Those are the simple macro realities that we face.

Dr Farry:

I wish to pick up the point that was made about DFP and the impenetrability of its methodology and, indeed, David's question on the analysis of the CBI paper, if I caught that correctly. Has DFP consulted either of you gentlemen formally? Or, is this your first formal opportunity, besides in the media, to give your opinions on what should be happening?

Mr Simpson:

My colleague has a much more elevated status than I do. I am just the amateur about town who makes amateur comments. I am not professionally involved, but you have to give regard to Victor's official status.

Mr Hewitt:

Do not put any stock in my official status. I have no communication with DFP on an official level.

The Deputy Chairperson:

So, this is not 'I'm a Celebrity … Get Me Out of Here!'; this is the Finance Committee.

Dr Farry:

Some of the economists at last week's meeting stressed the lack of a think-tank facility. In other jurisdictions, a healthy exchange between politicians, senior civil servants, academia and other interested private sector parties is the norm. We do not really have that. There is very much a silo mentality towards the Budget here, which does not give a terrible amount of comfort. This question may sound very academic, but it is not meant to. In the public service, are efficiency and subsidy mutually exclusive concepts from a purely economic point of view? Is the notion of subsidy inherently political and something that we do for reasons other than good economics?

Mr Hewitt:

No. There is a theoretical justification for subsidies, which is based on the nature of the activity. Take healthcare, for example. People's thinking tends to have short-term horizons, and they tend to invest less in their health than they should. There is, therefore, a good justification for the public purse stepping in to subsidise healthcare provision.

Dr Farry:

That is essentially a market failure argument.

Mr Hewitt:

It is a market failure argument. However, it is only one of a number of arguments for subsidies. Some of the reasons for subsidies are political or social, but there is also an economic efficiency argument for subsidies in certain circumstances.

Dr Farry:

Both of you have referred to many decisions over the past number of years that have been taken for various reasons. You are giving us a clear message that, looking to the future, those are not really sustainable.

Mr Simpson:

They are sustainable if that is the political will. What we have both been saying is that, if the economy is the real priority, some of the socially motivated decisions have to be questioned.

Dr Farry:

Is the notion of protecting the economy the right terminology to use? Is that almost a defensive way of saying that we have to protect what we have done in the past? Should the emphasis be on handling the economy differently, particularly bearing in mind other things on the horizon that will come into play over the next couple of years, such as changes to EU state aid rules, which may have to be thrown into the pot when we think about reallocating resources?

Mr Hewitt:

To be perfectly frank, my personal view is that our economic development model is coming to the end of its useful life. To caricature it somewhat, it is about selling Northern Ireland as a low-cost place in which to do business. Businesses will get pretty good labour for a relatively low cost. We give grants for capital and training, and property prices here are also reasonably low. That is the basis on which Northern Ireland is being sold to the market. That model will take us to a certain place in the market, because we will be able to attract companies that are interested in

Northern Ireland as a cost centre. Companies and, indeed, Invest NI are quite frank about that.

That is why those of us who are keen on things such as corporation tax really want to shift the argument to promoting Northern Ireland as a profit centre. At the moment, the existing model is being squeezed and the EU are coming down on state aid, so the ability to plough money in to reduce your costs even further is becoming more and more limited. Frankly, Invest NI has very few arrows left in the quiver once the grant regime starts to deteriorate.

Ms Simpson:
I agree with Victor, but to add to that slightly, we have been selling ourselves as a low-cost economy. We sometimes dress it up by saying that we are a skilled low-cost economy, but I think that that argument is misleading. To come back to the priority; if Invest NI is no longer going to play financial arrows across the target range, we now have to rely even more on playing the skills argument. That creates the public dichotomy over whether we have an adequate supply of skills or whether we are failing to create the range of skills that we will need in five or 10 years' time, which means that we do not have them in the shop window to sell. When comparing the North and the South, the argument is that the Irish have done more with their institutes of technology than we have done, and it is standing them in good stead. There is not direct proof for that at the moment, but I would like to see that developed further.

The Deputy Chairperson:
A trend seems to be developing in the Committee of looking at the utilisation of outside expertise in our work and anything that we might recommend. Do members agree that we will return to discuss that point at a future meeting?

Members indicated assent.

Mr Frew:
You are very welcome, gentlemen. Thank you for your presentations. I am relying on John's paper here, but I will take input from you both. John, you spoke about the need for training and skills programmes, yet Invest NI says that middle management is the area that is lacking. We are sending 50% of our young people to university. A lot of them go away, never to return. Do you think that we are sending too many people to university? Are we missing the point, in that we are

not worrying about the skills base?

People have said that corporation tax is not a panacea or a silver bullet and it might not be as good as we think, but do you agree that it is the biggest single tool that we have to help our economy? I have another question, but I will let you answer those two first.

Mr Hewitt:

To give you an example of what is happening on the training front at the moment, as of 20 October 2010, a large chunk of the financing of our higher and further education system suddenly disappeared. That part of the education system is now effectively much like water and sewerage, in that it has become an unfunded lump. That is because the teaching grant to universities and further education colleges in England went down by about £4 billion. That is entirely comparable spending through the Barnett formula, so we take a consequential hit of well over £100 million. That does not meant that you cannot continue to fund them, but you are not going to be getting anything to fund them with. That is the sort of pressure that you are facing.

Having been heavily involved with corporation tax for what seems like forever — it can be added to the word "Europe" on my tombstone — we see corporation tax as, in a sense, a game changer, but it comes with a price tag.

You will need to look carefully at whether the price that you would ultimately have to pay, not only in lost taxes but in administration, outweighs the likely long-term benefits. That said, I see no other instruments on the horizon that are not merely variations on what we have done for many years. That is why corporation tax remains a central plank in the argument for giving us the tools to get on with the job.

Mr Simpson:

At time goes by, Victor's views and mine on corporation tax have come a little bit closer. We started two or three years ago on opposite sides of the debate, but I have come far enough to say that I agree with Victor that the corporation tax change, should it happen and if we are prepared to pay the cost, is a game changer. However, it will change the game only if we do the other things that we should do to strengthen the economy. Those who think that once we make the corporation tax change we can sit back and wait for external investment to flow in will be disappointed.

Your question referred to how many people and what we are lacking. The number of young people in Northern Ireland going to university is at the high end. However, I would not want to discourage that so long as they go to university because they have the ability and they pursue courses that develop their abilities in their career choice.

Unfortunately, there is still too high a drop-out rate in the first year of university. That worries me for the people concerned because of what dropping out may do to them, but cost is also a worry. However, I would not want to alter what is happening at university level in order to push people back into a different form of further education. There is room to develop further education and take up the middle management-type qualifications that organisations need. That fits exactly with what I hope people in further education hope to achieve.

I am in discussions to understand better what is happening in further education. However, we do not have a curriculum development plan for further education, although we do have allocations of funding for next year. We are moving a year at a time. We do not have a long-term view, but we should be looking at how to formulate one.

Mr Frew:

We are talking about freezes in public-sector pay, but does efficiency mean job losses?

Mr Simpson:

Oh, yes.

Mr Frew:

Could pay freezes be enough to reduce absenteeism and increase work rate? Would that be enough to create efficiencies, or does it mean some job losses? Would a recruitment freeze create problems in future for bringing in young people?

Mr Simpson:

A recruitment freeze in one year is always a disadvantage for those who are reaching the point in their careers when that would have been the year they would have been looking for those jobs. There is a distorting effect: if you do not recruit trainee nurses for two years, what are you doing to those who would otherwise have wanted those jobs?

We have to be more open about freezing public-sector pay. A salary freeze is one thing; however, I would be very surprised if a system that operated more efficiently did not do so with fewer people. Our economy will need skilled people, but it does not need two of them doing the work of one. We should not freeze the labour market by trying to protect jobs when we should be shuffling people around a bit.

Mr Hewitt:

History seems to show that genuine efficiency comes from the substitution of technology and capital for people. Few of you will have been in a bank recently: you interface with a bank either through the Internet or through an ATM.

The Deputy Chairperson:

Victor, what is the point in going into a bank when you cannot get anything out of it?

Mr Hewitt:

Banks certainly do not want you there, because they would have to employ someone to deal with customers face to face. They have substituted technology for labour. In many ways, public services are a service industry, and, over time, we will see the substitution of technology and capital for people. That is how manufacturing went; that is why you get such huge increases in productivity in manufacturing. You get rid of people and replace them with machines.

That process will be slower in the public sector, and there are some areas in which certain combinations of people are needed to provide a service. The famous example is that of a string quartet. One hour's music from a string quartet requires four man-hours or woman-hours of input, but if you break it down to three you no longer have a string quartet. There are areas in the public service where the people are the service, but, more and more, technology will replace people.

Ms Purvis:

I will change the focus of the discussion slightly to look at the people who suffer from health and educational inequalities and who will be affected because those inequalities place greater demand on the public purse. My focus is on preventative spending. John talked about training, skills and further education, and Victor talked about strategic public expenditure planning. I am concerned about a number of issues, including our long tail of educational underachievement, our 250,000 functionally illiterate adults, and how we focus our Budget on innovation and preventative spending for future planning purposes. Victor, you talked about mobilising a multi-agency approach to look at those issues. For example, there is a great deal of research about early-years intervention for children and young people, which, in the long run, is investing to save. What emphasis should the Executive place on preventative spending in this CSR?

Mr Hewitt:

You are right to mention the research on early years. All the research from the United States, the UK and around the world shows that the return on focusing on very early years is enormous if done right. Our problem is that programmes are running, so it becomes difficult to create new pools of money, especially when resources are going down. Money has to be extracted from other programmes. I suggested a couple of ways of doing that that have been tried in the past. Some of you may remember the Executive programme funds, one of which was a children's fund that took an inordinate length of time to put together. Nonetheless, it was a good idea because it involved looking holistically across the board. In ERINI, we did a great deal of work on how much was spent on children in Northern Ireland and, later, on older people.

The other way is through an interdepartmental, interagency task force, an example of which was the Making Belfast Work scheme. That was interesting, because Departments and agencies came together and produced their work programme, but the scheme did not manage the money; it was managed centrally. The pool of money was held centrally and managed for the scheme in a sense, but it did the operational side of things.

Ms Purvis:

Was that top-sliced from Departments and put into a central fund?

Mr Hewitt:

As I recall, it probably was. It was quite amusing: when the Executive programme funds were funded by top-slicing, we were told that some projects would have to stop. However, when it came to bidding for the money back through funds, virtually none of those projects that were such high priority was part of the bids for the funds. There is a bleeding-stump mentality on these things, but you are quite right: if we can find ways of working together and preventing problems further down the road, that can only be a good thing.

Mr Simpson:

I will just add to Victor's point, Chairperson, and draw on my experiences in west Belfast and the greater Shankill. The Northern Ireland education budget, for each pupil across the Province, is probably quite acceptable compared with what happens elsewhere. However, the way in which it is used to meet priority needs of the kinds that you mentioned is not very satisfactory.

My experience across the other side of the city probably bears out your experience elsewhere in that we do not treat people with special educational needs in early years with any sense of priority at all. The attitude is to have per capita funding of pupils wherever they are without regard to social need. I think that you and I are searching for the same answer: let us identify priorities. However, there is an acknowledgement in the political process that we do not use our total education budget very efficiently. That is not a matter for this Committee, but it is for somewhere. The education allocation leaves much to be desired.

The Deputy Chairperson:

Thank you. I gave a false alarm there. I knew that as soon as I said "final question" the last person in would ask the last question. Daithí, you are welcome. This is the final question.

Mr McKay:

Thank you, Chairperson. I am keen to hear your views on the social economy and on addressing social need as an economic stimulant. Average household incomes here are lower than those across the water while average household spending is among the highest, yet we have significantly higher levels of fuel and child poverty. The green new deal, which we debated recently, shows how addressing social need can act as an economic stimulant through construction work. Do you have any proposals for using the social economy to revitalise the economy?

Mr Simpson:
That is too difficult.

Mr Hewitt:
That is a very difficult question. Economists and public expenditure practitioners would consider the nature of the expenditure. They would ask whether it was an investment that would produce a later return or whether it was just consumption, in that it is meeting a need for today only with no real carry-through. A large part of social expenditure is more consumption than investment. It is only really at the margins that social expenditure translates into tangible returns.

Spending on early years will produce long-term return, but the demand is immediate. The major problem is managing the tension between the two. For example, if there is a flood in Belfast, we throw money at it and give to people who should have had insurance. That puts a plaster on the problem when what we should do is improve our sewerage system so that we do not have to do that in the future. That is a bit of a caricature, although not too much of a caricature of what has actually happened.

Mr Simpson:
Daithí's question poses the tension. When you are faced with what you consider a social need, think that it a priority, and put funds into dealing with it, those funds are not available to do something else. The question is: what is the right balance?

Fuel poverty is an interesting issue, and I will not open it up any wider other than to say that the right answer for fuel poverty is not necessarily to subsidise the cost of fuel; it is to improve the energy efficiency of where people live. That would give you a better long-term answer.

Ms Purvis:

And income levels.

Mr Simpson:

That is broadening the issue.

Mr McKay:

Your paper, John, talks about outsourcing public services. I was interested to see that prison and prisoner management is one of the headline sectors. What are the benefits of that for that sector, given the context that we are in?

Mr Simpson:

I am just being pragmatic in numbers terms. The only evidence is that the cost per prisoner for retaining people in Her Majesty's custody in Northern Ireland is so much higher than it is for prisons that are privately managed on the other island. We have a problem, and perhaps the organisation could be changed to help to reduce the cost.

Mr McKay:

Are prisons in Britain mainly separately managed?

Mr Simpson:

Sorry? I do not know how they manage to get the cost per person so high, but it is damned high.

Mr Hewitt:

Normally, you would expect to have more prisoners than prison officers, but that is possibly turned on its head in Northern Ireland.

The Deputy Chairperson:

It would appear from yesterday's news that it is easier to get out of jail than to get into it, so I do not know what we are worrying about.

Gentlemen, thank you very much. We certainly enjoyed your presentation; it was very helpful. You are an excellent double act, yet you have managed to preserve your individualism, which is important. If you have other views on the questions that you heard, you are very welcome to write to us. Thank you once again, I look forward to seeing you in the future.