WORK OF SIR DAVID VARNEY ON THE NORTHERN IRELAND ECONOMY

Critique of the outcome from the Varney Reviews for the Committee for Finance and Personnel

PRICEWATERHOUSECOOPERS

May 2008

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23 May 2008

Dear Mr McAteer,

The Work of Sir David Varney on the Northern Ireland Economy

I refer to you letter of 9 instant, inviting PricewaterhouseCoopers to provide a critique of the outcome from the Varney Reviews for the Committee for Finance and Personnel.

In accordance with your request I attach a brief critique, which I hope will inform the deliberations of your Committee.

We would be happy to elaborate on our response and if you have any queries in respect of the document please contact me directly or my colleagues Philip McDonagh or John Compton.

Thank you again for the opportunity to respond.

Yours sincerely,

Hugh Crossey

Hugh Crossey
Managing Partner

Encl…/

1. Background to the Varney Reviews

On 22 March 2007, the then Chancellor, Gordon Brown, announced a review, led by Sir David Varney, to report on: *"How current and future tax policy, including the tax changes announced in the Budget 2007, can support the sustainable growth of businesses and long-term investment in Northern Ireland."*

In his announcement, the Chancellor stated that the review would be considered, *"… in the context of the tax environment across the European Union, including within the UK and the Republic of Ireland."* The Chancellor's specific comments on the wider tax environment reflected the call, by Northern Irland political parties and business organisations for a reduction in the rate of regional corporation tax to 12.5 per cent, matching that of the Republic of Ireland.

On 1 June 2007, Sir David Varney's Review team sought comments and evidence which would support the delivery of the terms of reference. In the call for evidence document, respondents were prompted to respond under three headings:

- the effect of tax on business decision making;
- national and international context; *and*
- other drivers that improve the business environment.

The Review, published on 17 December 2007, concluded that, *"…on an assessment of the costs and benefits to the UK, there is not a case for a lower corporation tax rate in Northern Ireland* [as] *such a policy would run the risk of encouraging profit shifting from the rest of the UK to Northern Ireland.*[1]" The Review also examined other areas of tax policy and failed to find, *"…an overwhelming case for differential tax policies in these areas for Northern Ireland."*

On 29 January 2008, government announced a second review by Sir David Varney, carrying on from his first review and focusing on identifying further measures to promote private sector investment. The terms of reference for this second review were based on, *"…[an] agreement from all parties about… the opportunities provided by the peace process, the need to strengthen the private sector, to create increased employment opportunities and to reform the public sector…*[2]"

Unlike the first review, which was empowered to examine Northern Ireland's incentives in the context of the wider international tax environment, Varney II focused on an examination of incentives for growth in Northern Ireland, *"…that fall within the responsibility of the Northern Ireland Executive and the UK Government*.[3]"

Published on 30 April 2008, Varney II welcomed the priority the Northern Ireland Executive had given to the economy in its *Programme for Government* and the strategies developed to support economic development. The Review concluded that the Executive should focus on the rapid and effective implementation of those strategies, but also embrace a widening and deepening of existing reform. Specifically, the Review recommended action in a number of areas, including:

- deepening and intensifying public sector reform, in particular increasing the role of the private sector in the delivery of core public services and transferring non-core services to the private sector in order to help stimulate its growth;

- ambitious labour market and welfare reform, aimed at increasing the employment rate and reducing the number of people on Incapacity Benefit;

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[1] Review of Tax policy in Northern Ireland. December 2007. Page 1
[2] Varney Review of the Competitiveness of Northern Ireland. January 2008. Terms of Reference
[3] Varney Review of the Competitiveness of Northern Ireland. January 2008. Terms of Reference

- more employer-led skills training to help tackle weaknesses in the stock of skills in the labour market, which is a legacy from the past;

- ensuring a joined up approach between Invest Northern Ireland, UK Trade & Investment and the Irish Industrial Development Agency (IDA) to market Northern Ireland to the full; *and*

- continuing development of the all-island economy with the Irish Government, supported by the UK Government, including increased trade, movement of labour and capital, tourism, energy markets and financial services as well as many other sectors.

The review made a number of specific recommendation related to privatising state assets and to ring-fencing the proceeds of any sale of Belfast Port, were the Executive to proceed with its sale. This was concurrent with the Prime Minister's announcement that the Executive could keep up to £2bn of the proceeds of any privatisation process.

2. Assessment of Varney – the economy

We broadly concur with Varney I and II in their evaluation of the Northern Ireland economy and that an apparent strong economic performance concealed underlying structural weaknesses including:

- an over dependence on the public sector;
- an underdeveloped private sector;
- low levels of business formation and R&D spend;
- lower levels of productivity, and GVA per capita
- low levels of labour market participation; *and*
- high levels of long-term unemployment and uneven sub-regional growth.

Varney I readily acknowledges the precarious reliance of the region on continued levels of public expenditure growth for its apparently high-level prosperity and that, *"… the dominance of the public sector can adversely impact on the prospects of the private sector*.[4]"

We agree with the Varney conclusion that the task of raising regional output relies on supporting private sector growth, increasing labour productivity and increasing exports. We also concur with the conclusion that there is no single driver that in isolation can boost regional productivity; that investment in public infrastructure is a key input for economic growth; and that existing structural and institutional weaknesses limit the growth potential of the private sector and should therefore be the focus of public policy debate and action.

We also agree that the return of devolution offers a unique opportunity to initiate reforms that could not – for one reason or another – have occurred under direct rule and we further agree that capitalising on this opportunity is heavily dependant on the ability and willingness of the public and private sectors – but particularly the public – to undergo a cultural transformation: incremental change alone will be insufficient.

We were disappointed not to have seen greater emphasis on the short-term challenges to growth and stability resulting directly from the impact of the Comprehensive Spending Review (CSR), the rapidly accelerating cost of doing business and the likely sharp falls in public sector expenditure growth occurring from 2009 on. Collectively, these will directly impact on future regional economic

[4] Review of Tax policy in Northern Ireland. December 2007. Para 1.12.

growth and will prove a significant challenge for the Executive as it seeks to regenerate the local economy.

Assessment of Varney – corporation tax

In the preparation of responses to Varney I, PwC warned that a single-minded focus on a harmonisation of corporation tax with that of the Republic of Ireland was to ignore the political reality of the difficulties facing Treasury and the Prime Minister, were such an eventuality to be considered. Setting aside the legality of any such action, the attendant problems of 'brass plating' and transfer pricing within the UK would have been exacerbated by the calls from other regions of the UK for similar concessions.

Varney I largely dismissed the ERINI study in support of tax harmonisation, claiming that it, *"…underplays the role of supply-side factors and overestimates, relative to the academic literature, the responsiveness of investment to changes in the rate of corporation tax."* Nevertheless, in terms of a literature review, both ERINI and Varney I drew extensively on equally authoritative academic sources to make their respective cases and we believe that Treasury opposition to any sub-regional tax differential was epitomised in the statement *"…on an assessment of the costs and benefits to the UK,* (our emphasis.) *there is not a case for a lower corporation tax rate in Northern Ireland*[5]*."*

We also believed that the implications of the Azores Judgement could have benefitted from wider debate, insofar as the European Court of Justice (ECJ) recognised that it is possible for a regional body to set a reduced tax rate without it constituting State Aid, providing it is sufficiently autonomous, on both a legal and factual basis, in relation to the central government of the Member State. In such cases, the ECJ ruled, the regional body and not the central government must play the central role in the definition of the local political and economic environment.[6]

In this context, we noted the evidence of the then Secretary of State, Peter Hain to the Northern Ireland Affairs Committee[7], where he confirmed that. *"… if we amended legislation to allow Northern Ireland to have a special rate of corporation tax, it would count as* [EU] *state aid under the Azores judgment, so it would impact upon the current flexibility we have in terms of financial assistance to business in Northern Ireland in other respects: … we could have corporation tax relief or grants and loans… but not both … That is a matter of the law."*

We acknowledge that amending the constitutional position of Northern Ireland to reflect that of say, Gibraltar, (which, under the ECJ Azores ruling, could set whatever corporation tax rate it saw fit), would be difficult for some political parties. Nevertheless, determining the precise implications of such a step for economic regeneration and for political cohesion would have been a worthwhile exercise and we note that Sir David returns to this in Varney II[8].

3. Assessment of Varney – other fiscal incentives

In our own submission and that of the Business Alliance to Varney I, we drew Sir David's attention to the work on fiscal incentives undertaken by the Milford Group in 2001/02 and subsequently endorsed by DETI and DFP and the then Secretary of State, Dr John Reid. This acknowledged that international research found a correlation between heightened levels of investment in R&D

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5 Review of Tax policy in Northern Ireland. December 2007. Page 3

6 European Court Of Justice. Azores Judgement. C-88/03.

7 Transcript of oral evidence. hc 476. Northern Ireland Affairs Committee: Political Developments in Northern Ireland. Wednesday 18 April 2007

8 Review of the Competitiveness of Northern Ireland. April 2008. Para A.19

and innovation, training and skills development, and marketing; and growth in exports, per-capita GVA and productivity.

Our own and the Businesses Alliance's proposals recommended tax incentives to encourage this level of investment and demonstrated that this was both fiscally neutral over time and could effectively reduce the corporation tax liability of R&D and skills-intensive investors, to a level equal to, or below that of the Republic of Ireland. We noted that, in February 2002, the Milford Group had met with Treasury officials and the then Paymaster General who had confirmed that these proposals did not constitute state aid under EU regulations, were capable of being implemented on a sub-regional level and would, in their judgement, encourage additional investment.

In his Budget Statement in March 2002, the Chancellor referred directly to the need to develop specific regional policies, stating, *"…the more each of the UK's regions and Scotland, Wales and Northern Ireland enter into global competition, the more we must encourage and help them harness their distinctive strengths…and, with a modern, locally-led regional policy, rise to the challenge of making their skills, innovation and enterprise world class."* We took this as a clear message that the Chancellor favoured, and would encourage, regional economic policy-making to tackle specific regional issues.

We were therefore both disappointed and surprised to note Sir David's comments in Varney I[9] that these issues could either divert R&D away from other UK regions, be ineligible through lack of market failure , or be, de facto, state aid and ineligible. The comments concluded that. "…*the incentive effect of a higher level of AIA[10] may not be sufficient for this measure to be worth pursuing*" and that grant schemes – widely criticised by successive direct rule ministers as contributing to a grant dependency culture – would, *"… in general be preferable to tax allowances for encouraging investment by firms in training and marketing."* We note that he repeats this argument in Varney II.[11]

In contrast, the 2006 review of the Irish Patent Income Tax Exemption Scheme, undertaken by the Irish Department of Finance concluded that there was a significant body of international evidence to support the view that industry does respond positively to specifically-targeted tax incentives, stating, *"… the cost-benefit return to tax credit schemes is substantially positive: tax credit schemes return an R&D spending of up to twice their cost,"* We note that Sir David agrees with this conclusion.[12] The Irish report also noted that, when account was taken of the fact that the Scheme also provided incentives to individuals and the third level education sector, the benefits of the Scheme considerably exceed its costs. The 20 per cent tax credit, introduced in the 2004 Irish Finance Act, for incremental qualifying R&D expenditure over the amount spent in a base year, is based upon the Milford model

We believe that Sir David's dismissal of regional tax incentives was flawed and contradicts both the previous Treasury position and the Chancellor's position on regional incentives, as demonstrated in 2002. We therefore believe that there is scope to both challenge this position and revisit regional tax exemptions as incentives for regional investment.

Assessment of Varney – general

It is worth moving beyond the headline submission on corporation tax and examining other specific recommendations made in response to Sir David's June 2007 call for comments and evidence.

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9 Review of Tax policy in Northern Ireland. December 2007. Para D17-

10 Annual Investment Allowance

11 Review of the Competitiveness of Northern Ireland. April 2008. Annex A; Tax Policy Issues

12 Review of the Competitiveness of Northern Ireland. April 2008. Para A.8.

The Business Alliance, in its submission to Varney, analysed the economy and its challenges and sought support for key actions, viz:

- A significant reduction in the size, cost and intervention of central government;
- Public expenditure commitments maintained at existing levels;
- A ring-fenced economic development budget;
- Integration of departmental and Invest NI) skills and workforce policy;
- A managed programme to externalise and privatise assets; *and*
- Additional funding to ensure the infrastructure deficit is addressed.

In addition, the Business Alliance response argued that additional funding to help deliver on these objectives could be found through:

- Driving down the cost of governing Northern Ireland and, where necessary, increasing revenues;
- Selling public assets and the transfer of assets to the private sector, with the income ring-fenced and retained within Northern Ireland; *and*
- Seeking new and additional support from UK, EU and other sources

In regard to the analysis of the economy and its challenges, we broadly concur with Varney I and II, as has already been discussed. We also believe that the outcomes and recommendations of Varney II largely support the objectives, summarised above, that formed the core of previous submissions. With regard to the Prime Minister's commitment to let the Executive ring-fence the proceeds of privatisation up to £2bn, we consider that ring-fencing all privatisation proceeds is simpler, more transparent and a greater incentive to the Executive.

We note Sir David's caveat in respect of current economic development strategy, *"… more needs to be done to increase the productivity and competitiveness of the Northern Ireland economy…* [by]*…setting challenging new targets… Future policy also needs to ensure the right approach to regional policy… ensuring that opportunities for and benefits of, growth, are shared fairly across the whole of Northern Ireland*[13]." In this regard, Sir David reflects our own belief that the challenge is not what to do – the challenge is what to do *differently*.

In summary therefore, we believe that in both reports, Sir David has gone to some pains to ensure that current Treasury and regional policies remain undistorted by 'special' Northern Ireland incentives. In this we are not surprised. Whether this robust Treasury-centric policy is either justified or appropriate is probably moot as Sir David has ruled out change.

Nevertheless, we believe that the Executive could – and should – push back on the topic of tax incentives for particular activities, but that in other and more general areas, there is considerable scope for action to reduce the size, influence and cost of government, whilst a prudent and considered externalising of public assets would serve to kick-start the private sector.

Varney - key issues requiring further consideration

There are a number of areas where we believe the contents of both reports require either elaboration of further consideration. These are, as follows:

- The Reports largely ignore the potential impact of reduced public expenditure increases, increasing business costs and global investment uncertainty on the local economy and on

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13 Review of the Competitiveness of Northern Ireland. April 2008. Para 1.31.

the climate surrounding private sector growth and any proposed privatisation of state assets. The estimated cost of this impact should be quantified;

- The Reports refer to, but fail to define, the nature of constitutional change that would permit Northern Ireland to comply with the ECJ ruling on the Azores Judgement, thus permitting the Executive to set a reduced corporation tax rate without such an action constituting State Aid. The implications of this and its cost/benefits should be quantified;

- We believe that Sir David's dismissal of regional tax incentives was flawed and contradicts both the previous Treasury position and the Chancellor's previous statement on regional incentives. We therefore believe that there is scope to both challenge this position and revisit regional tax exemptions as incentives for regional investment;

- We accept the recommendation that there is considerable scope for action to reduce the size, influence and cost of government, and believe that the reducing the number of departments should be included in the current RPA process, as should consideration of a wider range of organisational reform;

- The Reports recommend the sale of public assets in general and specific assets in particular to reduce the size and cost of government and accelerate private sector growth. The Executive should be asked to commit to the principle of privatisation and to set a time line for the process;

- The Reports offer no criteria for either the process of asset sales or the process or for determining value for money. This should be pursued and defined;

- Sir David recommends that implementing ISNI be made a priority. We believe SIB should be asked how both procurement and delivery can be accelerated and what the optimum outcomes of policy acceleration could be. This exercise should include the Report's recommendation to investigate the tolling of roads as potentially increasing the road network and if strategic alliances with the private sector would accelerate the process;

- The Prime Minister's commitment to let the Executive ring-fence the proceeds of privatisation up to £2bn, lacks clarity, particularly as the Executive is already committed to sell £1.1bn of fixed assets (excluding public corporations) in the period to 2010-11. We believe that ring-fencing all privatisation proceeds, is a simpler, more transparent and is a greater incentive to the Executive. Any monies raised from this process should be directed towards additional infrastructure investment and should be in addition to the bloc.