Review of the Competitiveness of Northern Ireland

Sir David Varney

April 2008

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Foreword by Sir David Varney

April 2008

Dear Chancellor,

Northern Ireland has made enormous progress over the past decade. Growth in employment and output is unmatched anywhere in the UK outside London and the South East. For this success all parties should take credit. Nonetheless, significant challenges remain if Northern Ireland is to transform itself into a high-value, knowledge-led economy fit to continue to compete in the global economy in the decades ahead.

The Northern Ireland Executive has recognised these challenges and it is encouraging that the economy has been placed at the heart of the Executive's Programme for Government. I strongly welcome its commitment to make economic growth its top priority. The Executive is still relatively young, but the work that has already gone into its programmes for economic development, from skills to enterprise and innovation, is truly impressive.

The Executive now stands on the cusp of a new stage in its development. Having laid down its strategy, the need is to move from analysis to action. This transformation will require strong leadership and a willingness to take tough decisions and ensure implementation is rapid. But I am confident that the Northern Ireland Executive, supported by the UK and Irish Governments, can make this transformation happen.

There are no silver bullets that can transform the competitiveness of the economy. Instead, the Executive will need to maintain a relentless focus on the portfolio of policies and their implementation to deliver increased competitiveness. The key policies should have clear timelines and deliverables so that the Executive can monitor implementation. The UK Government will need to continue to support Northern Ireland through this process.

The Executive has identified policy areas where change needs to occur and this Review proposes more; the key now will be delivering meaningful change. The public sector needs to be reshaped to support a balanced economy with a stronger, more entrepreneurial private sector. There are too many unskilled people in the labour market and resources need to be mobilised to provide the specific skills most needed by the economy.

The Northern Ireland Executive has considerable resources at its disposal and needs to ensure they are directed at enhancing the competitiveness of the economy. Northern Ireland needs also to exploit its special position, having the benefits of being part of the UK, while sharing many collaborative interests and opportunities with Ireland in terms of trade promotion, skills, innovation and public services.

But it is not only the Northern Ireland Executive that has the ability to help drive change. To support this agenda, this Review sets out how the UK Government should help the Northern Ireland Executive to take and implement the difficult decisions that are needed to reform their economy by providing incentives that are specifically linked to reform. The UK Government also has a role in continuing to follow policies in reserved areas that promote prosperity for all in Northern Ireland, building on the measures announced in Budget 2008.

I have consulted widely in preparing this Review and have benefited from a substantial response to my call for evidence. I have also spoken to a wide range of key stakeholders during my visits to Belfast and Dublin, including to many Northern Ireland Executive Ministers, and to a wide range of other organisations. I am grateful to the Northern Ireland Executive for the support that they have provided to my Review team. I have been consistently impressed by the commitment that both the public and private sectors have towards increasing investment and economic prosperity in Northern Ireland.

Looking ahead, there is tremendous scope to build on the successful peace process and develop the economy across a whole range of industries from tourism to financial services. I wish the Northern Ireland Executive well, working with the UK Government and Irish Government, to create a vibrant economy and bring prosperity for all.

Sir David Varney

Executive summary

1. The Northern Ireland economy has the potential to be, in the twenty-first century, the economic success story it was in the nineteenth. It has emerged from decades of conflict with significant international goodwill and some fundamental strengths.

2. Between 1997 and 2006 Northern Ireland had the highest growth rate of any UK region outside London and the South East. It had the lowest unemployment rate of any region in the UK last year. Furthermore, it has core strengths that equip it for further success in the global economy in the years ahead:

- macroeconomic stability as part of the UK economy;
- a young population and an excellent education system. GCSE and A-level results are among the best in the UK; and literacy and numeracy are significantly above the OECD average; and
- strong transport links to the rest of the UK, Ireland and Europe and an £18 billion infrastructure investment plan for the decade ahead. Northern Ireland was the first region in Europe to have 100 per cent access to broadband.

3. These existing strengths make Northern Ireland a location of choice for many investors – and the economy has, as a consequence, seen good flows of foreign direct investment (FDI) over recent years.

4. But globalisation will intensify the challenges for the Northern Ireland economy in the years ahead. The private sector in Northern Ireland is relatively underdeveloped and, while the economy currently has relatively low costs, globalisation will continue to ensure a significant shift of low-value manufacturing and other sectors away from Europe to emerging markets such as China and India. Despite its strengths Northern Ireland has some structural weaknesses. It has the lowest productivity and lowest employment rates in the UK.

5. So, in the years ahead, the Northern Ireland economy will need to develop new sectors in which to become a world leader – to become a high-value, competitive global economy. It will need to close the productivity gap with the rest of the UK. To do so it must be flexible, building on its core strengths of stability, its skilled workforce and strong business climate to attract further investment. This will mean addressing challenges as well as building on strengths.

6. It will mean unlocking the talents of all its people:

- having achieved the lowest levels of unemployment in the UK, Northern Ireland should now address its high level of inactivity – getting people off Incapacity Benefit and into work; and
- building on the flow of highly skilled new entrants to the workforce, Northern Ireland must ensure that it tackles the stock of poor skills – helping those with basic or no skills to move up the ladder; and ensure it is geared up to provide the skills that investors need most.

7. It will mean ensuring a thriving, innovative business sector:

- ensuring that Northern Ireland's world class universities continue to build on promising innovation initiatives, and that businesses are aware of support available through research and development (R&D) tax credits to support innovation.

8. It will need a public sector that supports, and does not hinder, growth:

- the public sector in Northern Ireland is too big – public expenditure is 67 per cent of gross value added, compared with 45 per cent in the UK as a whole and 35 per cent in Ireland. Reducing the size of the public sector, including by selling surplus public assets, will reduce the risk of crowding out the private sector and present new investment opportunities for business;
- public sector wages are around 20 per cent higher than private sector wages and the public sector employs over one quarter of all workers, compared with one fifth in the rest of the UK. Reducing the wage differential over time will help to ensure that private investors can access the most skilled workers in Northern Ireland; and
- in the meantime, the Executive should use funds released from asset sales and increased value for money savings to continue to support investment in key infrastructure and vital services to support economic growth.

9. The Northern Ireland Executive has in place a wide range of strategies for addressing many of these key challenges. This Review welcomes these strategies, for example:

- the Programme for Government which makes economic growth the Northern Ireland Executive's top priority;
- the previous direct rule administration's draft regional economic strategy, which puts private sector-led growth at the heart of its strategy; and
- the implementation of the Review of Public Administration, one of the most ambitious public sector reform programmes in the UK.

10. This Review urges the Executive to implement these and other strategies with urgency and for the Governments of the UK and Ireland to support the Executive in this task.

11. In addition, this Review recommends further action in a number of areas. In particular:

- 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;
- 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;
- the Review recognises the importance of future flows of FDI in bringing new, innovative business to the economy, and creating highly skilled, high-value jobs. The economy already has many strengths on which to build, but there is scope to go further, in particular to ensure a joined up approach between Invest Northern Ireland (Invest NI), UK Trade & Investment (UKTI) and, where appropriate, the Irish Industrial Development Agency (IDA) to market Northern Ireland to the full; and

- capitalising on Northern Ireland's uniquely advantageous position as part of the successful UK economy and part of the all-island economy, which in recent years has been one of the most dynamic economies in the world. Continuing political progress and completion of devolution provide a huge opportunity to open up 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.

Summary of the findings of this Review

Firstly, in order to strengthen the ability of the First Minister and deputy First Minister to have a clear oversight of the competitive position of Northern Ireland, this Review recommends publication on an annual basis of a report prepared by an independent Competition Analysis Board (CAB), somewhat similar to the National Competitiveness Council in Ireland.

Employment

In order to maintain its low unemployment rate while tackling high inactivity levels, the Review recommends that the Northern Ireland Executive should consider the following measures:

- ensure the rapid and thorough implementation of Pathways to Work, the scheme to encourage more people on Incapacity Benefit back into work;
- consider more integrated models of employment and benefits delivery. Ultimately, the ambition of the Executive should be for employment services and benefits to be administered in a single agency reporting to a single Executive Department;
- build on the integration of skills and employment within one Department by ensuring that implementation of all workforce policies is truly joined-up;
- ensure that those in work with low skills stay employed, through better assessment of basic skills needs and the delivery of support and training; and
- further and more rapidly develop the new Local Employer Partnerships to help individuals back into work.

Further, the Review recommends that the UK Government set out how they might be able to support the Executive in the future to deliver challenging welfare reforms that tackle the stock of people on Incapacity Benefit.

Skills

Northern Ireland has a detailed and extensive skills strategy, *Success through skills*. This Review recommends that this is prioritised to ensure real action can be taken swiftly in two areas.

Firstly, given the skills profile of Northern Ireland, the Review believes that improving basic skills should be a priority for the Northern Ireland Executive. To achieve this, this Review suggests:

- Northern Ireland should ensure the flow of skills into the workforce remains strong through implementation of the Bain Review and early implementation of the 14-19 strategy, to ensure that no young people fall through the gaps between the school and further education (FE) sectors;

Summary of the findings of this Review *(continued)*

Skills *(continued)*

- improving basic skills in the current workforce must be the Executive's primary goal, through delivery of targets on functional literacy and numeracy and Level 2 qualifications;
- reviews of *Success through skills* and recent FE reforms should assess their effectiveness at delivering basic skills and increasing workforce training, including what can be learnt from the new system in England, and consider opportunities for greater collaboration with Ireland; and
- the Executive should pledge, as a first step, to bring all eligible public sector workers up to Level 2 and explore the development of a similar private sector pledge.

Secondly, the Review suggests a number of steps to improve intermediate and higher-level skills:

- following the results of pilots, the Department for Employment and Learning should consider how to increase supply and take-up of youth and adult apprenticeships;
- the above review of the new FE system should also consider its effectiveness in delivering intermediate skills, again considering changes in England, and whether it has the structural flexibility to respond quickly to the changing demand of employers and inward investors;
- providing students with better information on the demand for skills through appropriate careers advice in schools and ensuring students have the opportunity to meet young, skilled workers in newer industries with which they are unfamiliar;
- further work to explore whether additional support or incentives such as bursaries would be effective in increasing the supply and take-up of those skills most in demand by the economy;
- the Executive should take the lead in promoting partnership models for supporting foreign direct investment (FDI); and
- a focus on attracting students and graduates with appropriate skills from outside Northern Ireland and consideration of how to improve cross-border job opportunities.

Investment

The full set of proposals set out elsewhere within this report, on skills, enterprise and investment in infrastructure, will be essential in improving levels of domestic business investment and FDI.

- with respect to business investment, this Review believes that the proposed review of the planning system is welcome, but the timescale should be quickened to enable reform to take place more rapidly. It should consider some of the lessons from the *Barker Review of land use planning*, particularly with regard to financial incentives for local authorities to expedite planning applications that bring economic benefits.

In order to support growth in FDI, this Review suggests the following:

- Invest NI should undertake further work with UKTI to develop further the benchmarking process in order to validate the business sectors in which it can demonstrate that Northern Ireland has an internationally competitive offer;

Summary of the findings of this Review *(continued)*

Investment *(continued)*

- the work of Invest NI should be focused through a review. This review should include: the role of Ministers in supporting trade promotion; governance of Invest NI; improved working links with the Irish IDA and UKTI; and embedding links to other Government Departments, universities and non-departmental public bodies; and
- UKTI and, where appropriate, the IDA should further support Invest NI to hone its FDI offer, including through the specific actions identified in the *Review of tax policy in Northern Ireland.*

Innovation

Northern Ireland's *Regional innovation strategy* outlines Northern Ireland's plans to increase innovation in the future, and this Review endorses its direction of travel. To build on this strategy, the Review suggests that:

- the Executive should consider whether more should be done to support clusters based on world-class expertise and support for university excellence;
- the Executive, Invest NI and HM Revenue and Customs (HMRC) should work together to further address the take-up of R&D tax credits in Northern Ireland;
- the Executive should prioritise embedding a permanent third stream of finance for universities such as the Northern Ireland Higher Education Innovation Fund;
- current further education (FE) reforms should ensure that FE skills provision clearly supports the *Regional innovation strategy;*
- the Executive should ensure that reciprocal arrangements for the innovation voucher scheme are developed, and explore arrangements to allow Northern Ireland's businesses to access research support in Great Britain; and
- to improve further the level of international technology transfer and collaborative research, the Executive, UK and Irish Governments and research funding bodies should jointly explore how mainstream science funding and long-term strategy can be aligned.

Enterprise

Building on its current approach, the Northern Ireland Executive should consider the following in order to increase both start-ups and the number of large firms through growth:

- with Invest NI and the Department for Business, Enterprise and Regulatory Reform, investigate the causes of the low uptake of the Small Firms Loan Guarantee and whether there is a case for further intervention to support the scheme;
- a review of forms of financial assistance to ensure that they do not have a market distorting effect and which considers possible reforms of assistance to further reward performance rather than expenditure;

Summary of the findings of this Review *(continued)*

Enterprise *(continued)*

- examine in more detail the barriers to growth faced by businesses in Northern Ireland to ensure that its interventions are tailored to their particular concerns. Where these issues are shared with businesses in Ireland, Invest NI and Enterprise Ireland should work together to develop interventions; and
- keep regulatory burdens on Northern Ireland businesses to the minimum necessary, working where appropriate with the UK Government.

Public sector reform

To improve public sector efficiency, the Northern Ireland Executive should consider the following:

- continuing with value for money programmes and the reform of central government agencies as set out in the Review of Public Administration, and reviewing the number of Executive Departments;
- look at how it could use the public sector pay process to reduce the public-private sector pay differential over time, so that public sector pay reflects better the local labour market;
- further asset disposals where there is no clear economic or social case for retaining them, in order to deliver more efficient services as well as releasing extra funds for investment;
- whether some services, currently delivered by the public sector, could be more productive if they were in the private sector. These include, in particular, public car parks, the Driver and Vehicle Agency, ownership of the housing stock and Belfast Port; and
- how public services might be more efficiently delivered through different types of delivery model, including the potential for greater contestability, and explore reform of procurement policy so that small and medium-sized companies can benefit where this provides value for money.

The Review believes that the emphasis on infrastructure investment must be maintained through effective implementation of the *Investment strategy*. To achieve this, the Review believes that:

- the priorities for infrastructure investment should be clearly aligned to support economic development. It is therefore important that Northern Ireland's overall investment approach, while recognising the need for social and environmental investment, prioritises economic development; and
- in order to achieve more capacity for infrastructure investment, the Executive should consider areas in which there is a case to reduce the level of government intervention and bring in investment from the private sector.

Summary of the findings of this Review *(continued)*

In order to assist the Northern Ireland Executive in taking forward public sector reform, the Review urges the UK Government to confirm existing incentives and provide further incentives to achieve this in the following ways:

- confirm that the Northern Ireland Executive has flexibility to use its public sector pay process to reduce the public-private pay differential over time, so that public sector pay reflects better the local labour market, with savings being retained in Northern Ireland;
- confirm the retention of further value for money savings beyond those in the Comprehensive Spending Review;
- offer similar arrangements to those that apply in Great Britain for dealing with overhanging debt if the Northern Ireland Executive should decide to transfer the Housing Executive to a Registered Social Landlord;
- retention of the proceeds of the sale of Belfast Port if the Northern Ireland Executive were to decide to sell the port; and
- introduce further flexibilities to allow retention of the proceeds of increased sales of surplus land and similar assets.

1 Introduction

BACKGROUND

Recent historical context

1.1 Securing peaceful and stable devolved government has been the UK Government's top priority for Northern Ireland. The Government has recognised that political and economic development are mutually reinforcing, and therefore has attached particular importance to promoting a strong Northern Ireland economy as well as securing political agreement.

1.2 The economy of Northern Ireland inevitably suffered during the Troubles and has not enjoyed the spectacular success of the Irish economy since the early 1990s. However in recent years this position has changed, with increased employment, growth and investment, and confidence in the potential of the Northern Ireland economy has returned. To underpin and reinforce this process, there have been three major economic and financial packages for Northern Ireland since 1997, announced by the previous Chancellor in 1998, 2002 and 2007. Indeed the May 2007 package was a specific response to a commitment made by the UK Government and Irish Government in the St Andrews Agreement, which paved the way for the restoration of devolution.

Terms of reference

1.3 The May 2007 package included a commitment to review taxation in Northern Ireland, which was completed through the *Review of tax policy in Northern Ireland* published on 17 December 2007 (more details are set out in Box 1.1).[1] In response, the Chancellor announced a further review, to consider how to improve the competitiveness of the Northern Ireland economy. The terms of reference of this Review are:

Building on Sir David's earlier analysis and agreement from all parties about the unique circumstances of Northern Ireland (in relation to 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) this review will explore in more detail how to expand the private sector and to enhance Northern Ireland's competitiveness.

1.4 In meeting these terms of reference this Review has built on the findings of the *Review of tax policy in Northern Ireland*, focusing on identifying measures that fall within the responsibility of both the Northern Ireland Executive and the UK Government to promote private sector investment and enhance competitiveness in Northern Ireland. This Review has considered a number of areas identified in the first review including employment, skills, investment, innovation, enterprise and public sector reform.

[1] *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury, 2007.

Box 1.1: The *Review of Tax Policy in Northern Ireland*

On 22 March 2007, the then Chancellor commissioned a Review to report on:

"How current and future tax policy, including the tax changes announced in the Budget in 2007, can support the sustainable growth of businesses and long-term investment in Northern Ireland."

This Review reported on 17 December 2007. Key findings from the Review were:

- that a clear and unambiguous case for introducing a 12.5 per cent rate of corporation tax in Northern Ireland cannot be made given the up-front cost and likely displacement of both capital and profits from the rest of the UK and other factors; and
- that there are a number of key challenges that need to be addressed to build a successful private sector-led economy in Northern Ireland – including strengthening the skills base, addressing high economic inactivity, tackling the size and efficiency of the public sector, fostering innovation and prioritising trade and investment promotion across government.

Drivers of productivity

1.5 The term "competitiveness" usually describes the overall performance of the economy in question, particularly with regard to its productivity, export performance and standard of living.[2] To increase productivity in the UK, the Government has set out a framework of five key drivers of productivity – skills, investment, innovation, enterprise and competition:[3]

- **skills** – a pool of skilled labour is required for the introduction and use of advanced operating techniques and to attract investment;[4]
- **investment** – investment by government and business is key to growth. Investment in infrastructure by government can reduce transportation costs to firms; investment by companies in newer and better technologies can speed up the rate at which a worker can complete a task; and foreign companies investing in the domestic economy can bring the benefits of already competitive and productive firms;[5]
- **innovation** – the creation of new (or advances in existing) practices or technology is key to increasing the productivity of labour and capital;[6]
- **enterprise** – enterprise increases competition in the market, with start-ups often introducing new technologies and practices;[7] and
- **competition** – competition provides firms with incentives to be better than their rivals through innovation and reduces inefficiencies, thereby driving up productivity.[8]

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[2] *Labour market statistics: 2006 update,* Statistics Research Branch DETINI, DELNI, 2006.

[3] HM Treasury's Productivity in the UK series, available from www.hm-treasury.gov.uk. In the most recent report of the series, in addition to the five drivers of productivity, five government levers are set out. *Productivity in the UK 7: securing long term prosperity*, HM Treasury, 2007.

[4] *Productivity in the UK 3: the regional dimension*, HM Treasury, 2001.

[5] Ibid, 2001.

[6] *think/create/innovate: the regional innovation strategy for Northern Ireland*, DETINI, June 2003.

[7] *Productivity in the UK 3: the regional dimension*, HM Treasury, 2001.

[8] Ibid, 2001.

1.6 Two other factors also influence the success of any economy. The first is employment, which, along with productivity, is the key driver of increased output. The second is the public sector, through its policy choices and the employment of a significant share of the workforce.

1.7 Increasing the competitiveness of the Northern Ireland economy will boost employment, GDP and the standard of living,[9] helping to rebalance the public-private sector split in the economy and close the gap between Northern Ireland's performance and that of other parts of the UK and Ireland. Attracting foreign direct investment (FDI) is an important part of this, bringing direct benefits and producing spillovers that benefit the economy as a whole.

Macro-economic foundations

1.8 It should be noted that macroeconomic stability underpins the competitiveness of any economy. Budget 2008 sets out the Government's continuing commitment to delivering stability for all the countries and regions of the UK in difficult global economic conditions. In addition, it sets out developments in tax policies that will benefit Northern Ireland, as well as developments in other key reserved areas of economic policy such as competition policy. More details on this are set out in Box 1.5 below.

THE NORTHERN IRELAND ECONOMY: OPPORTUNITIES AND CHALLENGES

The Northern Ireland economy

1.9 Northern Ireland is building on a number of core strengths. Within the UK, Northern Ireland has had one of the lowest unemployment rates and has experienced the fastest growth of any region outside London and the South East in recent years (see Chart 1.1). Some commentators have estimated that Northern Ireland has the potential to have the third highest percentage rise in economic output over the next 20 years compared with other regions, behind only London and the South West.[10] However, while this is a positive story, Northern Ireland still faces some significant challenges. Northern Ireland gross value added (GVA) per capita was 80 per cent of the UK average in 2005 and has remained around this level for over a decade;[11] public spending accounts for 67 per cent of Northern Ireland's GVA;[12] and although the level of unemployment is at a record low, the level of inactivity remains much higher than the UK average.[13]

[9] The standard of living is often proxied by GDP per capita (among other factors such as access to education and healthcare) meaning that as the state of the economy improves, the standard of living should also rise.

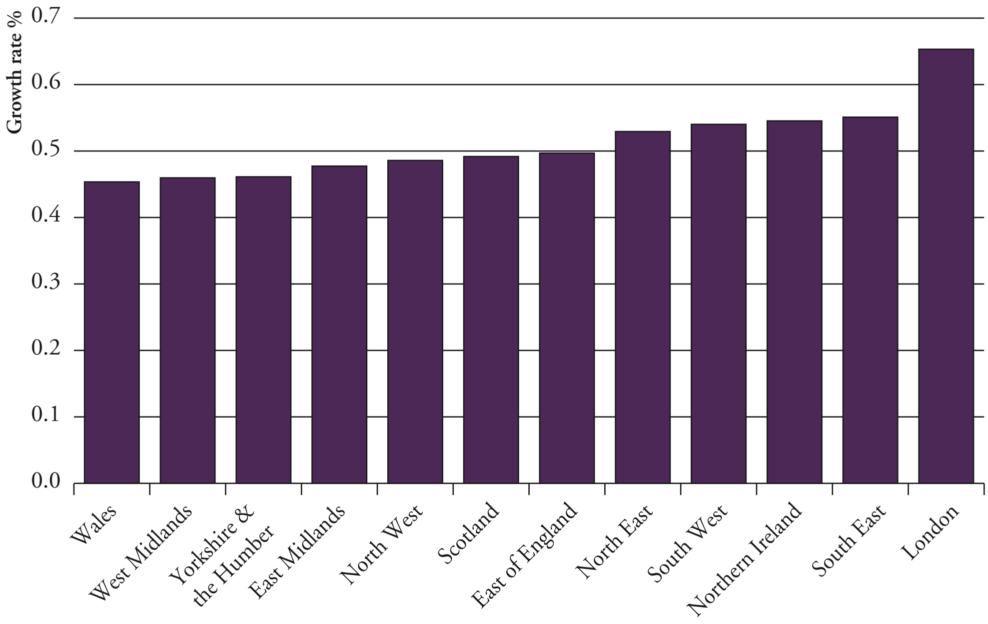
[10] *Economic review: the regional outlook of the UK economy*, Deloitte, Quarter 3 2007.

[11] *Regional and sub-regional GVA estimates,* ONS, December 2007.

[12] Ibid, 2007; Public expenditure statistical analyses, HM Treasury 2007.

[13] *Skills and the Northern Ireland labour market – an overview*, Rogers, D., DELNI, 2008.

Chart 1.1: Growth rate per capita in the United Kingdom regions 1997-2006



Source: PESA (2008)

Key sectors

1.10 The key business sectors in Northern Ireland are manufacturing, wholesale and retail and real estate, renting and business activities. Manufacturing accounts for 16 per cent of total GVA,[14] while wholesale and retail accounts for 15.3 per cent of total GVA. Wholesale and retail employs the greatest number of people, accounting for 15.4 per cent of total employment, followed by manufacturing with 10.4 per cent.[15] Northern Ireland tends to be over-represented compared to the UK average in low productivity sectors, such as agriculture, while it is somewhat under-represented in high productivity sectors such as financial intermediation and business services. A full breakdown is provided below.

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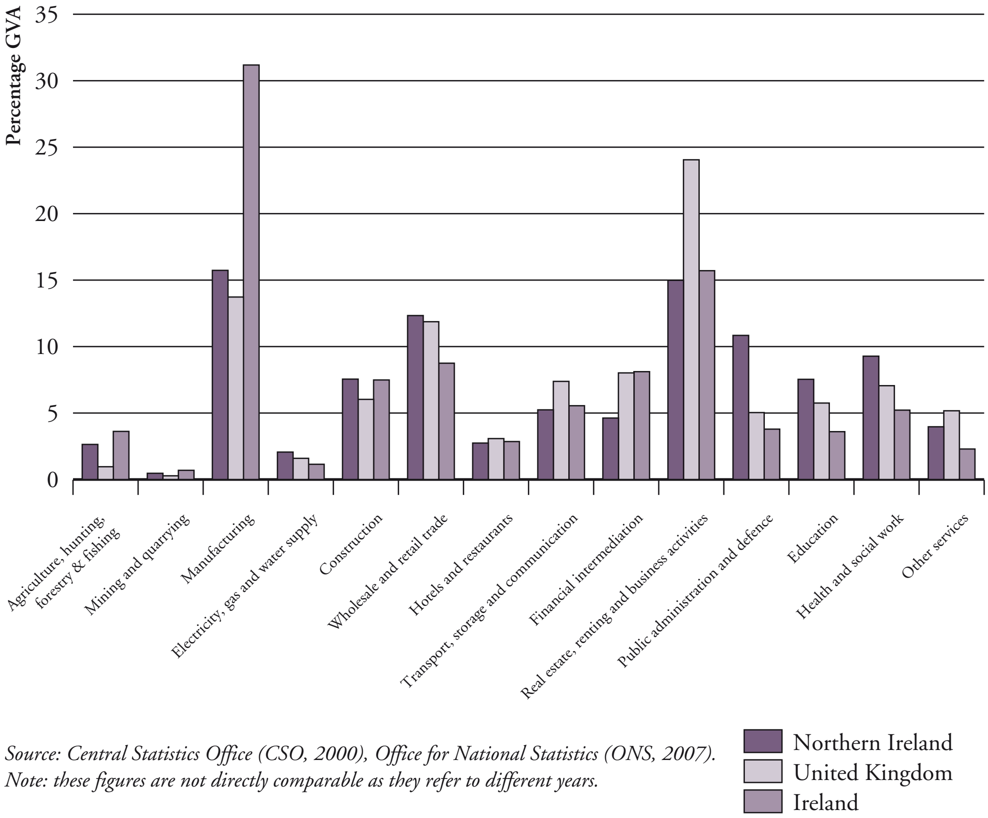
[14] *Northern Ireland Annual Business Inquiry*, DETINI, 2007, Table 1.

[15] Ibid, 2007.

Chart 1.2: Sectoral breakdown of gross value added – Northern Ireland, United Kingdom and Ireland



Source: Central Statistics Office (CSO, 2000), Office for National Statistics (ONS, 2007).
Note: these figures are not directly comparable as they refer to different years.

Foreign direct investment

1.11 In recent years, Northern Ireland has been particularly successful in attracting foreign investment. In a time of rapid and accelerating globalisation Northern Ireland will need to ensure that it continues to remain well-equipped to cope with the changing nature of world business and investment and that it continues to focus on attracting high-value investment. It is not the aim of this Review to “pick winners” in terms of identifying specific sectors for Northern Ireland to focus on in the future. Instead the Review focuses on ensuring that Northern Ireland continues to structure itself so that the economic fundamentals are attractive both to investors and for growing domestic businesses. The Review believes this is the right approach for ensuring the long-term competitiveness and flexibility of the Northern Ireland economy in the years ahead.

Exports

1.12 Northern Ireland has a relatively small domestic market, with a population of just 1.7 million. It is therefore important that businesses in Northern Ireland are well placed to compete in global markets in the future, as income from exports will be a key driver of growth. Northern Ireland exports totalled about £5.2 billion in 2006,[16] about 20 per cent of GVA,[17] compared with UK exports which totalled approximately £243.8 billion in that year,[18] approximately 21 per cent of GVA. Machinery and transport account for about 42 per cent of exports and manufactured goods for 16 per cent. Key export markets for Northern Ireland are Ireland, which accounted for 41 per cent of Northern Ireland's total exports in 2005-06, a much greater proportion than for any UK region, the European Union (excluding Ireland), which accounted for 24 per cent, and North America, which accounted for 20 per cent.[19]

Opportunities for Northern Ireland

1.13 Northern Ireland has a number of strengths and opportunities on which it can build to boost competitiveness and develop its economy.

Existing pool of labour

1.14 Northern Ireland benefits from a relatively young population and an excellent education system. Literacy and numeracy have been consistently measured as significantly above the OECD average[20] and GCSE and A-level results are among the best in the UK.[21] These are similar advantages to those that helped the development of Ireland's "Celtic Tiger".[22] Labour costs in Northern Ireland are below the UK average, with median gross weekly earnings 12 per cent below the UK average, the lowest of any region.[23]

Growth and employment

1.15 The Northern Ireland economy has grown rapidly in recent years, returning the highest per capita rate of growth of all UK regions between 1989 and 2006,[24] and, as noted above, has significant growth potential in the coming years. Given the unique security challenges of recent years, this represents an excellent performance. Most of this growth has been attributable to the increasing levels of employment, with the unemployment rate now one of the lowest of any UK region at 4.2 per cent.[25] While unemployment is relatively low, there remains potential to increase the size of the workforce further through encouraging the economically inactive to return to work.

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16 *UK regional trade in goods statistics*, HMRC, 2007.

17 *Regional and sub-regional GVA estimates*, ONS, December 2007.

18 *UK regional trade in goods statistics*, HMRC, 2007.

19 *Northern Ireland draft regional economic strategy,* DFPNI, 2007; *Northern Ireland manufacturing sales and exports survey 2006/2007*, DETINI, 2007.

20 *PISA 2003 – NI and international results compared*, Johnston, I., Statistics and Research Branch, DENI, DELNI, 2005.

21 *Regional Trends 39*, ONS, 2006.

22 *Catching up with the leaders: the Irish Hare*, Honohan, P. and Walsh, B., Brookings Panel on Economic Activity, 2002.

23 *Annual survey of hours and earnings 2007*, ONS, 2007.

24 *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury, 2007.

25 *Labour force survey*, ONS, December 2007 – February 2008, seasonally adjusted.

Attracting investment

1.16 Invest Northern Ireland (Invest NI), the economic development organisation for Northern Ireland, has a history of successfully attracting FDI to Northern Ireland in recent years, in particular in ICT and financial services. For example, international companies such as ICICI OneSource, Northbrook Technology and Citigroup have chosen to invest in Northern Ireland over recent years. The UK holds the second largest stock of FDI in the world, and Northern lreland's share of FDI into the UK appears to be on a par with other UK regions.[26] This recent history is helped by a strong incentives package available to foreign investors (see Box 4.1 in Chapter 4).

Further opportunities

1.17 There are a number of further opportunities that Northern Ireland can exploit. Northern Ireland was the first region in Europe to benefit from 100 per cent broadband coverage.[27] It has good transport links to Ireland, Great Britain and the EU; and Northern Ireland has a relatively low crime rate.[28] Furthermore, Northern Ireland can benefit from its areas of particular natural beauty, which could help the tourism industry flourish (see Box 1.2).

Box 1.2: The potential for tourism

There is significant potential for Northern Ireland to benefit more from its areas of outstanding natural beauty and major attractions, such as the Giant's Causeway, which could help the tourism industry to flourish. A potential for attracting "cultural tourism" has also been identified. Northern Ireland's difficult history has affected its tourist industry over recent years, with research suggesting that up to £1.5 billion in tourism revenues were lost during the period 1976-2005. However, following the return of stability and increased visitor numbers over recent years, this could be an important area for future development, as it allows Northern Ireland to make the best of its natural resources. In particular, attracting tourists on an all-island basis will continue to be a key strategy for both Northern Ireland and Ireland.

Challenges for Northern Ireland

1.18 As well as the opportunities outlined above, there are several important challenges that need to be addressed if the economy's full potential is to be realised. A number of these are related to international economic developments well outside of Northern Ireland's immediate control, as summarised by the Northern Ireland Finance Minister Peter Robinson in a recent speech:

"What happens in Northern Ireland may have a very limited impact on the wider world economy, but what happens in the world economy has an enormous impact on what happens in Northern Ireland. As we cannot change the international environment, we must adapt to whatever financial climate it is that we face… there are many varied challenges confronting an economy like Northern Ireland's which include: climate change; energy cost escalation; the growing economic might of China and India; an ageing population; technological innovation; and global political instability. These are big challenges, but there are also enormous opportunities and one of our key tasks must be to position ourselves to benefit from them."[29]

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26 *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury, 2007.

27 *Investment strategy 2008-2018*, Northern Ireland Executive, 2008.

28 *Experiences of crime: findings from the 2006/07 Northern Ireland Crime Survey*, Freel, R. and French, B. Northern Ireland Office, January 2008.

29 Rt Hon Peter D. Robinson MP, MLA, Minister for Finance & Personnel, on the occasion of the Newry Chamber of Commerce Business Lunch Canal Court Hotel Newry, 3 April 2008.

Large public sector

1.19 Not only must Northern Ireland position itself to respond to these changes, but it will also need to address a number of key challenges within its own sphere of control. In particular, the Northern Ireland economy is heavily reliant on the public sector, which accounts for 67 per cent of GVA compared with 45 per cent in the UK as a whole.[30] This large public sector risks "crowding out" the private sector by making it more difficult to attract suitably skilled labour. In Northern Ireland, the average public sector wage is 19 per cent higher than the average private sector wage[31] and it is frequently claimed that the best graduates and highly skilled workers in Northern Ireland choose to work in the public sector as a result of the higher wages, job security and excellent pension.

1.20 There is no single optimal level of public spending as a percentage of GDP. There are examples of successful economies that have both relatively high and relatively low levels of public spending. However, this Review believes that the current size of the public sector is not sustainable in Northern Ireland for the following reasons:

- the large public sector is not self-financing, as the amount raised locally in taxes does not equal local public spending. Indeed households generally pay lower local taxes and charges than in Great Britain. The net fiscal deficit is about 30 per cent of GVA, or around £7 billion, which is clearly not economically sustainable;
- the large public sector tends to crowd out private sector activity, even though it is financed by large fiscal transfers from the rest of the UK rather than high local taxes. There are a number of reasons for this, including labour market distortions created by public sector wages and benefit levels, which are relatively high compared with private sector wages, and high levels of public sector asset holdings, which deprive the private sector of development opportunities; and
- having high levels of public spending can be helpful if directed at promoting economic growth, but in Northern Ireland the greatest differentials of public spending per head compared with the UK average tend to be in social rather than economic areas such as general public services, law and order, agricultural subsidies, housing and culture.

1.21 This Review therefore believes there is a need to rebalance the public and private sectors and to rebalance public spending priorities, and is encouraged by the fact that the Northern Ireland Executive's Programme for Government confirms that growing the economy is its top priority.[32]

High rate of inactivity

1.22 While unemployment is relatively low, Northern Ireland suffers from a very high rate of economic inactivity at 26.9 per cent[33] – this has remained about 6.5 percentage points higher than the rest of the UK over the past decade.[34] This partly reflects a higher number of students, but also differences in the number of long-term sick and low employment rates among those reported disabled.

[30] *Public expenditure statistical analyses,* HM Treasury, 2008; ONS.

[31] The headline differential is 23.2 per cent but controlling for occupational mix the differential is 19.2 per cent. *2007-08 pay and workforce plan*, DFPNI, July 2007, Annex E (updated using 2007 Annual Survey of Hours and Earnings figures).

[32] *Building a better future: programme for Government 2008-2011*, Northern Ireland Executive, 2008.

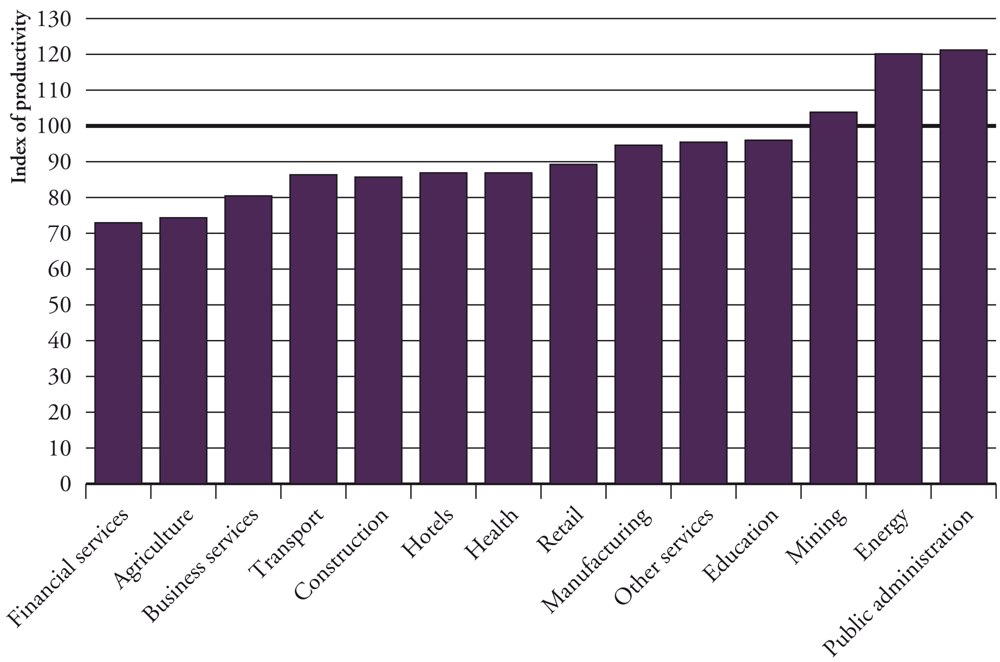
[33] *Labour force survey,* ONS, December 2007 – February 2008, seasonally adjusted.

[34] The inactivity rate in Northern Ireland has varied between approximately 27 per cent and 30 per cent since 1984; UK average is approximately 21 per cent. *Pathways to Work pilots – the next stage of welfare reform in NI,* Russell, J., DELNI, 2005.

Raising productivity

1.23 Northern Ireland has a private sector productivity gap with the rest of the UK, with output per employed person 93 per cent of the UK average excluding the Greater South East.[35] Private sector productivity in Northern Ireland is held back by a lack of basic skills, relatively low levels of enterprise, and historic under-investment in transport infrastructure. While the number of people who only have basic skills is on a par with the UK average, the stock of working adults who have no qualifications is the highest in the UK by a significant margin at 24 per cent.[36] Entrepreneurial activity and business start-ups are slightly lower than the UK average, with a relatively low rate of "churn" among enterprises. Research and development (R&D) levels are below the UK average, with business and enterprise R&D levels the lowest of any UK region, reflecting a relative absence of larger firms.

Chart 1.3: Index of Northern Ireland sectoral productivity relative to the United Kingdom average (index value = 100)



Source: DETINI, 2004

Lack of large, high-turnover businesses

1.24 More than 99 per cent of businesses in Northern Ireland employ fewer than 250 people.[37] While this is largely in line with the UK average, Northern Ireland is characterised by an absence of large, high turnover businesses, which account for only 19.5 per cent of turnover compared with 49 per cent in the UK as a whole.[38]

[35] Private sector productivity is forcast to be 93 per cent of the UK average for 2007/08. *Draft DETI corporate plan 2008-2011*, DETINI, March 2008.

[36] *Skills and the Northern Ireland labour market – an overview*, Rogers, D., DELNI, 2006. Data relate to 2005.

[37] A total of 98.1 per cent of firms employ fewer than 50 people and a further 1.6 per cent employ between 50 and 249 people. *Small and medium enterprises in Northern Ireland*, DETINI, December 2006.

[38] Northern Ireland Business Alliance submission to the Review, February 2008.

GOVERNANCE OF THE NORTHERN IRELAND ECONOMY

1.25 Northern Ireland has emerged from decades of conflict with much international goodwill. The UK is committed to supporting normalisation in Northern Ireland. The Irish Government has committed to investing in Northern Ireland through infrastructure and innovation policy[39] and all-island collaboration can help progress economic development, for example in infrastructure development, energy markets and trade links.[40] Beyond this, Northern Ireland receives additional support from the EU and the US.

Role of UK Government

1.26 The Northern Ireland Executive, the UK Government and the Irish Government are the three main governmental influences on the Northern Ireland economy, along with social partners including private sector employers, trade unions and the third sector. The UK Government has devolved many functions to the Northern Ireland Executive, including regional economic policy and land use planning, education, employment policy and regeneration. However, it retains control over fiscal policy, macroeconomic stability and some other areas of policy (see Box 1.3) and so inevitably has a crucial role to play in improving the competitiveness of the Northern Ireland economy. To support it over the short, medium and long term, Northern Ireland received a spending package from the UK Government, following the return of devolution in May 2007.[41]

Box 1.3: Policies reserved to the UK Government

Under the devolution settlement a number of key policies remain reserved to the UK Government. These include: macroeconomic policy; the public spending framework; central government taxation; competition policy; some aspects of deregulation; financial regulation; and some aspects of science, innovation and enterprise policy. The UK Government promotes inward investment and trade through the work of UK Trade & Investment. Although social security spending is devolved, under the parity principle Northern Ireland follows UK Government policy.

Role of the Irish Government

1.27 The Irish Government has an important role in promoting the competitiveness of the Northern Ireland economy. The Irish Government supported the St Andrews Agreement, and the subsequent financial and economic package in May 2007, providing £436 million for investment in joint infrastructure and science funding in Northern Ireland.[42] *The comprehensive study on the all-island economy*, which reported in 2006, outlined where and why the two administrations should cooperate to achieve optimal results for both economies (for example, in infrastructure and spatial planning, telecommunications and tourism) and, as a result, timelines and implementation plans have been jointly developed.[43] The *Review of tax policy in Northern Ireland* set out in detail the story of the two island economies over recent years, including the lessons that can be learned from Ireland's recent economic success.[44]

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39 *Transforming Ireland, a better quality of life for all: national development plan 2007-2013*, Department of the Taoiseach and Department of Finance, January 2007*; Strategy for science, technology and innovation 2006-2013*, Department of Enterprise, Trade and Employment, 2006.

40 InterTrade Ireland submission to the Review, February 2008.

41 HM Treasury press notice www.hm-treasury.gov.uk/newsroom_and_speeches/press/2007/Press_35_07.cfm.

42 The Irish Government provided Northern Ireland with funding packages worth £400 million for infrastructure and £36 million for research and development. HM Treasury press notice www.hm-treasury.gov.uk./newsroom_and_speeches/press/2007/Press_35_07.cfm.

43 *Comprehensive study on the all-island economy*, British-Irish inter-Governmental conference, 2006.

44 *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury 2007.

Support from the EU and US

1.28 Northern Ireland has also received significant support from the EU and US. The EU has supported Northern Ireland over recent decades including through the PEACE programme for community development.[45] In May 2007 a European Commission Taskforce was established to support efforts to improve competitiveness and involve Northern Ireland more closely in European programmes. The Taskforce reported in April and will be maintained to monitor progress and support the region further.[46] The EU has recently announced significant new funding in the form of three new European regional development fund programmes that will continue until 2013.[47] The US has been consistently supportive of Northern Ireland, both of the peace process, and in encouraging investment through, for example, the Secretary of Commerce's "Trade Mission" in June 1998. More recently, four New York City Pension Funds have committed to investing $150 million in the Emerald Infrastructure Development Fund.[48]

CURRENT ECONOMIC STRATEGY

1.29 Recently, a much greater emphasis has been placed on the economy in Northern Ireland by both the UK Government and the Northern Ireland Executive, especially during the most recent period of Direct Rule and since the restoration of devolution in May 2007, with many initiatives to drive up growth and address the challenges outlined above.

Policies in Northern Ireland

1.30 A number of policies, strategies and programmes of work are in place. These include:

- the Northern Ireland Executive *Budget 2008-2011*, which sets out funding allocations and priority outcomes;[49]
- the *Programme for Government*,[50] which establishes economic growth and reform of public services as top priorities and sets out the target of halving the private sector productivity gap with the UK average (excluding the Greater South East), which is projected to be 7 per cent in 2007-08, by 2015, and a number of other key goals, including increasing employment levels and the number of R&D active companies;
- the *Northern Ireland draft regional economic strategy*,[51] which sets out a private sector led growth strategy for Northern Ireland;
- the *Regional innovation strategy*, which sets out key aims and targets for innovation, for example the creation of a coherent innovation infrastructure, more business R&D, developing a culture of innovation and enterprise, and sustaining the regional innovation system;[52]

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45 http://ec.europa.eu/index_en.htm.

46 *Northern Ireland – Report of the Taskforce*, European Commission, April 2008.

47 These new funding programmes were announced on 14 April 2008. The largest of the initiatives is the sustainable competitiveness programme for Northern Ireland worth €614 million (£493 million), a North/South Peace III programmes worth €333 million (£268 million) and a Northern Ireland and Scotland programme worth €226 million (£182 million). For more details see www.northernireland.gov.uk/news-dfp-140408-614million-eu-programme.

48 www.comptroller.nyc.gov/press/2008_releases/pr08-04-039.shtm.

49 *Budget 2008-11*, DFPNI, 2008.

50 *Building a better future: programme for Government 2008-2011*, Northern Ireland Executive, 2008.

51 *Northern Ireland draft regional economic strategy, DFPNI, 2007.*

52 *think/create/innovate: the regional innovation strategy for Northern Ireland*, DETINI, 2003.

- the *Northern Ireland skills strategy*,[53] which sets out plans to address current and future skills needs to ensure that the economy remains globally competitive by 2015 and beyond;
- the *Investment strategy*, which aims to invest £18 billion over the next ten years (and £5.6 billion of that in 2008-11) and outlines a framework of "investment pillars" to target the investment appropriately;[54]
- independent reviews into health (the *Appleby Review*[55] addressed likely future resourcing needs, making recommendations on funding and efficient use of resources) and education (the *Bain Review*[56] reported on funding arrangements, taking into account curriculum changes and demographic trends and making recommendations on moving towards a more efficient, effective and integrated schooling system);
- the policies and strategic direction of the Northern Ireland Departments. For example the Department for Employment and Learning's objectives include economic development through the provision of skilled labour and helping people back into employment; the Department of Enterprise, Trade and Investment's responsibilities include economic policy; the Department of Finance and Personnel's objectives include prioritisation of the economy's resources; the Department for Regional Development's responsibilities include transport; and the Department for Social Development's include regeneration and housing. In addition, other Departments have involvement with areas that affect growth and competitiveness; and
- public service agreements (PSAs), which set targets for improving public service delivery and economic services provided by the Northern Ireland Executive.[57]

Need to go further in implementing policies

1.31 While the strategies and policies outlined above are an excellent foundation that this Review supports, more needs to be done to increase the productivity and competitiveness of the Northern Ireland economy by implementing these policies effectively and setting challenging new targets in order to improve the position of Northern Ireland with respect to the rest of the UK and EU. Future policy also needs to ensure the right approach to regional policy in Northern Ireland, ensuring that the opportunities for, and benefits of, growth are shared fairly across the whole of Northern Ireland.

53 *Success through skills – the skills strategy for Northern Ireland*, DELNI, 2004.

54 *Investment strategy 2008-2018*, Northern Ireland Executive, 2008.

55 *Independent review of health and social care services in Northern Ireland*, Appleby, Professor J., August 2005.

56 *Schools for the future – funding, strategy, sharing: the independent strategic review of education*, Bain, Professor Sir G., December 2006.

57 *Building a better future: programme for Government 2008-2011*, Northern Ireland Executive, 2008, Annex A.

Box 1.4: Regional policy in Northern Ireland

While variations in economic performance are notable between Northern Ireland and other UK regions, such variations are even more noticeable between areas within Northern Ireland, for example between Belfast and more rural areas. Modern regional policy will therefore involve striking the right balance between a focus on Belfast as the hub of activity and on developing more rural regions such as west of the Bann or the southern counties of Northern Ireland.[58]

The Northern Ireland Executive is currently addressing this issue through its review into locations of public sector jobs, led by Professor Sir George Bain. The terms of reference for the review are available through the website of the Department of Finance and Personnel.[59]

The Northern Ireland Executive's approach to regional policy should also be embedded in the all-island strategy. For example, the Belfast-Dublin corridor provides opportunity for development and agglomeration of sectors such as financial services, where a large, all-island cluster could build up expertise and become a world player.

UK Government policies

UK Government controls some areas of policy

1.32 As noted above, the UK Government retains control over some areas of policy that have a crucial role to play in improving the competitiveness of the Northern Ireland economy. Through its policies, the UK Government helps to promote a strong Northern Ireland economy in a number of ways:

- the Government's successful macroeconomic policies have helped to deliver sustained economic growth, low unemployment and low inflation in Northern Ireland;
- Northern Ireland has the best funded public services in the UK, with public spending per head significantly higher than in England;
- as noted in the *Review of tax policy in Northern Ireland*, Northern Ireland, as part of the UK, has a competitive tax system both internationally and in relation to Ireland. Several aspects of taxation are lower in Northern Ireland than Ireland. In addition, households in Northern Ireland pay less tax than in England because rates are lower than council tax, there is no police precept and there have in the past been no separate domestic water charges;
- Northern Ireland benefits from operating within the rigorous approach to competition policy developed and applied by the UK Government;
- similarly, business in Northern Ireland benefits from the Government's drive to reduce regulatory burdens including the costs of tax administration, although in devolved areas it is for the Northern Ireland Executive to reduce regulatory costs;
- the financial services industry in Northern Ireland benefits from operating within the UK's regulatory systems, which are currently being strengthened following the turbulence in the international financial markets;
- science, innovation and enterprise policies are partly reserved and partly devolved. In reserved areas Northern Ireland benefits from, for example, the work of the Research Councils and being part of the UK Government's long term science strategy;

58 *Northern Ireland draft regional economic strategy*, DFPNI, 2007.

59 www.dfpni.gov.uk.

- Northern Ireland benefits from the UK Government's reforms to tackle poverty such as UK-wide tax credits and the application in Northern Ireland of labour market and welfare reforms such as the New Deal and Pathways to Work; and
- with the support of the Government and the US administration, the Northern Ireland Executive is hosting a major Investment Conference from 7 to 9 May in Belfast for US businesses to help develop the Northern Ireland economy through further foreign investment.

Budget measures

1.33 In addition, the UK Government set out a number of measures in Budget 2008 that will improve competitiveness in Northern Ireland – more detail on these measures is given in Box 1.5.

Box 1.5: Measures in Budget 2008 that will increase the competitiveness of the Northern Ireland economy

Budget 2008 set out a number of measures that will improve competitiveness in Northern Ireland. These include:

- policies to maintain macroeconomic stability, with forecasts of continuing economic growth and low inflation. In 2007, the UK economy had the fastest economic growth among the G7 economies;
- policies to maintain a competitive tax system. From April 2008 the main rate of corporation tax is being reduced to 28 per cent, the lowest ever rate of corporation tax in the UK and the lowest in the G7;
- policies to stimulate enterprise and improve access to finance for small and medium-sized (SME) firms, including a temporary 20 per cent increase in the funds available through the Small Firms Loans Guarantee, additional Enterprise Capital Funds, a new capital fund for female entrepreneurs and an increase in the Enterprise Investment Scheme;
- measures to improve the ability of SMEs to win public sector procurement contracts;
- confirmation of a commitment to a reduction of 25 per cent in the administrative burden through regulation and to ensuring that the benefits of regulation justify the costs;
- reform of incapacity benefits with the introduction of the Employment and Support Allowance. Welfare reform is of particular benefit in Northern Ireland, which has the highest proportion of the population on Incapacity Benefit in the UK; and
- £21 million of additional funding for the Northern Ireland Executive as a consequence of increases in spending on child poverty pilots and contributing to the costs of modernising the public sector.

1.34 This Review welcomes the measures taken by the UK Government in reserved areas of policy. The UK Government should continue to take account of the circumstances in Northern Ireland when framing UK-wide policies, and UK Government Departments, including HM Treasury, should cooperate closely with their Northern Ireland counterpart Departments, particularly in areas where there is both a devolved and reserved dimension.

Promoting cross-border economic collaboration

Lessons from Ireland

1.35 There is much that the UK Government and the Northern Ireland Executive can learn from the success of the "Celtic Tiger" economy. As noted in the *Review of tax policy in Northern Ireland*, key ingredients of Ireland's success include: a strong macroeconomic policy and prudent fiscal policy; a successful partnership with the private sector, unions and voluntary sector; a successful economic and industrial strategy; a well-organised and effective inward investment agency; good use of public spending to reinforce economic objectives particularly in education, skills and innovation policy; effective use of EU receipts; favourable demographic factors; and the favourable impact of the peace process.

The all-island economy

1.36 In addition to learning from the successful Irish experience, a key comparative advantage of Northern Ireland compared with other regions of the UK is that it is geographically linked to one of the most dynamic economies in the world in recent years. Since partition, there has historically been relatively little interchange between the economies on the island. This is now rapidly changing but there remains huge potential to develop all-island economic cooperation further to the mutual advantage of both jurisdictions.

1.37 A wide range of measures was set out in the *Comprehensive study of the all-island economy* published in October 2006. This programme of work should be intensified including:

- increasing inward investment through cooperation between the Irish, UK and Northern Ireland agencies;
- promoting all-island trading opportunities and movement of labour and capital;
- developing all-island markets such as the Single Electricity Market launched in November 2007;
- a coordinated approach to economic and regional planning;
- a coordinated approach to public service delivery (including maximising economies of scale) and to public sector investment planning;
- jointly developing successful sectors such as tourism and financial services;
- jointly building links with social partners, including private sector employers, trade unions and the voluntary sector; and
- continuing to tackle cross-border crime.

1.38 This Review urges the Northern Ireland Executive and the Irish Government to press forward with this programme of work and suggests that consideration should be given to updating the 2006 report and reporting progress and new initiatives since then.

Governance of competitiveness policy

National Competitiveness Council

1.39 The Northern Ireland Executive will need to build on its recent steps to put the economy at the centre of public policy. Fundamentally, this means ensuring an integrated strategy to drive economic policy on competitiveness. This Review has been particularly struck by the comprehensive nature of the Annual Competitiveness reports prepared in Ireland by the National Competitive Council, which supply thorough, up-to-date and comparative data and analysis to Irish Ministers on the competitiveness of the Irish economy (see Box 1.6).

Box 1.6: Ireland's National Competitiveness Council

The National Competitiveness Council (NCC) was established in 1997 as a social partnership body. It reports to the Taoiseach on key competitiveness issues facing the Irish economy, together with recommendations on policy actions required to enhance Ireland's competitive position. Each year the NCC publishes the two-volume Annual Competitiveness Report:

- *Volume 1, Benchmarking Ireland's Performance*, is a collection of statistical indicators of Ireland's competitiveness performance in relation to 16 other economies and the OECD and EU averages; and
- *Volume 2, Ireland's Competitiveness Challenge*, uses this information along with the latest research to outline the main challenges to Ireland's competitiveness and the policy responses required to meet them.

As part of its work, the NCC also publishes additional papers on specific competitiveness issues.

1.40 **This Review therefore recommends strengthening the ability of the First Minister and deputy First Minister to have a clear oversight of the competitive position of Northern Ireland through publication on an annual basis of a report prepared by an independent Competition Analysis Board (CAB), somewhat similar to the NCC in Ireland.** The data to prepare the numeric analysis should be collected in cooperation with the work being carried out in Ireland and the timescale of publication of the independent assessment should be similar. This Review suggests that the First Minister's and deputy First Minister's response to the CAB report should constitute an Executive Action Plan (EAP). There should then be no need for a plethora of other strategy documents, and the EAP could then set down outcome milestones, which could form the basis of performance appraisal. Such a process should help to place the economy, and competitiveness policy, at the forefront of Executive business, and hence it is the first recommendation of this Review, which should support and fit with the findings of subsequent chapters.

CONTENTS OF THIS REPORT

1.41 The focus of this Review is to identify measures to promote private sector investment and enhance competitiveness in Northern Ireland. The Review is structured around a number of challenges first identified in the *Review of tax policy in Northern Ireland*:

- making the most of Northern Ireland's **people** through increasing employment (Chapter 2) and strengthening the skills base (Chapter 3);
- developing **business** through promoting investment (Chapter 4), fostering innovation (Chapter 5), and encouraging enterprise (Chapter 6); and
- reforming the **public sector** (Chapter 7).

1.42 Each chapter is structured with a brief introduction, a discussion of the current situation in Northern Ireland and a section outlining possible policy responses.

Section A: People

2 Employment

High levels of employment are crucial to sustained economic growth. Northern Ireland is in a strong position in this respect, with an unemployment rate that is among the lowest of any UK region. It has a young and growing workforce and the birth rate in 2006 was the highest of all UK regions.[1] In addition, after a long period of emigration, Northern Ireland is beginning to experience the benefits of significant inward migration. However, this masks a very high rate of economic inactivity, which has not declined over recent years.

The challenge for Northern Ireland is therefore to maintain its low unemployment rate while tackling high inactivity levels and, in particular, the high levels of disabled and long-term sick who are receiving Incapacity Benefit.

The Review recommends that the Northern Ireland Executive should consider the following measures to meet this challenge:

- ensure the rapid and thorough implementation of Pathways to Work, the scheme to encourage more people on Incapacity Benefit back into work;
- consider more integrated models of employment and benefits delivery. Ultimately, the ambition of the Executive should be for employment services and benefits to be administered in a single agency reporting to a single Executive Department;
- build on the integration of skills and employment within one Department by ensuring that implementation of all workforce policies is truly joined-up;
- ensure that those in work with low skills stay employed, through better assessment of basic skills needs and the delivery of support and training; and
- further and more rapidly develop the new Local Employer Partnerships to help individuals back into work.

Further, the Review recommends that the UK Government set out how they might be able to support the Executive in the future to deliver challenging welfare reforms that tackle the stock of people on Incapacity Benefit.

INTRODUCTION

2.1 Employment levels are key to economic growth. Economic output can be increased through increasing the overall amount of hours worked in an economy or by increasing the productivity of each worker. Increased productivity is regarded as critical for long-term economic success and is therefore addressed throughout much of this Review, in relation to skills, investment, innovation and enterprise. However, while productivity improvements are critical, economic growth must also be driven by ensuring that all members of the workforce are fully utilised. Getting more people into work requires overcoming barriers for those looking for work, helping people who are unable to work due to sickness or caring responsibilities and encouraging people not actively seeking work to do so.

[1] *Statistics press notice – births in Northern Ireland 2007*, NISRA, 2008.

EMPLOYMENT IN NORTHERN IRELAND

Relatively low unemployment rate

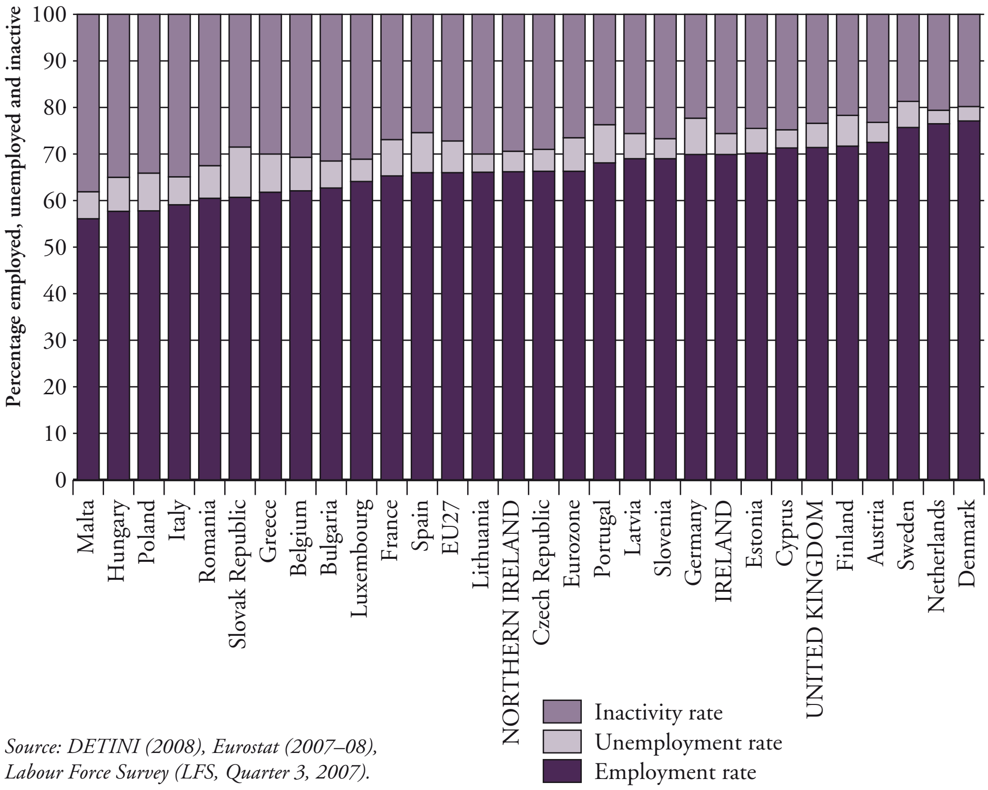
2.2 The Northern Ireland economy is characterised by low unemployment and strong job growth. The unemployment rate is among the lowest of any UK region at 4.2 per cent[2] – well below the UK average of 5.2 per cent and the EU average of 6.8 per cent.[3] Employment growth has been impressive over the past decade, with some of the fastest growth in the UK. This reflects Northern Ireland's success in creating new jobs – over the period 1990 to 2006 the number of jobs in Northern Ireland grew by 30.8 per cent, double the UK average.[4] However, despite this, the employment rate (which excludes both those who are economically inactive and those who are unemployed) in Northern Ireland remains the lowest of any UK region at 70 per cent – significantly below the UK average of 74.9 per cent.[5] Chart 2.2 shows Northern Ireland's position within the EU.[6]

Chart 2.1: Unemployment rate for the United Kingdom, Northern Ireland and Ireland 1999–2006

Source: United Kingdom figures – Labour Force Survey, Office for National Statistics; Ireland figures – Central Statistics Office.
Note: United Kingdom and Northern Ireland figures refer to the Winter quarter of each year, Ireland figures refer to the entire year.

2 *Labour force survey,* ONS, December 2007 – February 2008, seasonally adjusted.
3 Eurostat, January 2008.
4 *The state of the Northern Ireland economy*, Morahan, T., DELNI, 2006.
5 *Labour force survey*, ONS, December 2007 – February 2008, seasonally adjusted.
6 *Northern Ireland labour market report*, DETINI, March 2008. Based on data from Eurostat.

Chart 2.2: International comparison of employment, unemployment and inactivity rates



Source: DETINI (2008), Eurostat (2007–08), Labour Force Survey (LFS, Quarter 3, 2007).

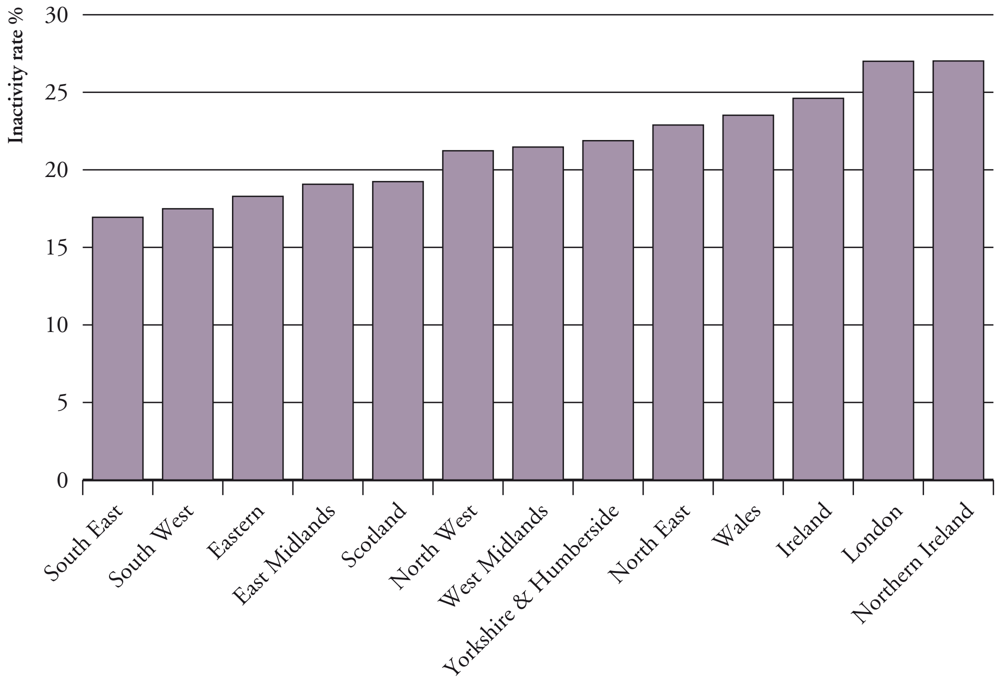
Low employment rate driven by high economic inactivity

2.3 This disparity between unemployment and employment figures reflects a very high rate of economic inactivity. The economic inactivity rate in Northern Ireland is 26.9 per cent – the highest of any UK region by approximately two percentage points and significantly above the UK average of 21 per cent, as illustrated in Chart 2.3.[7] It is also relatively high by European standards, as shown in Chart 2.2. This reflects a long-term trend, with economic inactivity rates having been stable at around 6.5 percentage points higher than the rest of the UK over the past decade.[8] Although some of the recent fall in unemployment may have come at the expense of more people moving onto Incapacity Benefit, this does not explain the persistent gap between economic inactivity in Northern Ireland and the rest of the UK.

7 Ibid, 2008.

8 The inactivity rate in Northern Ireland has varied between 27 per cent and 30 per cent since 1984. *Pathways to Work pilots – the next stage of welfare reform in NI,* Russell, J., DELNI, 2005.

Chart 2.3: Economic inactivity in the United Kingdom and Ireland



Source: LFS (2007), DELNI (2005).

Reflecting large number of long-term sick

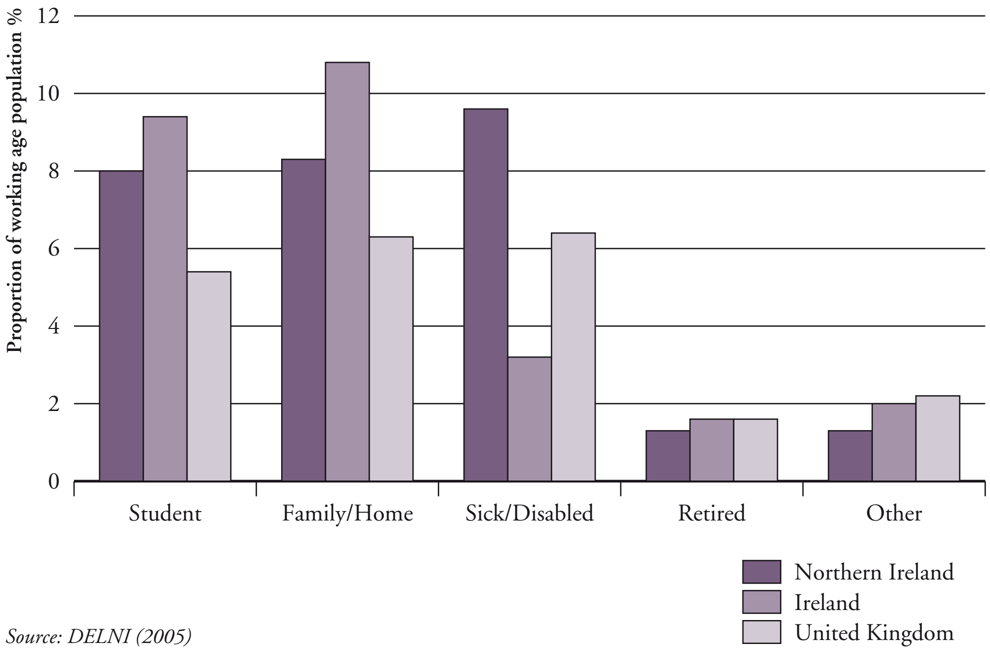
2.4 This high inactivity rate can be broken down. The proportion of students among the economically inactive in Northern Ireland is higher than the UK average and thus partially accounts for the overall difference in inactivity rates. However, excluding students and carers, who are contributing to society in other ways, there remains a significant gap of 2.5 percentage points.[9] Much of this differential can be explained by the difference in rates of reported long-term sickness[10] and in the lower level of employment among those reported disabled. Research for the Department for Employment and Learning (DEL) suggested that the employment rate for disabled males in Northern Ireland is 40 per cent, compared with 60 per cent in the South West of England, despite the employment rate for non-disabled males being the same; around 82 per cent for both regions.[11]

9 Students and those looking after their family and or home account for 53 per cent of the economically inactive in Northern Ireland compared with 51 per cent in the UK as a whole. Excluding these groups, the inactivity rate in Northern Ireland is 12.7 per cent compared with 10.3 per cent in the UK as a whole. *Labour force survey*, ONS.

10 A total of 11 per cent of the Northern Ireland working age population are likely to describe themselves as inactive due to sickness or disability compared with the Great Britain average of 6.3 per cent. E*conomic inactivity*, Rogers, D., DELNI, 2004.

11 *Regional variations in labour market outcomes for the disabled: what can we learn from the Labour Force Survey?*, Michael Anyadike-Danes, ERINI, DELNI, 2005.

Chart 2.4: Economic inactivity by reason – Northern Ireland, Ireland and the United Kingdom



Source: DELNI (2005)

2.5 In terms of age, the disparity in activity rates is most marked for the 45-64 age group,[12] which may point to a "lost generation" resulting from the start of the Troubles. More positively, however, once students have been excluded, rates are better for the 16-25 cohort.

Focus must be on the long-term sick

2.6 This analysis clearly indicates that the challenge for Northern Ireland, and therefore the focus for action, needs to be on the long-term sick, especially men, who are likely to be among the older members of the workforce. The causes of this particular incapacity problem are likely to be complex and, as alluded to above, may be in part related to the start of the Troubles. While health indices for Northern Ireland suggest that there are slightly higher incidences of illness and disability,[13] this alone does not fully explain the differences in the number of declared long-term sick.

Investment in skills is important

2.7 Inactivity rates and skills are, perhaps not surprisingly, closely related, with higher skilled groups having a considerably higher rate of employment and activity than those with low or no qualifications. Skills are not, of course, the only barrier to work and many inactive people face multiple difficulties,[14] but, given Northern Ireland's skills profile (described in detail in Chapter 3), it is highly likely that some of the difference is attributable to poor basic skills. Further, despite the low overall rates of unemployment, the proportion of the most long-term unemployed in

[12] Looking at all inactive people, the inactivity rate for the 45-64 group is 11.4 percentage points above the UK average, compared with 6.6 per cent for all age groups. DELNI analysis for the Review, 2008.

[13] The proportion of working age people with a long-term limiting illness is higher Northern Ireland than most regions in Great Britain. www.poverty.org.uk/I36/index.shtml.

[14] The level of activity for qualified disabled people is 59 per cent, but for unqualified disabled people, this drops to 21 per cent. *Prosperity for all in the global economy – world class skills*, Leitch Review of Skills, Leitch, Lord S., December 2006.

Northern Ireland is twice the UK average.[15] Given that almost one quarter of working-age adults in Northern Ireland have no qualifications,[16] it is very likely that many in that group struggle to find employment because of poor skills, suggesting that basic skills interventions should in particular be aimed at the long-term unemployed.

People must be supported in returning to work

2.8 Recent research in the UK[17] has suggested that the position of individuals claiming Incapacity Benefit over a long period of time may partly be caused by a lack of system responsiveness to their individual situations. For example, some people's situations may have changed since they first registered for Incapacity Benefit, and their health may have improved. Others may be capable of some work but have previously been told it was not available. A simple lack of support to return to work, or of communication of opportunities, may be keeping people on incapacity and other benefits when they could be in work.

Benefit levels may reduce incentives to find work

2.9 In addition, the low rates of private sector wages[18] compared with nationally set benefits may indicate a potential benefits trap which could lead more people to choose to be unemployed or incentivised to claim Incapacity Benefit when they might be able to take on some work. Benefit levels are set uniformly across the UK at a point where, compared with employment at the minimum wage, an individual would be better off in work. However, establishing the level at which "work pays" is not exact, given extra costs which are not as easily quantifiable, and a largely subjective question about the rate at which an individual would rather not work. If more jobs are at the minimum wage in Northern Ireland, and private sector wages are generally lower than the UK average, there is greater likelihood that work incentives will be weaker for a higher proportion of the population. The Northern Ireland Executive may wish to gather more evidence to establish whether this is the case in Northern Ireland.

POLICY RESPONSES

2.10 The solutions to these issues are by no means simple, as individuals not in employment often face many barriers to going back into, or first starting, work. Nonetheless, 90 per cent of people who sign up for Incapacity Benefit expect to return to work.[19]

Government support to help people find work

The New Deal

2.11 For the unemployed, Northern Ireland has broadly followed the Great Britain policy approach centred on the New Deal (see Box 2.1 below). The New Deal has proved to be very successful in Northern Ireland. Since April 1998, total registered unemployment in Northern Ireland has fallen by 60 per cent (to December 2007), while within certain New Deal groups unemployment has fallen by significantly more over the same period – by 81 per cent for the aged 18-24 group and 91 per cent in the aged 25-49 group. The reduction in unemployment for the aged 50+ group was 80 per cent. For all three groups, this was the biggest reduction of all UK regions.[20]

[15] The proportion of long-term claimants in Northern Ireland (i.e. those claiming unemployment-related benefits for over one year) is 20.6 per cent compared with 16.7 per cent for the whole of the UK. Further, the proportion claiming unemployment-related benefits for over five years is 1.7 per cent compared with 0.9 per cent for the UK as a whole. *Labour market statistics: 2007 update*, Statistics Research Branch, DETINI, DELNI, 2008.

[16] See Chapter 3 on skills for more detail.

[17] *The impact of Pathways to Work*, Bewley, H. et al, DWP, 2007.

[18] The median private sector wage is 83 per cent of that of the UK as a whole. *Skills and the Northern Ireland labour market – an overview*, Rogers, D., DELNI, 2006.

[19] *Budget 2008 – stability and opportunity: building a strong, sustainable future*, HM Treasury, 2008.

[20] DELNI submission to the Review, February 2008.

Box 2.1: Welfare to Work and the New Deal

Welfare to Work refers to all active labour market policies,[21] including the New Deal and the emphasis on seeking work (rather than unemployment) through Jobseekers' Allowance (JSA) (rather than Unemployment Benefit).

The New Deal is a programme that provides Jobseeker's Allowance claimants with the help and support they need to find work, including training and preparing for work. It currently involves several strands – New Deal for young people (mandatory for claimants aged 18-24 after claiming JSA for six months), New Deal 25 Plus (mandatory for JSA claimants after eighteen months), New Deal 50 Plus (voluntary for the over-50s who have been claiming a main benefit for over six months), New Deal for lone parents (voluntary) and New Deal for disabled people (voluntary).

The Government document *Ready for Work*, published in December 2007, announced that the Flexible New Deal will be introduced from October 2009, replacing the current New Deals for the unemployed with more personalised, flexible support.[22]

Pathways to Work

2.12 Given the analysis set out above, the key focus now in Northern Ireland should be on those claiming incapacity benefits. Pathways to Work was introduced as a pilot in Northern Ireland in October 2005 and will be available across the whole of Northern Ireland this year (see Box 2.2). The scheme has shown impressive results in trials across the UK and **this Review welcomes its introduction in Northern Ireland and encourages rapid and thorough implementation. Further, the Review suggests that the UK Government set out how they might be able to support the Executive in the future to deliver challenging welfare reforms that tackle the stock of people on Incapacity Benefit.**

Box 2.2: Pathways to Work

Pathways to Work is a programme due to be fully rolled out across the UK in 2008, aimed at encouraging those claiming Incapacity Benefit to return to work. The scheme comprises several elements:

- the "choices" package, which offers programmes aimed at improving labour market readiness and opportunities;
- the Return to Work Credit, for those who find work for at least 16 hours per week;
- in-work support through, for example, mentoring, financial advice and an aftercare service; and
- the Advisers' Discretionary Fund, which can provide rewards of up to £100 per claimant to fund activities or purchases that increase that individual's chances of finding work.

A recent evaluation of Pathways to Work[23] showed that the programme significantly increased the probability of being employed and not claiming Incapacity Benefit a year and a half after the initial benefit enquiry. The programme was also found to have stronger employment effects on women than on men, while the effect on Incapacity Benefit receipt was found to be stronger on men than on women. It was also found to have a stronger effect on those under 50 years of age and on those with dependent children.

21 *Policies for full employment*, DWP, 2004.

22 *Ready for Work: full employment in our generation*, HM Treasury, 2007.

23 *The impact of Pathways to Work*, Bewley, H. et al, DWP, 2007.

A more integrated system response

2.13 A concern raised with the Review was the extent to which the agencies in Northern Ireland that have a role in supporting people into work do not appear to be fully joined up. Given that the barriers to work can be multiple, there is considerable merit in joint working across Government Departments. At the moment benefits are delivered by the Department for Social Development, while employment services are provided by the Department for Employment and Learning. The Welfare to Work system in England and Wales, based on the merger in 2002 of the working age parts of the Benefits Agency and the Employment System to form JobCentre Plus, has been broadly welcomed as an effective way of helping people off benefits and back into work.[24]

2.14 While Northern Ireland has followed this model with the co-location of jobs and benefits offices, reviews of operations have suggested that the model of interagency cooperation is not as fluid as it could be.[25] Management is still split between two Departments. As welfare policy across the UK moves to an even more integrated model of delivery, with the implementation in late 2008 of a simplified Employment Support Allowance (ESA), seamless integration will become more significant. The ESA will replace Incapacity Benefit and Income Support for new claimants with a single integrated benefit, with new claimants undertaking a new Work Capability Assessment to consider what they are capable of and ensure they can take advantage of the support that is available. **The Review suggests that further consideration should be given to how the Department for Employment and Learning and the Department for Social Development can work together even more closely to implement policies such as the ESA. Ultimately, the ambition of the Executive should be for employment and benefits services to be administered through a single agency, reporting to a single Executive Department.**

Skills and employment

Coordinating employment and skills interventions

2.15 The coordination of employment and skills interventions in an integrated service was one of the key recommendations of the *Leitch Review of Skills*.[26] Such integration already exists in Northern Ireland. The Executive has moved responsibility for employment and skills into one department, which provides an excellent opportunity for a truly coordinated employment and skills policy. **Building on this integration, the Department for Employment and Learning will need to ensure that implementation of all policies is truly joined-up.**

2.16 As discussed earlier, poor skills may be a contributory factor in keeping many people out of the labour force. For the inactive, the implementation of Pathways to Work should help to improve their skills. Welfare to Work has been successful in upskilling unemployed people, but Northern Ireland will need to continue to focus on this, especially for the long-term unemployed. However, two thirds of Jobseeker's Allowance claims each year are repeat claims, and half of these are from people with low or no skills.[27] By supporting working skills, not simply for those out of work, but for those who remain vulnerable when they get into work, Northern Ireland can improve the chances of sustaining work. **The Northern Ireland Executive should therefore consider how it might be able to deliver better assessment and support for basic skills training for those who have recently moved from unemployment into work.** Further details on basic skills training can be found in Chapter 3.

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[24] *Economic Survey of the United Kingdom*, OECD, 2005.

[25] *Social Security Agency strategic business review – baseline position*, DSDNI, 2006.

[26] *Prosperity for all in the global economy – world class skills*, The Leitch Review of Skills, Leitch, S., December 2006.

[27] Ibid, 2006.

The role of employers

2.17 Employers have a key role to play in supporting people to get back into work, to ensure that the support delivered by government provides people with the preparation and training that enables them to meet the requirements of employers. Budget 2007 announced that a number of employers had agreed to work with JobCentre Plus at the local level to help the economically inactive and long-term unemployed back to work. A series of these local employment partnerships was announced in the May 2007 devolution package. However, in Northern Ireland progress towards the initial ambition of 5,000 places with employers has been slow. **This Review feels there is merit in the Executive working with local employers to develop the partnership model further. Where possible, this should include further and more rapid development of these partnerships.**

3 Skills

An appropriately skilled workforce is key to economic competitiveness, allowing firms to make use of new technology and produce high-value goods. Northern Ireland has a highly skilled population in general, with GCSE and A-level results that are among the best in the UK. About a third of the workforce holds a degree or higher professional qualification.

Like all regions in the UK, Northern Ireland has a stock of people who have only basic skills. Moreover, Northern Ireland has a particularly large proportion of working-age adults – including within the current workforce – with no qualifications at all. In addition, there are some concerns among employers in Northern Ireland that, while skill levels are generally high, there is a mismatch between the types of qualifications held and the skills increasingly needed by employers.

Northern Ireland has a detailed and extensive skills strategy, *Success through skills*, designed to address a number of these issues. This Review recommends that this is prioritised to ensure real action can be taken swiftly on the two most important areas for action, highlighted below.

Given the skills profile of Northern Ireland, the Review believes that improving basic skills should be a priority for the Northern Ireland Executive. To achieve this, this Review suggests:

- Northern Ireland should ensure the flow of skills into the workforce remains strong through implementation of the Bain Review and early implementation of the 14-19 strategy to ensure that no young people fall through the gaps between the school and further education (FE) sectors;
- improving basic skills in the current workforce must be the Executive's primary goal, through delivery of targets on functional literacy and numeracy and Level 2 qualifications;
- reviews of *Success through skills* and recent FE reforms should assess their effectiveness at delivering basic skills and increasing workforce training, including what can be learnt from the new system in England, and consider opportunities for greater collaboration with Ireland; and
- the Executive should pledge, as a first step, to bring all eligible public sector workers up to Level 2 and explore the development of a similar private sector pledge.

The Review also suggests a number of steps to improve intermediate and higher-level skills:

- following the results of pilots, the Department for Employment and Learning should consider how to increase supply and take-up of youth and adult apprenticeships;
- the above review of the new FE system should also consider its effectiveness in delivering intermediate skills, again considering changes in England, and whether it has the structural flexibility to respond quickly to the changing demand of employers and inward investors;

- providing students with better information on the demand for skills through appropriate careers advice in schools and ensuring students have the opportunity to meet young, skilled workers in newer industries with which they are unfamiliar;
- further work to explore whether additional support or incentives such as bursaries would be effective in increasing the supply and take-up of those skills most in demand by the economy;
- the Executive should take the lead in promoting partnership models for supporting foreign direct investment; and
- a focus on attracting students and graduates with appropriate skills from outside Northern Ireland and consideration of how to improve cross-border job opportunities.

INTRODUCTION

3.1 The quantity and quality of skilled labour available in an economy is an important determinant of economic performance and productivity growth. Research suggests that one-fifth or more of the productivity gap between the UK and countries such as France can be explained by the difference in skills levels.[1] Skills complement physical capital, and are needed to take advantage of investment in new technologies and organisational structures. Access to higher-level skills has been shown to be a necessary (though not sufficient) condition for companies moving from low to high value-added strategies[2] – strategies that support the sort of economy to which Northern Ireland aspires. In addition, management skills have an important influence on how firms react to competition and new innovations, and on how physical investments and human capital are employed.

3.2 Discussions of skills in an economy tend to identify three broad levels. "Basic skills" cover functional numeracy and literacy.[3] "Intermediate skills" provide technical qualifications required by technicians, semi-professionals and skilled tradespeople. "Higher-level skills" are degree-level qualifications, which are often more specialised and expensive to attain.

1 *Prosperity for all in the global economy – world class skills,* Leitch Review of Skills, Leitch, Lord S., December 2006.

2 Research suggests that a company's choice of market strategy is heavily path dependent, and relies on a number of factors. In general a company cannot easily shift from a low-value to a high-value product, as this will have been heavily determined by their product market strategy, business model and investment costs. To make the change also requires more capital as well as better skills. *Enterprise product strategies and employer demand for skills in Britain: evidence from the Employers Skills Survey*, Mason, G., 2004.

3 The Leitch Review understood "basic skills" to be at National Qualifications Framework Level 2, equivalent to five "good" GCSEs or their vocational equivalents. "Intermediate skills" were understood to be NQF Level 3, equivalent to two or more A-levels, and "higher level skills" NQF 4, equivalent to degree-level qualifications. *Prosperity for all in the global economy – world class skills*, Leitch Review of Skills, Leitch, Lord S., December 2006.

3.3 The vision for Northern Ireland's workforce is set out in its skills strategy, *Success through skills*: "by 2015, the Northern Ireland economy is highly competitive in global terms; it is based on high-value jobs … the workforce, increasingly, is literate and numerate and has good information and communications technology (ICT) skills. Individuals can solve problems, work in teams, are innovative and enterprising and expect to learn new skills throughout their working lives."[4] This ambition, and the targets attached to it, is closely aligned with those set out in the Leitch Review[5] for the whole UK, and the aspirations for Ireland as set out in *Tomorrow's skills: towards a national skills strategy.*[6] The Leitch Review argued that making the UK a world leader in skills is an economic imperative: for the UK to compete in a global economy in coming years, the balance between low and high skills has to improve.

3.4 The challenge, for all three economies, is similar. A high-quality school education system is clearly an essential element. But focusing on schools policy will not be enough. As both the Leitch Review and Ireland's Expert Group on Future Skills Needs point out, the majority of the workforce in 2020 has already left formal education. 70 per cent of the UK workforce in 2020 are already over 16 years of age and it is estimated that 60 per cent of Ireland's workforce in 2020 will come from the existing stock. For all three economies, fulfilling their skills ambitions will require significant upskilling of the existing workforce, as well as investment in the school and education system.

SKILLS IN NORTHERN IRELAND

Achievement in schools among the best in the UK

3.5 The current Northern Ireland skills picture is complex, and in many ways the region has a polarised population in terms of skills. The strengths of the younger generation in particular is one key reason for recent growth. The mean score for pupils' literacy and numeracy has been consistently recorded as significantly above the OECD average.[7] GCSE and A-level results are among the best in the UK, with 59 per cent of GCSE candidates receiving five or more A*-C grades at GCSE, the highest proportion of any region, and 81.3 per cent of candidates achieving three or more A-levels compared with 74.2 per cent in England and 71.4 per cent in Wales.[8]

4 *Success through Skills*, DELNI, 2006.

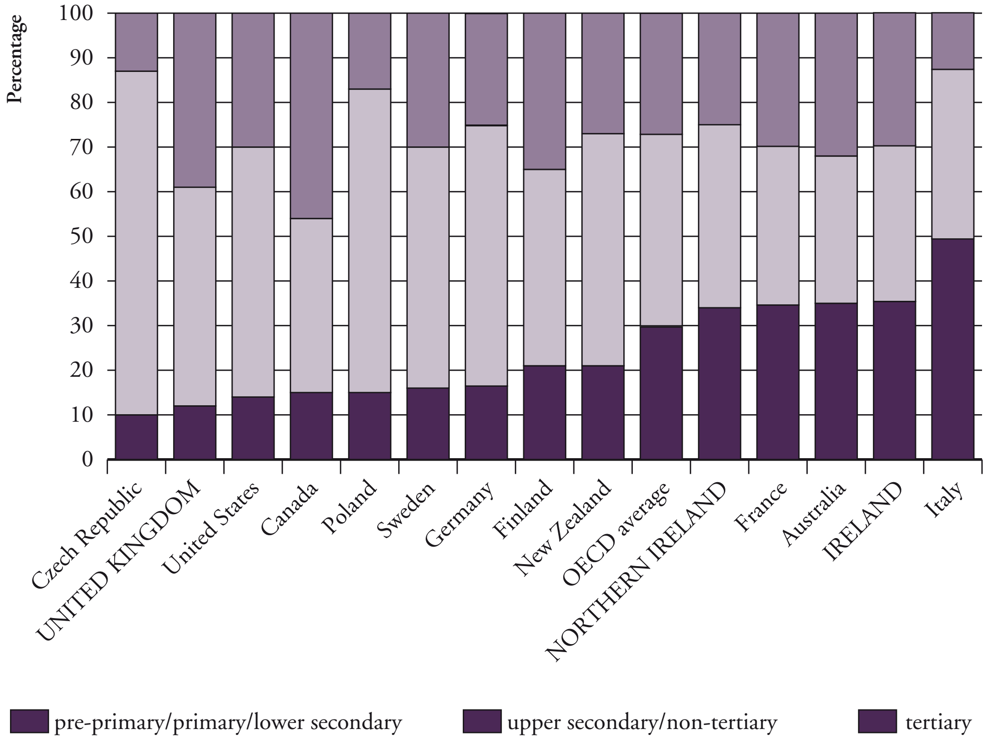
5 *Prosperity for all in the global economy – world class skills,* Leitch Review of Skills, Leitch, S., December 2006.

6 *Tomorrow's skills: towards a national skills strategy*, Expert Group on Future Skills Needs, 2007.

7 *PISA 2003 – NI and international results compared*, Johnston, I., Statistics and Research Branch, DENI, DELNI, 2005.

8 *Regional Trends 39*, ONS, 2006.

Chart 3.1: Level of educational attainment – international comparisons



Source: OECD Education at a glance 2007, Labour Force Survey
Note: Northern Ireland figures are not directly comparable due to variations in the classification of levels of education. Some countries do not sum to 100 per cent due to rounding errors.

3.6 While Northern Ireland can boast of some of the best and the brightest young people, there is some concern that Northern Ireland also has a long "tail" of young people who have fairly poor skills. Some recent data suggest that the gap between the highest and the lowest performing 15 year olds in reading, mathematics and science is the largest among the four UK countries, with Northern Ireland having some of the lowest scores across the UK as well as some of the highest. However, qualifications data suggest that the proportion of young people leaving school with no graded qualifications is roughly in line with the UK average, so these results should be treated with some caution.[9]

[9] *Student achievement in Northern Ireland: results in science, mathematics and reading among 15-year olds from the OECD PISA 2006 study*, Bradshaw et al., OECD Programme for International Student Assessment, 2007.

Table 3.1: Regional Educational Attainment 1995/96–2005/06

Performance Indicator	Region	1995/96	1999/00	2005/06
Percentage achieving 2+ A-levels Grade A-E	**NI**	90	93	98
	England	83	87	97
	Wales	87	92	94
Percentage achieving 5+ GCSEs Grade A*-C	**NI**	52	57	63
	England	45	49	59
	Wales	42	49	54
Percentage achieving 5+ GCSEs Grade A*-G	**NI**	84	87	90
	England	86	89	91
	Wales	79	85	86
Percentage achieving no GCSEs	**NI**	5	4	3
	England	8	6	2
	Wales	11	8	7

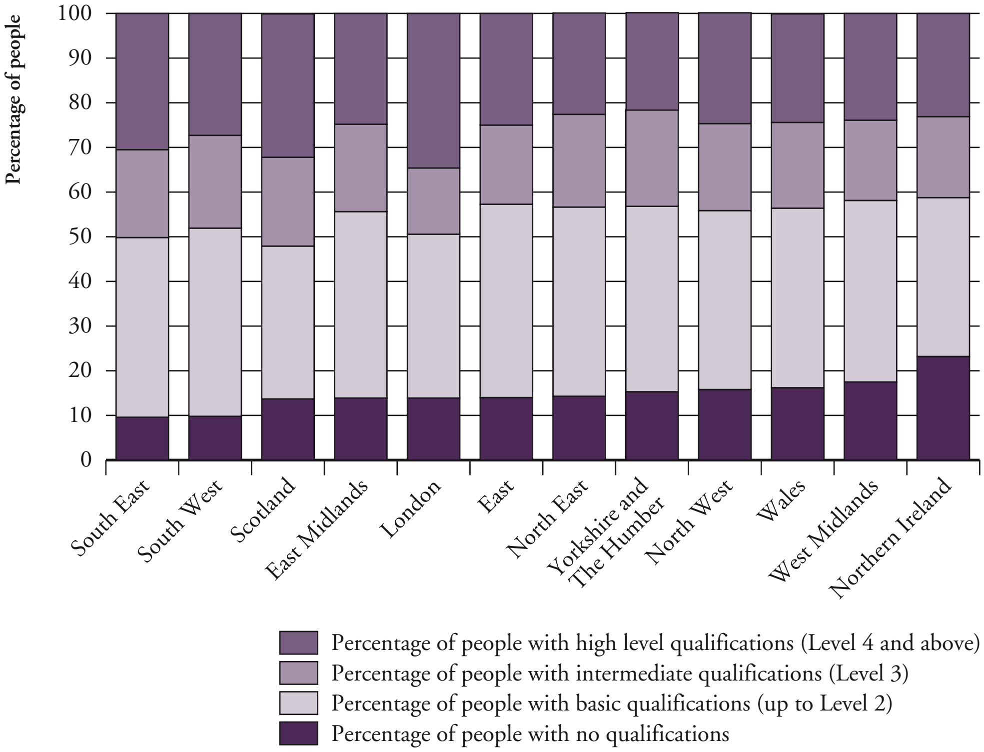
Note: Scotland is not included as the results are not directly comparable.
Source: Northern Ireland draft regional economic strategy (2007); Department of Education.

Poor skills within existing workforce

3.7 Within the existing Northern Ireland workforce the proportion of higher-level skills is around the UK average, with just under one-third of the current workforce holding a Level 4 qualification (degree or higher professional qualification) or above.[10] Taking into account the whole population, however, only 23 per cent have a Level 4 qualification, which is just below the UK average, and well below that of Scotland, London and the South East of England.[11] This difference is partly a reflection of the higher levels of inactive people in Northern Ireland who lack higher skills.

10 *Regional competitiveness and state of the regions*, DTI, 2007.
11 *Regional Trends 39*, ONS, 2006.

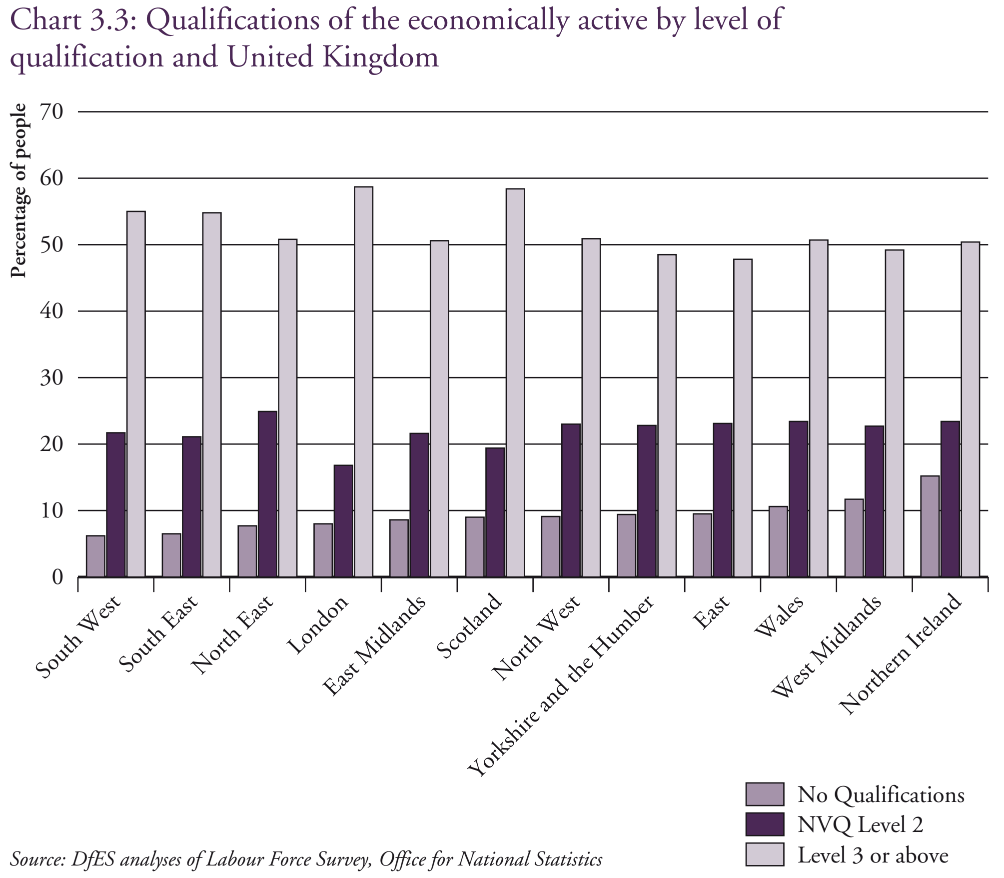
Chart 3.2: Qualifications of the working age population by United Kingdom region



Source: Nomis data, Jan – Dec 2006
Note: the percentage of people with qualification levels basic and intermediate also include other qualifications (for example, foreign qualifications). These figures were calculated using the Labour Force Survey (ONS) method of apportioning – 55 per cent of other qualifications are at NVQ Level 1, 35 per cent at NVQ Level 2 and 10 per cent at NVQ Level 3.

3.8 Furthermore, while the number of people who only have basic skills is on a par with the rest of the UK (around 74 per cent are educated to at least NVQ Level 2, the same proportion as the UK overall)[12] the stock of working-age adults who have no qualifications is the highest in the UK by some margin, at 24 per cent (see Chart 3.2). As would be expected, a large proportion of the inactive population have poor basic skills.[13] However, the problem of low skills is not confined to those out of the workforce: among economically active adults, 15 per cent have no qualifications. This is noticeably higher than any other UK region (see Chart 3.3).

[12] *Regional competitiveness and state of the regions*, DTI, 2007.
[13] *LFS Microdata*, July-September 2007.



Skills challenges for Northern Ireland

Improving skills at every level

3.9 There are two broad, and inter-related, skills challenges for Northern Ireland, in common with most other regions of the UK and Ireland. The first is the need to drive up skills levels across the board, but in particular to grapple with the stock of people with low and basic skills. Figures show today's flow into the "no qualifications" group in Northern Ireland is actually lower than in other parts of the UK.[14] Current school education is therefore providing a strong flow of skills for the future, although it will need to continue to work to shorten the "tail" of people who have no qualifications. More significantly, Northern Ireland will simply not be able to fulfil its full growth potential unless it is able to upskill the stock of poorly qualified people already in the workforce.

3.10 The causes of the particularly high number of those of working age without basic skills are not fully understood, although the age profile of those affected suggests it may well be linked to upheaval during the years of the Troubles.[15] In order to improve levels of basic skills, the Executive will need to tackle entrenched personal barriers to education, often among people who have been out of the labour market for many years. This challenge is discussed in more detail in Chapter 2.

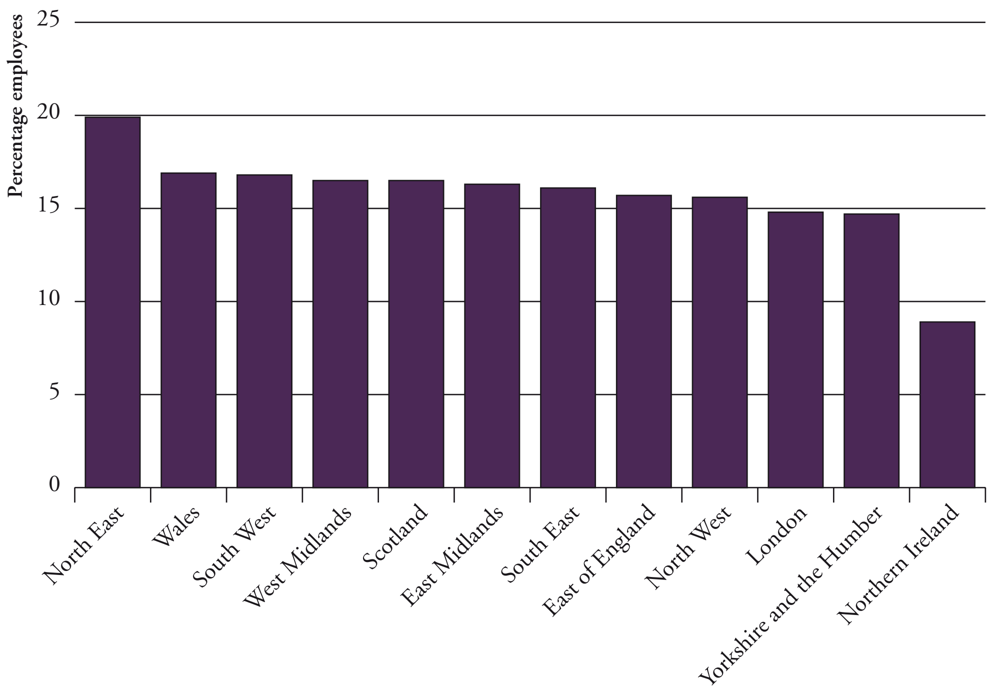
3.11 As the charts above show, the proportion of intermediate skills in Northern Ireland is similar to many other UK regions. However, one potential issue, which merits further investigation, is the extent of employer involvement in training to provide intermediate skills. Intermediate skills are often delivered through a mix of publicly funded training and employer-led training. Evidence

[14] Only 4 per cent of students in Northern Ireland received no GCSEs in 2003/4 compared with 5 per cent in England and 7 per cent in Wales. *Northern Ireland draft regional economic strategy*, DFPNI, 2007.

[15] DELNI Submission to the Review, February 2008.

suggests that Northern Ireland has some of the lowest employee training levels in the UK: 8.9 per cent received some form of training in the past four weeks, compared with 15.9 per cent for the rest of the UK.[16] This difference may be related to the lack of large companies in the economy, who tend to invest more in employee training than smaller companies. The extent of employer involvement in training to provide intermediate skills and how this can best be encouraged should be explored further.

Chart 3.4: Percentage of employees who received job-related training in the last four weeks



Source: Department for Education and Skills, Labour Force Survey (2007)

Ensuring skills meet the demands of the economy

3.12 The second broad skills challenge is to ensure that the supply of skilled labour in Northern Ireland meets demand and that workers have qualifications that are economically valuable and which support the current and future needs of Northern Ireland's economy. This is particularly an issue for higher-level skills, but also for intermediate skills. Employers across Northern Ireland are currently reporting skills shortages, with specific concerns reported in ICT and at technician level generally.[17] Respondents to the Review also referred to a shortage of science, technology, engineering and mathematics (STEM) graduates.

3.13 Evidence of skills gaps and shortages needs to be treated with some caution. While Northern Ireland has the highest proportion of "difficult to fill vacancies" compared with the rest of the UK,[18] it reports the fewest number as attributable to skills problems (although this may, in part, be due to reporting differences between regions).[19] Moreover, skills shortages for particular

[16] *Incentives to train: ensuring employer engagement*, National Skills Forum, 2007.

[17] Northern Ireland Business Alliance submission to the Review, February 2008.

[18] 61 per cent of vacancies in Northern Ireland are "difficult to fill" compared with 46 per cent in Scotland, 35 per cent in Wales and 37 per cent in England. *Future skills Wales 2005 sector skills survey*, Future Skills Wales, 2006.

[19] 39 per cent of hard to fill vacancies in Northern Ireland are due to skills shortages compared with 49 per cent in England. *Northern Ireland skills monitoring survey 2005*, DELNI, 2007; *National employer skills survey 2005*, Learning and Skills Council, DfES and SSDA, 2006.

industries or skills sets are not, on their own, sufficient cause for intervention – they may simply reflect the relative attractiveness of a particular industry given the current job market.[20] Nonetheless, the lack of sufficient highly skilled workers in specific sectors was a point regularly made by respondents to the Review call for evidence.

Flexibility of education and training

3.14 Respondents to the Review suggested that part of the reason for this might be that the education and skills system is not adequately aligned to the requirements of the economy, in terms of both the type and number of appropriately qualified graduates. Respondents expressed concern that the process of delivering the required skills over both the short and long term is too bureaucratic, involving too many organisations. For example, concerns were expressed regarding the relationship between the funding structure of universities and FE colleges, which was claimed does not always support the strategic direction of Northern Ireland's economic development policy.[21]

3.15 In particular, there was general uncertainty about the ability of the economy to respond rapidly to a need for certain additional skills (for example, if a large foreign company was considering investing). The commonly held belief is that such a shortage could have an effect on the economy's ability to expand domestically, and to attract foreign direct investment (FDI), because companies would be discouraged from setting up or expanding if they could not easily access the appropriate skills. The effect on FDI is discussed in more detail in Chapter 4.

A Northern Ireland brain drain?

3.16 Another regularly citied cause of Northern Ireland's apparent higher-skills shortage is a "brain drain". It is often claimed that high numbers of those with good GCSEs and A-levels leave Northern Ireland to study and do not return, or study at Northern Ireland's universities but then leave Northern Ireland on graduation.

3.17 However, the evidence is more complex than this. Approximately 30 per cent of young people move away from Northern Ireland to study. Other than Scotland, where only 7 per cent move away, this compares favourably with other UK regions; 27 per cent of young people leave Wales and over 60 per cent leave the South East of England.[22] Out-migration from Northern Ireland has also declined considerably since the early 1990s.[23] Further, the group who leave contain a mixed set of abilities; proportionately more do so to study law or other vocational subjects (including medicine), and the cohort contains a higher proportion of students with the best scores and a higher proportion with some of the worst scores.[24]

3.18 However, a key issue for Northern Ireland is that the loss of students to study is not offset by a commensurate inward movement. For most regions, the students who move away are replaced by others coming to study. Taking these incoming students into account, Northern Ireland loses a net 29 per cent, more than any other region other than the East of England.[25] Submissions to the

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[20] For example, the Institution of Civil Engineers annual report on capacity and skills notes that the supply of skilled labour in engineering has been constrained by competition from other professions, such as the financial sector, which has been expanding rapidly recently. *The State of the Nation – Capacity and Skills*, Institution of Civil Engineers, 2008.

[21] Business Alliance Submission, First Report on Economic Challenges facing Northern Ireland, 2006.

[22] *Destination of Leavers from Higher Education 2005/06*, HESA, 2007.

[23] Northern Ireland domiciled higher education applicants. *An analysis of UCAS data 2003/4 academic year*, DELNI, 2005.

[24] Ibid, 2005; *Northern Ireland's graduates: the classes of '95 and '99*, Purcell, K. et al, DELNI, 2005.

[25] A further distinction needs to be made here, between those who leave Northern Ireland out of choice, and those who would rather stay. The proportion of those who would otherwise stay if accepted by a Northern Ireland institution appears to have declined in recent years. Only 4 per cent of applicants who left Northern Ireland in 2003/04 had chosen a Northern Ireland institution as their first choice. *An analysis of UCAS data 2003/4 academic year*, DELNI, 2005.

Review have suggested that political and social unrest were key factors in the decline in students coming from outside Northern Ireland, and recent years have shown some growth in the numbers of students coming from outside Northern Ireland to study.

3.19 Perhaps a more significant issue, however, is not where students choose to study, but ultimately where they choose to work once they have completed their education. Data suggests that, in this respect, Northern Ireland compares very favourably to other regions. Around 82 per cent of young people who study in Northern Ireland choose to remain, compared with 86 per cent in Scotland and 69 per cent in Wales.[26] Among those who leave to study, approximately 53 per cent do in fact return to Northern Ireland to work.[27] This puts Northern Ireland roughly in the middle of all UK regions, with London drawing most young people back to work (77 per cent) and Wales drawing the fewest (40 per cent).[28]

Underemployment of graduates?

3.20 Finally, some submissions suggested that some graduates are currently "under-employed" given their skills. Unemployment among recent graduates in Northern Ireland is the lowest in the UK, at 5.3 per cent, compared with 6.5 per cent across the UK.[29] The number of graduates employed in non-graduate roles shows little difference between Northern Ireland and the rest of the UK, with just over half of UK graduates starting their careers in non-graduate jobs, compared with 44 per cent of Northern Ireland graduates. For both groups this drops over the subsequent four years, also to a similar level (to around 15 per cent for the UK and 17 per cent for Northern Ireland).[30] Moreover, the portion of people with graduate-level skills who are not currently using them could be plausibly seen as a valuable pool of adaptable labour, enabling an otherwise tight labour market to respond flexibly to the arrival of higher-value FDI.

POLICY RESPONSES

Case for government intervention to improve skills

3.21 The case for intervention in skills markets is well established. Individuals and employers may not invest in the optimum level of education and training due to a number of "market failures". These include externalities (an employer may not pay the full cost of training an employee as they may not capture the full benefits should an employee move on), information asymmetries between employers and employees, and the difficulty for individuals in evaluating current costs and benefits against future returns.[31] However, the optimum level, and method, of government intervention is not as clearly understood. The balance between employers, individuals and government varies dramatically across countries. Broadly, however, it is understood that the balance of responsibility shifts across skills levels, with a strong case for government support and funding at basic levels, which diminishes as skill levels increase, since the returns to employers and individuals, and thus their private incentives to invest, tend to increase at higher skills levels.

[26] *Destination of leavers from higher education institutions: longitudinal survey of the 2002/3 cohort*, HESA, 2007.

[27] This is lower than the more commonly reported figure of 70 per cent. The difference is due to the survey used. This difference notwithstanding, it is the comparative position of Northern Ireland that counts.

[28] Analysis of longitudinal survey of destination of leavers from higher education institutions, HESA, 2008.

[29] *Regional Trends 39*, ONS, 2006.

[30] *Northern Ireland's graduates, the classes of '95 and '99*, Purcell, K. et al, DELNI, 2005.

[31] For a more detailed explanation of these failures, see: *The Leitch review of skills, Prosperity for all in the global economy – world class skills*, Leitch, Lord S., December 2006; *Market Failures in Skills*, Keep, Professor E., Skills for Business, 2006.

Northern Ireland's skills strategy

3.22 Northern Ireland's approach to its skills challenge is set out in its skills strategy, *Success through skills* (outlined in Box 3.1) launched in 2006. This preceded both the *Leitch Review of skills*,[32] which set out the likely skills needs for the UK for the year 2020 and how the UK could best meet those needs, and *Tomorrow's skills: towards a national skills strategy*,[33] which, similarly, set out how Ireland should meet the challenge of a changing economy competing in a global marketplace. Northern Ireland's approach to its skills challenge should be considered in the context of these reports, while taking into consideration its specific circumstances.

Box 3.1: Northern Ireland's Skills Strategy: *Success through Skills*

Success through Skills was launched in 2006, following a consultation that began in 2004. It sets out how the Department for Employment and Learning (DEL) plans to meet current and future skills needs to ensure that the economy remains globally competitive in 2015 and beyond.

Success through Skills is built around four themes:

- understanding the demand for skills;
- improving the skills level in the workforce;
- improving the quality and relevance of education and training; and
- tackling skills barriers to work.

Grouped under these themes are sixteen projects, designed to tackle a wide range of challenges facing the Northern Ireland economy. Some of the larger projects include:

- FE Means Business – a plan to reform the FE sector to improve quality and increase responsiveness to the requirements of the economy. This included a reduction in the number of FE colleges from sixteen to six, completed in August 2007, as well as consultation on reforms to the funding systems and curricula;
- a labour market information project – DEL undertook a large-scale review of labour market information and international best practice. This concluded in January 2008, and is designed to provide improved information flows between employers, individuals and education and training providers; and
- Regional Employment and Skills Action Plan – this project seeks to articulate skills needs at local and regional levels. One of the most significant developments is the constitution of a Skills Expert Group to advise on Northern Ireland's skills needs, as well as six sub-regional Workforce Development Fora (WDF), which are employer-led and responsible for articulating local needs. The WDF are based in the same six areas as the new FE colleges, which act as the secretariat for the Fora.

A number of other projects involve new arrangements for apprenticeship training, measures to improve management and leadership training, development of Northern Ireland's essential skills strategy and development of skills for innovation. The majority of these projects should be implemented during 2008-09 and be in place by 2011.

DEL will be reviewing its strategy during 2008 to assess the impact of implementation of the strategy, and to update it in light of national and international developments.

[32] Ibid, 2006.

[33] *Tomorrow's skills: towards a national skills strategy*, Expert Group on Future Skills Needs, 2007.

The challenge ahead

3.23 It is clear from the brief overview of Northern Ireland's skills strategy in Box 3.1 that the Executive has been active and energetic in seeking to tackle its skills challenges. Many of its policies (for example on labour market information) anticipate recommendations in both the Leitch Review and *Tomorrow's Skills*. The Review believes that this foresight and ambition demonstrates the depth of commitment within Northern Ireland to the skills agenda. The key challenge for the Executive will now be how, within its resources, to ensure that priority is given to those areas that will make the biggest difference to the state of Northern Ireland's skills. It is noticeable that the Department for Employment and Learning (DEL) has set itself a large number of projects that cover the whole spectrum of skills and target groups. It will be important for the Executive to ensure that those strategies are implemented effectively to deliver real change in the way all actors – individuals, employers and education and training providers – behave.

Basic skills

Standards in schools

3.24 With respect to basic skills, the best and most effective way of ensuring that the population has the skills to learn further, and make the most of employment opportunities, is to ensure that primary and post-primary compulsory education are effective. In this respect Northern Ireland is performing well relative to the rest of the UK. In the ongoing reforms to Northern Ireland's education system, the challenge for the Executive will be to ensure that Northern Ireland's educational advantage is maintained, while at the same time widening opportunities for all young people to share in that excellence. All schools and colleges should be brought up to the standards of the best. **The first step should be the implementation of the Bain Review. Further, the Department of Education and Department of Employment and Learning should work together to implement the joint 14-19 strategy as soon as possible, to ensure that no young people fall through the gaps between the school and FE sectors**.

Improving the basic skills of the current workforce

3.25 However, it is clear that most of the change to Northern Ireland's skills profile in the years ahead will have to come from transforming the existing workforce. As noted above, 15 per cent of the existing workforce have no qualifications. This is noticeably higher than Ireland and the rest of the UK. **Considering the skills profile of Northern Ireland, the Review believes that improving basic skills in the workforce should be clearly prioritised by the Executive**.

3.26 Functional numeracy and literacy are, of course, the building blocks of upskilling, but basic skills need to go beyond this to ensure that the workforce is truly adaptable and competitive in the global economy. The Leitch Review set the threshold for basic skills at Level 2. That is broadly equivalent to five good GCSEs (A*-C). Once learners have reached this stage they are much more likely to be interested in going on to further education or training[34] and are much more likely to invest in their own training, as well as have employers invest in them. Northern Ireland's ambition for 2015 is for above 80 per cent of the workforce to be qualified to at least Level 2, compared with the starting base in 2003 of 63 per cent.[35] This is also a key aspiration for the Leitch Review, which suggests 90 per cent of adults should be qualified to at least Level 2 by 2020.[36]

[34] *National adult learning survey*, DfES, 2002.

[35] *Skills strategy for Northern Ireland*, DELNI, November 2004; *Success through Skills – the skills strategy for Northern Ireland: a programme for implementation*, DELNI, 2006; *Building a better future: programme for Government 2008–11*, Northern Ireland Executive, 2008.

[36] *Prosperity for all in the global economy – world class skills,* Leitch Review of Skills, Leitch, Lord S., December 2006.

3.27 DEL has made progress in improving functional literacy and numeracy through its Essential Skills Strategy, which was launched in 2002 to provide a range of literacy and numeracy qualifications from entry level to Level 2. By February 2007 over 21,000 Essential Skills qualifications had been achieved, exceeding the Public Service Agreement of 18,500 by March 2007. A pilot in ICT skills was run over 2006-07. However, Northern Ireland still has some way to go: the International Adult Literacy Survey showed that 25 per cent of working age adults did not have the most basic literacy and numeracy skills.[37] This should be set in context of the Leitch Review, which calls for 95 per cent of adults to reach functional literacy and numeracy by 2020. Moreover, recent data suggest that the interim targets for Level 2 have not been achieved.[38] **This Review therefore encourages Northern Ireland to prioritise and press ahead with the delivery of their Level 2 and functional literacy and numeracy targets.**

Box 3.2: The Essential Skills Strategy for Northern Ireland

The *Essential Skills Strategy and Action Plan* was published by the Department for Employment and Learning in 2002 and, since the campaign began in 2003, the initiative has helped over 25,000 people improve their basic skills. Its vision is "to provide opportunities for adults to update their essential skills to assist them in improving their overall quality of life, their personal development and their employment opportunities and by doing so to promote greater economic development, social inclusion and cohesion". Classes are free, are held at different times during the day, are accessible through FE colleges, community centres and online and provide childcare facilities to encourage uptake.

3.28 **In its forthcoming review of *Success through Skills*, DEL may wish to examine in particular the effectiveness of its policies to tackle the lack of basic skills, and the balance of resources assigned to deal with them**. This should aim to ensure that the delivery of basic skills is prioritised. FE colleges, which will deliver the majority of these qualifications, will play a central role in achieving this ambition.

Improving employer engagement

3.29 It will also be important to engage employers and explore innovative ways of delivering basic skills training to meet their varying needs. A key concern of the Leitch Review was that publicly funded adult vocational training in the UK was too driven by providers. A central government body would plan provision based on imperfectly articulated demands from business, which it would then try to match, determining centrally the types, quantities and manner of qualifications on offer. As a consequence employers found the system bureaucratic, cumbersome and unlikely to meet their needs, which would result in an under-investment in employee training.

3.30 One of Lord Leitch's proposals to remedy this was more "demand-led" provision, with an increasing amount of funding coming through two schemes: Train to Gain and Individual Learning Accounts. Train to Gain provides employers with funding for investing in employee training up to Level 2 (and in some instances at Level 3), as well as a variety of brokerage services and subsidies, which the employer can use to choose how to provide training. Individual Learning Accounts (renamed Skills Accounts in England) enable individuals to do the same up to Level 3. By choosing how, when and where training is provided, it is hoped that these demand-led schemes will drive up take up, improve the economic relevance of training and improve quality and efficiency through increased competition in the sector.

[37] The most recent internationally comparable data on functional skills come from the International Adult Literacy Survey, which took place in1996 and has not been updated since.

[38] *The Leitch Review of skills – a Northern Ireland perspective*, Devine, T., DELNI, 2008.

3.31 Northern Ireland has chosen not to pursue the Train to Gain model or Skills Accounts at present. Instead, it is retaining a more traditional approach, establishing new Workforce Development Fora (see Box 3.1), relying on Sector Skills Agreements drafted with Sector Skills Councils. In this way, DEL is seeking to increase the relevance and flexibility of publicly funded training to employers and so increase the effectiveness of that training. However, the Review has some concerns that, without properly empowering individuals or employers, publicly funded provision may remain unresponsive, and incentives to invest in training may be weakened. In particular, Train to Gain and Skills Accounts would open up the possibility of new providers entering the market, potentially increasing competition, choice and quality of training.

3.32 Northern Ireland is currently undergoing fundamental reform of its FE system (see Box 3.1), and the Review believes that these reforms should be given the opportunity to bed down. **Once the reforms to FE provision and employer engagement have been more firmly established, DEL should take the opportunity of reviewing their effectiveness in delivering basic skills and increasing workforce training, and consider further potential methods for increasing competition among providers**. At this point, the new Workforce Development Fora will have been tested and the experience of Train to Gain and Skills Accounts in England will provide a useful case study for Northern Ireland. In addition, Ireland is also at the very early stages of considering individual or employer subsidies for basic skills. **Looking forward, therefore, Northern Ireland may want to consider the potential for collaborating with Ireland to put more basic skills funding in the hands of employers and individuals, possibly on an all-island basis**.

Employer pledge

3.33 Employer commitment to training can also be obtained in other ways. With respect to basic skills, the Leitch Review proposed a pledge, based on experience in Wales, for employers to help get eligible workers up to Level 2. In England, such a pledge has already been taken by all central government Departments and a number of significant employers, covering 1.7million employees.[39] **The Review believes that the Northern Ireland Executive, should, as a first step, make a pledge to bring all eligible public sector workers up to Level 2. It should consider, in collaboration with the private sector, the possibility of introducing a wider pledge**. There are already some examples of very good practice within the public sector in Northern Ireland on which to build, including an essential skills pilot for people joining the civil service without qualifications in English and mathematics.

Intermediate skills

3.34 In common with responses to the Leitch Review, respondents to this Review reported a shortage of intermediate skills within the economy. To increase the number of young people with appropriate intermediate skills, the Leitch Review recommended the extension and improvement of apprenticeship schemes for school leavers, a view echoed in the approach taken in Northern Ireland. Nonetheless, as with basic skills, to achieve its aim of increasing to 60 per cent by 2015 the proportion of workforce with at least a Level 3 qualification, the Executive will need to invest in improving the skills of the stock of existing workforce. Equally important will be to ensure that such skills are economically relevant.

[39] *World class skills: implementing the Leitch Review of Skills in England*, DIUS, 2007.

Apprenticeships

3.35 The Northern Ireland apprenticeship scheme was recently reformed, and a new scheme, *Training for Success*, was initiated in September 2007. This targets young people aged 16-24 and offers apprenticeships at Levels 2 and 3, as well as addressing barriers to employment by supporting skills development to reach Level 2. DEL has an ambitious target of 10,000 young people on apprenticeships by 2010. DEL has also recently piloted a series of adult apprenticeship projects. Evidence suggests that adult apprenticeships can be an effective way of developing adult skills at the intermediate level.[40] **Subject to the results of those pilots and budget constraints, DEL should consider rolling out adult apprenticeships more widely and consider ways to stimulate increased employer demand for both young people and adult apprenticeships**. In this, DEL should work closely with the UK Department for Innovation, Universities and Skills and the Department for Children, Schools and Families to learn lessons from the recently announced strategy for apprenticeships in England.[41] DEL should also ensure that apprenticeships are aligned with existing employer-led training, including Invest Northern Ireland's (Invest NI) Business Improvement Programme.

The role of FE colleges

3.36 Despite their focus on young people aged 16-18, FE colleges deliver a major proportion of higher intermediate skills training to the adult population. Reforms to FE colleges, delivered through *FE Means Business*, are promising, particularly the explicit commitment, through College Development Plans, to supporting the local and regional economy. The funding system is weighted towards software engineering, electronics, manufacturing engineering, ICT, hospitality, catering and tourism and construction. These priority skills areas were identified by the Northern Ireland Skills Task Force in 1999 and are currently being reviewed.[42] The Workforce Development Fora are intended to ensure that provision becomes more business led.

3.37 The Review welcomes the current reform of the FE sector, which should improve intermediate skills provision. Nonetheless, as discussed above, there remain some concerns about the flexibility of the sector and its ability to respond to rapidly changing economic needs. In England, Skills Accounts are currently being rolled out for all adult learners over the age of 19, and Train to Gain will be used to deliver some Level 3 courses. **Again, the Review recommends that Northern Ireland seeks to learn from this experience, and takes England's experience in demand-led Level 3 training into consideration when reviewing the success of its new FE structure in due course**.

3.38 Whatever the funding structure, it is vital that the Skills Expert Group and Workforce Development Fora are empowered to deliver real change quickly in response to employer demand. Here, Northern Ireland's size should be its strength. Close links across small areas with a smaller number of players in fewer sectors should allow progress to be achieved more rapidly than in a larger economy. However, concerns were expressed to the Review that these new bodies, even in their nascent form, were not sufficiently empowered to enact change. Further, Review respondents suggested that there is some duplication between the range of bodies that deal with skills. For example, both DEL and Invest NI, which delivers enterprise policy in Northern Ireland, hold funds to support funding of employer-led courses. There was also some concern that the priority skills areas for FE are not entirely aligned with those identified by Invest NI.[43] Once given time to

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40 *Apprenticeships and other vocational qualifications: a cost-benefit analysis*, McIntosh, S., 2007.

41 *World-class apprenticeships: unlocking talent, building skills for all. The Government's strategy for the future of apprenticeships in England*, DIUS, 2008.

42 *Further education means business: consultation document*, DELNI, November 2007.

43 While there is no prerequisite for intermediate and higher skills priorities to coincide, there are many examples where coordination has supported economic development. In North Carolina, a model on which many Northern Ireland reforms are based, for example, it was recognised that the life sciences sector could support an additional 3,000 jobs per year at below degree level. A network was then established connecting the FE and HE sectors to deliver skills at a range of levels and in a range of settings.

bed down, **the FE system and methods of workforce development training should be reviewed to examine whether they have the flexibility to respond quickly to the demands of employers and inward investors with respect to intermediate skills.**

Higher-level skills

3.39 As explained above, within the existing Northern Ireland workforce the proportion of higher-level skills is around the UK average, with just under one third of the current workforce holding a Level 4 qualification (degree or higher professional qualification). 32 per cent of young people go on to university education, compared with 29 per cent in England.[44]

Higher education choices

3.40 The Review heard a number of concerns regarding a drop in higher education take-up related to economically important subjects, or sectors, such as ICT. Theoretically, intervention in young people's otherwise rational choices of subjects to study should take place only where there is a market failure. In higher-level skills, this might relate to information, where young people are unaware of the potential rewards from different areas of study. There may also be government failures in the sense that public provision of higher education may distort price signals, which might otherwise guide young people's choices.

3.41 *Success through skills* has already established a framework to ensure that people of all ages have access to good quality careers advice and guidance. To help facilitate even better information flow on the demand for skills, **the Executive should work with businesses in key industries to ensure careers advice in schools covers those careers most in demand by the economy, and in particular that opportunities are given for students to meet young, skilled workers in newer industries that they may be unfamiliar with.** This will involve close collaboration between DEL and the Department of Education to ensure a continuity of advice throughout the formal education process.

Influencing provision and uptake

3.42 More generally, improved labour market information, driven by a recent Northern Ireland Executive review,[45] should help remedy gaps in information provision for all learners, and help support their long-term plans. However, governments often go further than this, and seek directly to influence provision and uptake through subsidy or incentive, where they can see a broader benefit for the economy. With respect to Northern Ireland, the Executive might want to consider what mechanisms it has to influence the uptake of training and education to support economic development priorities. Increased investment in the FE strategic priority areas has shown how government can effectively increase the uptake of certain subjects.[46] Other actors, for example Queen's University Belfast, through a bursary scheme for STEM subjects, have sought to provide incentives for further take up of these critical skills. Targeted incentives such as this may be one way forward. **As part of the current review of STEM subjects, the Executive may wish to consider whether additional support or incentives such as bursaries would be effective in increasing the supply and take-up of those skills most needed by the economy.**

[44] *Young participation in higher education, HEFCE*, 2005. Figures are from 2001-02.
[45] *Review of labour market information*, DELNI, 2008.
[46] *Further education means business*, DELNI, 2004.

Skills for inward investment

3.43 While there is rarely felt to be a case for direct government intervention in employer-led training at the very highest levels (degree level or above), there is potentially a case for government support of certain higher-level qualifications, particularly when related to the attraction of inward investment. It is arguable that inward investment represents a particular case, where market signals and information work inefficiently and learners are much less likely to be able to anticipate the movement of mobile capital and the implications for the jobs market. In these instances, supporting, wholly or in part, the provision or co-funding of courses, such as conversion courses, can support economic development. Such a strategy is claimed as a key reason for the Irish Industrial Development Agency's (IDA) success in bringing companies such as Intel into Ireland.[47]

3.44 There are successful examples of cooperation with inward investors in training in Northern Ireland. For example, DEL offered Citigroup training for its staff accredited by the Securities and Investment Institute through Belfast Metropolitan College. Other models, such as co-funding, which is being expanded in England through the Higher Education Funding Council for England, could also be applied to Northern Ireland. **This Review suggests that the Executive should take the lead in promoting partnership models for supporting FDI, as discussed in Chapter 4**.

Increasing supply through migration

Attracting highly-skilled migrants

3.45 Historically Northern Ireland's workforce has been reduced by significant emigration. Recently, one of the benefits of the peace process has been that these flows have been reduced and even reversed, with significant inward migration benefiting the economy. However, Northern Ireland may wish to do more to improve its supply of skills through migration. **Given the net flows of students out of Northern Ireland to study, the Executive may wish to focus on attracting more young people from other regions of the UK, Ireland and further afield to study in Northern Ireland**.

3.46 In addition, the Executive may wish to learn from the Irish skills strategy and also focus on attracting graduates with appropriate skills. The Irish experience suggests that, unlike some countries with a longer history of immigration, new immigrants to Ireland have tended to raise the overall skills profile.[48] The Irish skills strategy acknowledges the role that skilled migrants play in filling skills shortages, and actively targets not only the Irish diaspora, but also highly skilled non-English-speaking migrants.[49] Survey evidence from Northern Ireland also suggests that migrant workers tend to work at lower occupational levels than they did in their home countries, suggesting a potential reservoir of skilled labour.[50] The existing pool of skilled labour in Ireland, both Irish and non-Irish, of course provides a potential source of skills for the Northern Ireland economy. **The Executive should therefore consider ways to reduce frictional barriers to working in Northern Ireland, and work with its counterpart in Ireland to improve access to cross-border job opportunities, as identified in the *All-island study*.**[51]

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47 Submissions to the Review, February 2008.

48 *Tomorrow's skills: towards a national skills strategy*, Expert Group on Future Skills Needs fifth report, 2007.

49 Specific programmes include a scheme to recognise the equivalence of non-Irish qualifications, and English language training. Ibid, 2007.

50 *Survey of migrant jobseekers calling in DEL offices*, Rogers, D., DELNI, 2006.

51 *Comprehensive study of the all-island economy*, British-Irish inter-Governmental conference, 2006.

Section B: Business

4 Investment

Investment by domestic businesses and through foreign direct investment (FDI), as well as by the public sector (discussed in Chapter 7), is a key driver of productivity growth and competitiveness. While a lack of political and social stability in Northern Ireland may have affected FDI levels in the past, Northern Ireland now outperforms many other regions of the UK in attracting overseas investment.

Northern Ireland has a number of areas of real competitive advantage. These include a young population, high educational attainment, generous financial incentives for business, low operating costs, an excellent telecoms infrastructure, and low and falling crime rates.

Nonetheless, significant challenges remain. Global pressures will continue to squeeze Northern Ireland's traditional competitive advantages and Northern Ireland will need to ensure that it is able to attract mobile capital in high value-added industries. Northern Ireland will need to invest further to maintain parity with competing economies.

The Review believes that the emphasis on domestic business investment must be maintained. Alongside the full set of proposals set out elsewhere within this report, on skills, enterprise and investment in infrastructure, the Review believes that:

- the proposed review of the planning system is welcome, but the timescale should be quickened to enable reform to take place more rapidly. It should consider some of the lessons from the *Barker Review of land use planning*,[1] particularly with regard to financial incentives for local authorities to expedite planning applications that bring economic benefits.

Foreign businesses will ultimately make their decisions on the location of investment according to overall competitiveness; and the range of proposals elsewhere in this Review, especially on improving skills, innovation and infrastructure, should help improve the competitiveness of Northern Ireland compared with other regions. In addition to these broader policies, the Review suggests that to support growth in FDI:

- Invest Northern Ireland (Invest NI) should undertake further work with UK Trade and Investment (UKTI) to develop further its benchmarking process in order to validate the business sectors in which it can demonstrate that Northern Ireland has an internationally competitive offer;
- the work of Invest NI should be focused through a review. This review should include: the role of Ministers in supporting trade promotion; governance of Invest NI; improved working links with the Irish Industrial Development Agency (IDA) and UKTI; and embedding links to other Government Departments, universities and non-departmental public bodies; and
- UKTI and, where appropriate, the IDA should further support Invest NI to hone its FDI offer, including through the specific actions identified in the *Review of tax policy in Northern Ireland*.

[1] *Barker review of land use planning*, Barker, K., HM Treasury, 2006.

INTRODUCTION

4.1 The stock of physical capital held by businesses is closely correlated with productivity performance, as it directly influences how much a worker can produce. Investment increases labour productivity by increasing the capital each worker can utilise. Investment by businesses is therefore critical for growth.

4.2 Business investment in physical capital is complementary to other forms of investment, such as in skills and innovation, which are discussed in Chapters 3 and 5. Skilled workers enhance investment and investment in technology can improve production. Investment in information and communications technology (ICT), a specific sub-category of physical capital, can have a significant effect on the productivity of workers. Public investment in infrastructure, such as transport and public capital, also serves to enhance productivity and this is discussed in Chapter 7.

4.3 Foreign direct investment (FDI) can provide similar output gains through an injection of foreign capital into the economy and the creation of jobs, with all the associated benefits this brings. Overseas companies undertake FDI in order to access new markets, take advantage of business conditions (including skilled workforces and low labour costs) or locate near sectoral clusters. For host economies, these companies can bring new technologies, ideas and skills, and innovative processes.[2] In general, FDI firms tend to be both more productive and larger, and in general terms, large enterprises tend to invest more heavily in research and development (R&D) and innovation and have a stronger export base. High levels of FDI can also lead to spillovers to local enterprises through mechanisms such as strengthened supply chains, which can increase the productivity of domestic firms indirectly, as well as increasing output and, often, exports. The *Review of tax policy in Northern Ireland*[3] described global trends in FDI and how these are affecting Northern Ireland.

INVESTMENT IN NORTHERN IRELAND

Business investment

Business investment in line with the UK average

4.4 The rate of business investment in Northern Ireland is broadly in line with the UK average. During the period 1998 to 2004 net capital expenditure in Northern Ireland averaged 9.49 per cent of gross value added (GVA), in line with the average of 9.51 per cent for the UK as a whole.[4] While business investment can fluctuate sharply from year to year, net capital expenditure as a share of GVA declined during the period 1998 to 2004 before increasing in more recent years[5] – a trend that is observed in most UK regions. The story is therefore similar to that of the UK as a whole. However, this should be put in the context of historically low private investment relative to the UK's competitors. Lower private investment in the UK than some comparator countries has been thought to contribute to up to 20 per cent of the productivity gap between the UK and other countries.[6]

2 *A guide to foreign direct investment*, UK Trade and Investment, 2006; also see http://archive.treasury.gov.uk/pub/html/top/top8/an1.html.

3 *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury, 2007.

4 *Annual business inquiry*, ONS, July 2007.

5 *Northern Ireland annual business inquiry 2006*, DETINI, December 2007.

6 *Productivity in the UK 7: securing long-term prosperity*, HM Treasury, November 2007.

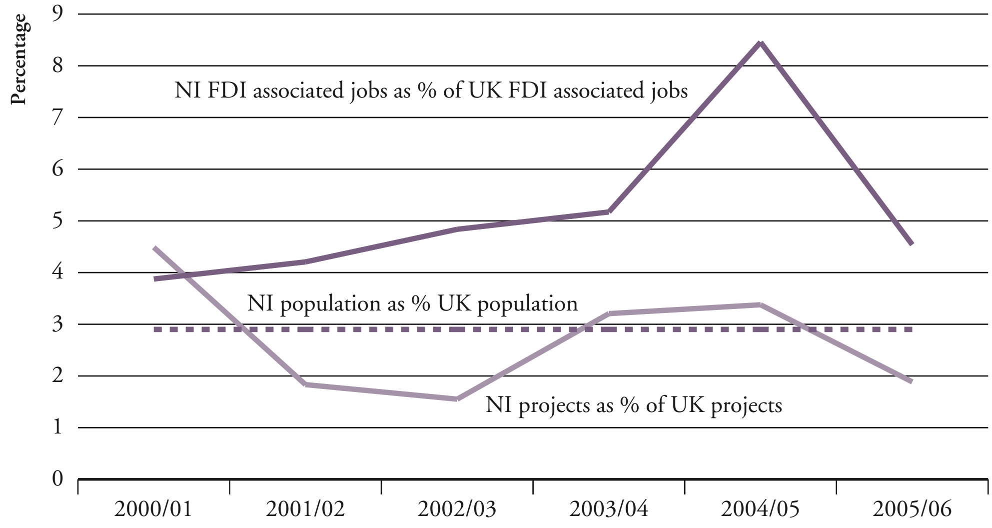
4.5 A stable and well-regulated economy such as the UK is often seen as a pre-requisite for high levels of business investment. However, it may not be sufficient on its own, as the UK case shows. The reasons generally cited for low base levels of such investment include lack of skilled labour and affordable land, relatively high operating costs, regulatory or finance barriers, and economic and political uncertainty. More recently, poor management skills have been cited as a potential reason for lower capital investment. Given that Northern Ireland has high skills, relatively affordable land and lower costs compared with the rest of the UK, as well as the same regulatory and finance arrangements, it might be expected to have higher levels of investment compared with the rest of the UK. However, it is likely that instability in Northern Ireland contributed to lower levels of business investment over recent years than would otherwise have been the case, although the evidence here is limited.

Foreign direct investment

Strong FDI performance in recent years

4.6 The level of FDI into Northern Ireland has been strong in recent years, and Northern Ireland has been successful in attracting FDI when compared with the UK as a whole. The number of projects per capita in recent years has been broadly in line with the UK average, but the number of jobs created has been well above the UK average. As Chart 4.1 shows, Northern Ireland accounts for 2.9 per cent of the UK population, and over the period 2000-01 to 2005-06 Northern Ireland accounted for 2.7 per cent of new projects and 4.3 per cent of new jobs resulting from FDI across the UK. This high level of FDI relative to the rest of the UK must also be set in the context of the UK's extremely strong performance in attracting FDI: the UK attracted the second greatest flow of FDI in the world in 2006, and the greatest flow in 2005, and holds the greatest share of FDI in the G7 as a percentage of GDP.[7]

Chart 4.1: Foreign direct investment – jobs and projects in Northern Ireland as a percentage of the United Kingdom total

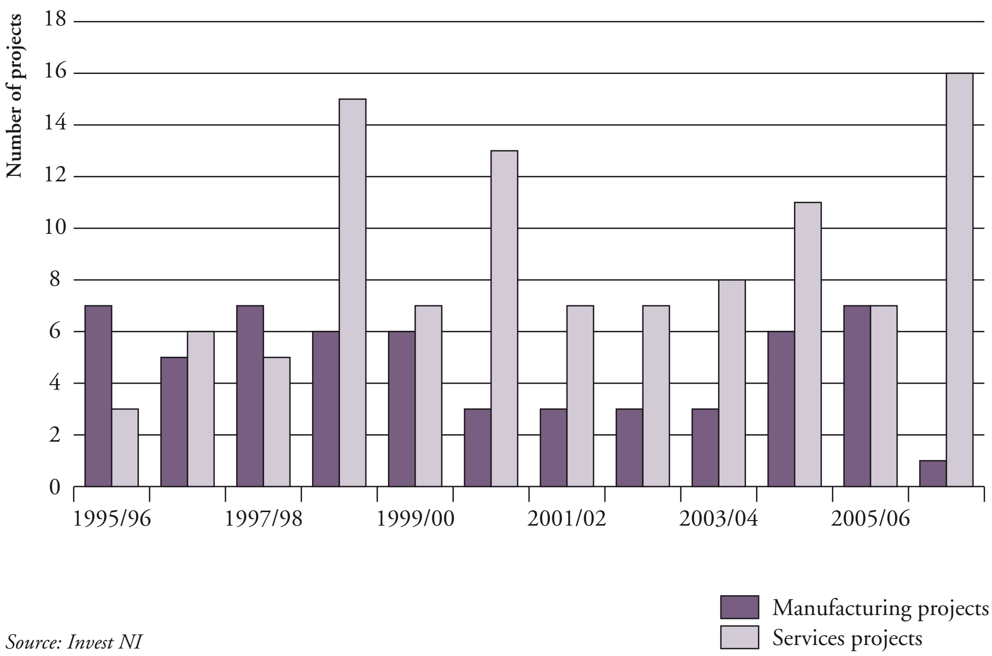


Source: UKTI, ONS

7 *World investment report*, UNCTAD, 2007.

4.7 The nature of FDI into Northern Ireland has shifted over time, away from manufacturing and towards service projects, as Chart 4.2 shows. Over recent years, FDI in Northern Ireland has been dominated by the ICT and business and financial service sectors, with six of the ten biggest investors (in job creation terms) operating in these sectors since 2002.[8] The US is by a significant margin the largest FDI investor in the region, making investments in 30 tradable services, and a further 62 non-tradable investments since 2002.[9]

Chart 4.2: FDI trends in Northern Ireland - manufacturing and services 1995/96 – 2006/07



Source: Invest NI

4.8 Recent significant investors have included ICICI OneSource, opening two outsourcing centres in Northern Ireland creating over 1,000 jobs, Northbrook Technology, a software development company which employs over 1,200 people across two sites in Northern Ireland, and Citigroup, whose technology centre in Belfast will create 560 jobs by 2009.[10] Belfast has recently been ranked as the top location in the United Kingdom for customer call and contact-centre based activities and Northern Ireland also boasts world-class companies in the aerospace, engineering and life sciences sectors.[11]

4.9 Following enhanced political stability, recent FDI flows have been driven predominantly by the strength of Northern Ireland's competitive advantages. These include a young population and a high quality education system.[12] There are generous financial incentives for business, both for domestic and specifically for FDI investors (see Box 4.1). Northern Ireland has highly competitive operating costs (in the Greater Belfast area the annual occupation cost per square

8 *FDI research project: final report*, Experian, DETINI, February 2008.

9 *Review of tax policy in Northern Ireland,* Varney, Sir D., HM Treasury, 2007.

10 *FDI research project: final report*, Experian, DETINI, February 2008.

11 *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury, 2007.

12 *Regional Trends 39*, ONS, 2006.

foot is as little as £22, compared with £43 in Manchester, £55 in Dublin, £49 in New York and £61 in New Delhi[13]) and an excellent telecoms infrastructure. However, the Executive will need to keep abreast of cost competitiveness to ensure these advantages remain, especially as costs are rising globally.[14]

Box 4.1: Incentives for investment in Northern Ireland

Northern Ireland offers an attractive package of financial incentives for investors. This includes:[15]

- revenue grants towards start-up costs, interest relief, factory rental costs, training costs, marketing development costs and R&D expenditure;
- pre-employment training grants;
- finance investment in the share capital of a company and the provision of government loans at commercial and concessionary rates;
- R&D capital spending can be written off against income;
- property tax exemptions for manufacturing property; and
- generous depreciation allowances.

Since its establishment in April 2002, Invest NI has offered assistance totalling over £630 million, contributing towards projects that plan to invest £2.6 billion.[16] Survey evidence suggests that Belfast ranks first among UK cities in terms of perceived financial incentives.[17]

Challenge is to attract high-quality FDI

4.10 However, Northern Ireland faces a number of challenges in continuing to attract the highest quality FDI. In the recent past much of Northern Ireland's FDI is likely to have been drawn by the relatively low costs in Northern Ireland compared with other UK regions and Ireland. With the speed of globalisation and the movement of low-cost operations eastwards, Northern Ireland will find it increasingly difficult to compete on cost. Furthermore, a key concern raised by respondents to the Review was the quality of FDI attracted, despite the gradual shift to service industries over recent years. Major investments in the period 2002-07 were mainly split between R&D and customer service centres. Northern Ireland has in the past attracted a relatively high amount of low-value FDI (for example, call centres) that do not pay above the Northern Ireland private sector median salary, usually bring lower domestic demand and lead to fewer spillovers. To enhance its competitiveness in the future, Northern Ireland must complement its existing flow of FDI by attracting more FDI whose location is determined less by cost and more by quality. DETI and Invest NI are already working towards this. For example, the Programme for Government, PSA framework and the DETI and Invest NI corporate plans prioritise private sector productivity and the need for value-added investments to grow a dynamic and innovative economy in Northern Ireland.[18]

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[13] *Global Market Rents,* CB Richard Ellis, November 2007.

[14] *Overview: business cost competitiveness in Northern Ireland*, ERINI January 2008 discusses how cost competitiveness in Northern Ireland is changing.

[15] www.investni.com

[16] *Invest NI performance information report 2002/3–2006/07*, Invest NI, 2008.

[17] *UK city monitor 2006*, Cushman and Wakefield, 2006.

[18] www.detini.gov.uk/cgi-bin/downutildoc?id=2143

Drivers of FDI

4.11 The drivers of FDI into an economy have been explored in depth elsewhere.[19] Research shows that the factors most important to business in making FDI decisions are transport, logistics infrastructure and labour costs.[20] Other important factors include skills and the potential for productivity increases.[21] A Northern Ireland Affairs Committee report from 1999-2000 cited reasons why certain investors chose not to locate in Northern Ireland – these included a small critical mass of labour available compared with other regions, distance from customer, and concerns regarding security or stability.[22]

POLICY RESPONSES

Business investment

4.12 Some of the variables affecting business investment sit outside the control of the Northern Ireland Executive, such as wider macro-economic policies. However, the majority can be addressed through the Executive improving those areas of economic policy that have indirect benefits for investment. The most significant of these are skills, enterprise and investment in infrastructure, which are covered in Chapters 3, 5 and 7.

Planning reform

4.13 One particular challenge cited by respondents as a check on indigenous investment – and which additionally affects FDI – is the planning system. A number of those who made submissions to the Review, both orally and in writing, cited the Northern Ireland planning system as a barrier to growth. Since land is a key component of production, constraints on its supply can push up the cost of production and therefore act as a major disincentive to investment. The Northern Ireland Executive has committed to a wholesale review of the planning system by 2011, including guaranteeing a response to all large-scale planning applications within six months of receipt. **The Review welcomes this, but suggests the timescale should be quickened to enable reform to take place more rapidly**.

4.14 The review of planning should include consideration of how and whether to expedite economically valuable projects, of the incentives for local authorities and Government Departments to maximise value for money for the public purse, and of greater use of methods for benefiting from the uplift in value caused by planning changes. **Additionally, the review should consider some of the lessons from the *Barker Review of land use planning*,[23] particularly with regard to the financial incentives for local authorities to expedite planning applications that bring economic benefits**. Finally, the planning review should take note of the recently published *Callcutt Review of housebuilding delivery*,[24] which makes a number of recommendations to ensure developers, housebuilders and the public sector work more closely in partnership to maximise value for money.

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19 *FDI research project: final report*, Experian, DETINI, February 2008.

20 *European attractiveness survey*, Ernst and Young, 2008.

21 The links between tax and inward investment are considered in detail in *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury 2007.

22 *Public expenditure in NI: inward investment*, Northern Ireland Affairs Committee's Fifth report 1999-2000.

23 *Barker review of land use planning*, Barker, K., HM Treasury, 2006.

24 *The Callcutt review of house building delivery*, Callcutt, J., DCLG, 2007.

Political stability

4.15 As identified above, political stability can have significant effects on investment, as a lack of certainty about the future is likely to increase assessment of possible risk and therefore the cost of investment. Hence, the role of the Northern Ireland Executive and all the political parties in ensuring continued political stability and peace should have a positive effect on business investment going forward. Similarly the law and order situation has been transformed in Northern Ireland in recent years, with low and falling crime rates for most crimes alongside a well-funded criminal justice system. The Executive should ensure that continued stability is its first priority.

Foreign direct investment

4.16 The desire to increase levels of FDI coming to Northern Ireland is one of the most significant drivers of this Review. This is of particular importance before the upcoming US investment conference on 7 May 2008 (see Box 4.2).

Box 4.2: The US-Northern Ireland Investment Conference, May 2008

In March 2007, the then Chancellor announced that an inward investment conference would be held in Northern Ireland. The conference will take place from 7 to 9 May 2008 and is being organised by the Department of Enterprise, Trade and Investment (DETI) and Invest NI. It will be attended by Chief Executive Officers and senior executives from US companies, identified from market sectors thought to offer the best future prospects for inward investment to Northern Ireland. Preceding the conference, trade envoys have visited Northern Ireland from the US, and Northern Ireland Ministers have visited the US on trade missions.

The importance of FDI

4.17 FDI has been credited as a key driver of the success of Ireland's economy,[25] and the Northern Ireland Executive is very keen for that success to be replicated in Northern Ireland. While the causes of the "Celtic Tiger" are complex, and FDI successes involved auspicious macroeconomic and trade conditions,[26] it remains the case that FDI is an essential priority for economies hoping to expand.

A range of policies support FDI

4.18 Predominantly, success in attracting high-value FDI will be a consequence of successful implementation of the wide range of other policies covered in this Review. **It is of course essential that those factors that are important for inward investment are given maximum priority within the Northern Ireland Executive**. In particular, this includes improving skills and investing in infrastructure, including transport. These are major drivers of competitiveness and consequently of location decisions. This Review considers skills (Chapter 3) and transport infrastructure (Chapter 7). Skills policies should ensure that workers are equipped with the necessary skills required to respond flexibly to changing skills needs in the economy and that training is responsive to business need. With respect to infrastructure, the Northern Ireland Executive should make further investment in transport and other infrastructure a priority because of its fundamental role in driving economic growth.

[25] FDI encouraged through government promotion schemes has been credited with turning Ireland's economy around since 1986. FDI amounted to about $10 billion of inflows into the Irish economy in 2004, from almost no base in 1990 (Eurostat http://europa.eu.int/comm/eurostat/). This compares with $224 million in 2004 for Northern Ireland, although this had almost doubled by 2006 (Locomonitor, 2007).

[26] *Annual competitiveness report 2007: volume 1 – benchmarking Ireland's performance*, Forfas, 2007; *Annual competitiveness report 2007: volume 2 – Ireland's competitiveness challenge*, Forfas, 2007.

4.19 In addition, as mentioned above with respect to business investment, the Northern Ireland Executive and all the political parties have a critical role in ensuring continued political stability and peace. This is an absolutely essential pre-requisite for many companies in choosing a country for investment.

The role of trade and investment promotion

4.20 However, beyond getting the economic fundamentals right, there is of course more that a region can do to increase foreign investment. As noted in the *Review of Tax Policy in Northern Ireland*,[27] companies often lack sufficient information on potential markets, which is why trade and investment promotion are key mechanisms for increasing FDI.

4.21 Best practice in obtaining FDI also requires a clear understanding of priority sectors. Research undertaken for the DETI has suggested Northern Ireland's marketing approach should include a clear focus on ICT and research and development related FDI. Investments in these sectors tend to be high quality, featuring profitable, high-tech companies paying wages above the national average. Analysis also shows they are likely to have the most potential in terms of high value, volume and likely growth over the next ten years.[28] DETI and Invest NI are currently focusing on ICT, financial services, business services and life sciences as part of their corporate plans.

Benchmarking Northern Ireland's sectors

4.22 Invest NI is the body charged with bringing FDI into Northern Ireland. Invest NI has recognised the importance of shifting its focus to high-value FDI, and this drive to push Northern Ireland up the value chain must remain at the core of Invest NI's work. The Review welcomes this approach. As stated in Chapter 1, it is not the role of this Review to advise Northern Ireland on which specific sectors it should focus. Nonetheless, it is critical that Invest NI's approach to attracting foreign investment clearly identifies target sectors in which Northern Ireland has a demonstrable internationally competitive offer. A benchmarking approach, which identifies the strategic drivers that influence investment decisions in these sectors, and Northern Ireland's merits, in quantitative terms, measured against its main competitors, could both underpin the choice of sector and identify any of the elements of the Northern Ireland offer which appear to be uncompetitive. UK Trade & Investment (UKTI) has experience of the benchmarking process. **This Review therefore suggests that Invest NI undertakes further work with UKTI to develop further the benchmarking process in order to validate the business sectors in which it can demonstrate that Northern Ireland has an internationally competitive offer**.

Promotion of inward investment

4.23 The role of inward investment agencies in promoting their area to potential investors is often seen as pivotal to FDI success. The relationships that are built with potential investors prior to their location decision, the level of detail and understanding that is put into considering their needs, and the ongoing support that they receive following investment are all critical to the success of that investment. The quality and proactive nature of the Irish Industrial Development Agency's (IDA)[29] engagement with potential investors during Ireland's own drive to increase FDI gives an interesting example of how this can be successful. While certain aspects of the Irish process are inevitably a product of their own political climate and customs, the importance given to securing FDI extends up to the involvement of the Taoiseach. Further details of Ireland's historical approach to securing FDI are set out in the previous *Review of tax policy in Northern Ireland*.[30]

[27] *Review of tax policy in Northern Ireland,* Varney, Sir D., HM Treasury, 2007.

[28] *FDI research project: final report*, Experian, DETINI, February, 2008.

[29] The IDA is sponsored by the Irish Department of Enterprise, Trade and Employment.

[30] *Review of tax policy in Northern Ireland,* Varney, Sir D., HM Treasury, 2007.

The role of Invest NI

4.24 Some submissions to this Review questioned the capacity of Invest NI to attract the high levels of FDI that Northern Ireland needs to achieve its stretching productivity and growth targets. This was not always framed as a criticism of Invest NI; often it was a comment on the powers or authority they have been given, their position in Government, or the role of Ministers in supporting them. Nonetheless, it does suggest the potential for the whole system to work more effectively if the Executive wants to fulfil its aspiration to make the economy Northern Ireland's number one priority.[31]

4.25 **Therefore, this Review believes there is merit in the Executive reviewing further how best to strengthen Invest NI in order to support Northern Ireland's FDI vision**. Specifically, such a review should consider the relationship of Invest NI within the Northern Ireland Executive, and its ability to influence effectively wider government policies that support inward investment. For example, it should consider whether, through changing structures, streamlining the decision-making process, or giving more autonomy to certain bodies, it can put in place a system which is more immediately supportive of those who want to invest – for example in committing to training workers in a specific skill needed by a company considering investing in Northern Ireland.[32] Currently, Invest NI is sponsored by DETI and has a Memorandum of Understanding with the Department for Education and Learning (DEL). However, to address some of the concerns raised above, such a review should consider whether to reform Invest NI's governance structure so that it can be more central to the work of the Executive, possibly through a direct line to the First Minister and deputy First Minister.

Coordinating policies on skills

4.26 Further, this review should consider whether Northern Ireland should strengthen the current Skills Expert Group, which joins together Invest NI with Departments, sector skills councils and universities, to ensure the whole education and training system can respond to changing economic needs.[33] Such a council is seen to have been successful in helping Ireland respond to its skills needs over recent years, and Northern Ireland should model this around the Irish example. This should ensure that Northern Ireland can be as proactive and flexible as possible in responding to FDI opportunities when they arise, specifically by providing a mechanism for a range of organisations to plan and deliver flexible training in necessary skills.

Box 4.3: Case study – Ireland's Expert Group on Future Skills Needs (EGFSN)

The EGFSN[34] was established in Ireland in 1997 and is made up of representatives from the Irish Industrial Development Agency and the business sector, education, and Government Departments and State Agencies.

The EGFSN is a body appointed by the Irish Government under the aegis of Forfas, the national policy and advisory board for enterprise, trade, science, technology and innovation. The EGFSN acts as the central national resource on skills and labour supply issues for the enterprise sector and on overall strategy for enterprise training in Ireland.

The group advises the Irish Government on projected skills requirements and associated labour market issues that impact on national potential for enterprise and employment growth. The EGFSN identifies any need for policy or structural changes and has a central role in ensuring that labour market needs for skilled workers are anticipated and provided for.

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[31] *Building a better future: programme for Government 2008-2011*, Northern Ireland Executive, 2008.

[32] Several submissions to the Review suggested that this in particular was needed, as at present there is no mechanism to ensure that Northern Ireland can deliver workers with certain skills if needed by a potential inward investor. Ireland's successful use of such an approach is often cited; for more detail on this, see *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury, 2007.

[33] For further discussion on skills policies please see Chapter 3.

[34] www.skillsireland.ie.

4.27 Finally, such a review might also wish to consider the effectiveness of Invest NI's marketing mechanisms for attracting investment. Possibilities for further consideration include creating more visible "champions" for Northern Ireland investment (for example politicians, academics or successful business people) and showcasing successful past projects.

The scope for joint working

4.28 Other inward investment agencies face similar situations and challenges. It will be important for Invest NI to continue to work closely across the UK and Ireland on the promotion of inward investment including through development of a more joined-up approach involving Invest NI, UKTI and the IDA. While there may be occasions when Northern Ireland and Ireland will be competing for FDI, there will always be areas where joint efforts will be mutually beneficial. The discussion on benchmarking above highlighted one area for potential collaboration. **The previous *Review of tax policy in Northern Ireland*[35] set out in more detail how UKTI and the IDA could support Northern Ireland in honing its FDI offer and this Review encourages them to press forward in doing so**. Joint working can, of course, also go beyond inward investment agencies to broader partnership, as the recent joint announcement between the Irish Government and the Northern Ireland Executive on financial services has shown (see Box 4.4).

Box 4.4: The financial services industry

The financial services sector is an area of strength for the UK as a whole with London being one of the world's foremost financial centres. Developing the financial services sector has also been an important part of Ireland's success in recent years. In 1987, the Irish Government set up the International Financial Services Centre (IFSC) in Dublin, under legislation designed to boost activity and employment in the Irish economy. The IFSC is globally recognised as a leading location for a range of internationally traded financial services, including banking, asset financing, fund management, corporate treasury management, investment management, custody and administration and specialised insurance operations. An estimated 10,700 employees work in the IFSC, and this figure is expected to grow by 1,000 this year.

Today, the skills that are central to Ireland sustaining its competitive advantage in the financial sector are at a premium internationally. A recent announcement by the Irish Government and the Northern Ireland Executive emphasised how joint working can help support Ireland's strategy for the further development and growth of international financial services while at the same time providing highly skilled jobs in Northern Ireland. The announcement emphasised the need for financial firms based in Ireland to exploit the opportunity of delegating some support functions to Northern Ireland, thus benefiting the whole island's economy, and confirmed that such deployment would be permissible under the existing Irish regulatory framework.

A role for tax credits?

4.29 Lastly, some respondents to the Review, including the Northern Ireland Executive, called for enhanced tax credits for R&D expenditure and for a tax credit for training specifically for inward investors as an additional incentive for them to locate and embed in Northern Ireland. Encouraging firms to invest in R&D and training is important to developing the Northern Ireland economy but this Review has found that such credits, limited only to new investors in Northern Ireland, would be both legally and practically difficult. Such tax credits for R&D would undermine the principles of simplicity, consistency and certainty that underpin the success of the UK's R&D tax credits system and would discriminate against indigenous Northern Ireland companies and firms with R&D operations in the rest of the UK. With respect to training the evidence does not suggest that tax credits are as effective as alternative mechanisms, and since educational and training expenditure is fully deductible from taxable income, there is a risk that a tax credit could

[35] *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury, 2007, p.75.

carry a level of deadweight cost. The Review therefore does not recommend this approach, but instead suggests increasing awareness and take-up of existing R&D incentives, as discussed in Chapter 5. In addition, the Review encourages the Northern Ireland Executive and UK Government to give further consideration to other mechanisms that might promote training. For a full discussion of tax credit proposals, see Annex A.

4.30 Northern Ireland already offers a very attractive incentive package for potential inward investors, as outlined in Box 4.1. Furthermore, many of the other findings of this Review address possible barriers to training and R&D which such tax credit proposals would hope to resolve. With respect to training and skills, this includes suggestions made above and in Chapter 3 concerning better understanding and meeting the skills needs of inward investors. The issues surrounding R&D activity are addressed directly in Chapter 5.

5 Innovation

Innovation boosts competitiveness and growth through introducing new technologies and ways of working. This benefits the innovator directly and also the wider economy through spillovers of those technologies to other firms.

Research and development (R&D) levels in Northern Ireland are below the UK average and the R&D undertaken is dominated by a small number of large firms. However, this low level of R&D reflects a relative lack of large firms and of firms in R&D intensive industries within the economy, and Northern Ireland has levels of R&D spending appropriate to its size and structure. Higher education accounts for more than half of R&D expenditure, and a relatively high degree of its funding comes from the public sector.

Northern Ireland has been proactive in addressing levels of R&D, and is in some respects leading innovation reform both nationally and on the island. Policies such as the pilot Proof of Concept fund and the Higher Education-Further Education Collaboration fund anticipate UK-wide commitments.

Northern Ireland's *Regional innovation strategy* outlines Northern Ireland's plans to increase innovation in the future, and this Review endorses its direction of travel. A key issue for the Executive will be ensuring that priority in funding and focus is given to the biggest challenges where the most difference can be made.

To build on this strategy the Review suggests that:

- the Executive should consider whether more should be done to support clusters based on world-class expertise and support for university excellence;
- the Executive, Invest NI and HM Revenue and Customs (HMRC) should work together to address further the take-up of R&D tax credits in Northern Ireland;
- the Executive should prioitise embedding a permanent third stream of finance for universities such as the Northern Ireland Higher Education Innovation Fund;
- current further education (FE) reforms should ensure that FE skills provision clearly supports the *Regional innovation strategy*;
- the Executive should ensure that reciprocal arrangements for the innovation voucher scheme are developed, and explore arrangements to allow Northern Ireland's businesses to access research support in Great Britain; and
- to improve further the level of international technology transfer and collaborative research, the Executive, UK and Irish Governments and research funding bodies should jointly explore how mainstream science funding and long-term strategy can be aligned.

INTRODUCTION

5.1 Innovation describes the exploitation of new ideas – it can result from new science and technology, changes in skills or business processes, or from the exploitation of new markets.[1] Innovation boosts productivity and growth through introducing new technologies and ways of working and benefits both the innovator directly and the wider economy through spillover effects. Spillovers, where firms take advantage of new technologies, can boost productivity of all firms through emulation and raise the capacity to innovate further. Innovation is sustained by competition but also needs the correct skills mix and investment to exploit the full potential of innovations.

5.2 The overall level of innovation within an economy will be driven not only by the incentives of private firms, but also by the actions of government and higher education institutions. Government can serve to stimulate innovation in private businesses either directly, where it perceives market failures are inhibiting investment in research and development (R&D), or indirectly, through procurement or research activity that generates spillovers. There are complex innovation relationships between higher education and business, with the former licensing innovations to the latter from applied or basic research, and creating spin-off companies. In the opposite direction, business provides user-driven research contracts for higher education and often helps set the research agenda through partnerships. Traditionally, government has supported innovation through supply-side policies – for example through investing in basic research, training and education. Increasingly policy acknowledges the demand-side of innovation, and new instruments are being sought to stimulate demand and encourage the "pull" from industry.[2]

INNOVATION IN NORTHERN IRELAND

Levels of research and development expenditure

Low levels of R&D spending

5.3 Spending on R&D is often used as a proxy for the level of innovation in an economy.[3] Overall R&D levels in Northern Ireland, at 1.2 per cent of regional gross value added (GVA), are lower than the UK average of 1.8 per cent, ahead only of the North East and Yorkshire and the Humber.[4] This should be put in the context of the UK's overall R&D performance, which has historically been poorer than many of its G7 competitors including Germany, Japan and the US.[5] It is worth noting that, in spite of the recent influx of high-technology companies into Ireland, overall levels of R&D spending there remain relatively low.[6]

1 *Investing in innovation: a strategy for science, engineering and technology*, HM Treasury, 2002.

2 *Innovation nation,* DIUS, 2008.

3 R&D does not capture all types of innovation that might drive productivity, particularly in service industries, where design, business process, marketing or organisational innovation may be equally important. *Innovation modes and productivity*, DIUS, 2007.

4 *Regional competitiveness and state of the regions*, DTI, 2007.

5 *The race to the top – a review of Government's science and innovation policies*, Sainsbury, Lord D., HM Treasury, 2007.

6 R&D spending in Ireland is 1.6 per cent of GNP. *Strategy for science, technology and innovation 2006-13*, Department for Enterprise, Trade and Employment, 2006.

Business R&D spending is comparable with similar areas

5.4 Northern Ireland's expenditure by businesses on R&D is among the lowest in the UK, accounting for only 0.5 per cent of GVA compared with an average of 1.2 per cent for the rest of the UK.[7] However, this is broadly comparable with similar areas such as Wales. R&D expenditure in Northern Ireland is dominated by a small number of large firms, with the ten highest R&D spending firms representing 41 per cent of total R&D expenditure.[8] However, reflecting the overall lack of significant large firms in the Northern Ireland economy, firms with over 250 people account for only 47 per cent of business R&D expenditure compared with 81 per cent in the UK as a whole.[9]

Higher education R&D spending is around UK average

5.5 Higher education expenditure in Northern Ireland represents over half of total R&D expenditure. Total higher education R&D spending is in line with the UK average when measured as a proportion of GVA, although given relative GVA levels Northern Ireland total funding is only around 83.5 per cent of UK levels.[10] Relative to other UK universities, proportionally more funding to support higher education research comes directly from the Government than from sources such as industry, the European Union (EU) or other overseas sources such as charities.[11]

5.6 Direct government expenditure on R&D is some of the lowest in the UK,[12] with only approximately 0.1 per cent of regional GVA spent on government research and development.[13] In 1999 £12 million was spent on government R&D in Northern Ireland, the second lowest amount of all the UK regions and noticeably behind Wales (£47 million) and Scotland (£200 million).[14]

Business research and development

Northern Ireland's industrial structure

5.7 The differences in business R&D levels between Northern Ireland and other regions (as between the UK and other countries)[15] are in part likely to be due to Northern Ireland's different industrial structure rather than underinvestment by its companies. As suggested above, across the UK R&D tends to be dominated by large firms. The relative absence of such firms in Northern Ireland goes some way to explain the difference in business R&D spending. Moreover, Northern Ireland has fewer R&D intensive firms, such as those in the pharmaceuticals, communications and software sectors, than the UK average. For example, the top ten sectors engaging in R&D in the UK as a whole account for 19.2 per cent of UK employment, but only 13.9 per cent of employment in Northern Ireland.[16] Recent research suggests that, if sectoral differences are controlled for, there is little difference in the rate of innovation between the UK's regions.[17] Given its current structure,

7 *Research and development in UK businesses 2006*, ONS, 2008.

8 Northern Ireland Executive submission to the Review, February 2008.

9 Ibid, 2008.

10 *An examintion of higher education research and development and knowledge transfer in Northern Ireland*, Hewitt-Dundas, N. et al, DELNI, 2005.

11 Direct support from Government in 2003 was £67 million compared with £3 million from industry, £4 million from the European Union Government and £7 million from United Kingdom charities. Ibid, 2005.

12 The regional disparities in government research are partly a reflection of the location of research institutes that operate on a national basis, but the Executive has the power to adjust overall levels within Northern Ireland through its own research interests.

13 Regional competitiveness and state of the regions, DTI, 2007.

14 *think|create|innovate: the regional innovation strategy for Northern Ireland*, DETINI, 2003.

15 For a discussion of the impact of the UK's sector mix on R&D measures, see *The race to the top – a review of Government's science and innovation policies*, Sainsbury, Lord D., HM Treasury, 2007.

16 Information supplied to the Review by DETINI, February 2008.

17 The research referred to here uses a broader measure than simply R&D. *Absorptive Capacity and Regional Patterns of Innovation,* Centre for Business Research, University of Cambridge, 2008.

therefore, it would be natural to expect that R&D levels overall in Northern Ireland would be somewhat lower than the UK average.

Possible barriers to business R&D

5.8 Such analysis therefore shows that Northern Ireland has levels of business R&D spending appropriate to its size and structure, and, while there is a general economic argument that firms tend to under-invest in R&D relative to the social optimum,[18] there is very little evidence that this applies to any greater extent in Northern Ireland than elsewhere. Consideration of Northern Ireland's innovation situation does not suggest it faces any unique barriers to innovation compared with other UK regions.[19] For example, in the 2006 UK Innovation Survey, 14 per cent of enterprises in Northern Ireland claimed costs were a key barrier to innovation, compared with 15 per cent in the UK as a whole.[20] Nonetheless, given the importance of innovation to raising productivity within an economy, it is important for all regions to consider how the level of business R&D could be increased. Research for DETI has suggested a range of factors that might be limiting business R&D in Northern Ireland, although the evidence of their existence or relative significance is not conclusive.[21] These are discussed in turn below.

5.9 One possible check on innovation in Northern Ireland could be lack of awareness of financial support, with a survey suggesting that only 24 per cent of firms in Northern Ireland claimed R&D tax credits during the period 2000-2004. The reasons for this apparent lack of awareness and penetration of R&D tax credits in Northern Ireland are unclear, although one possible cause – which has now been remedied – was the absence of an HM Revenue & Customs (HMRC) office in Belfast.

5.10 Secondly, it is suggested that, unlike larger areas, Northern Ireland is more reliant on its local labour market to support its skills needs and that this means there is more possibility of a mismatch between the applied skills demand from industry to undertake R&D and the skills produced by the regional education system. However, the research suggests that this is likely to have only a weak negative effect, and there are a number of similarly peripheral regions that have managed to achieve higher levels of business R&D.[22]

5.11 A third possible cause is poor linkages between businesses that stop clusters generating critical mass, although the reasons behind the failure of clustering are only poorly understood, and attempts by government to "seed" clusters have not been particularly successful.

5.12 Finally, the research suggested that the lack of large companies in Northern Ireland could have an effect on R&D. However, while large firms inevitably undertake much of the business R&D within any economy, it is also the case that small and medium-sized enterprises (SMEs) can be among the greatest innovators. This can be seen, for example, in high-technology start-ups emerging from the "Golden Triangle" of Oxford-Cambridge-London, suggesting that culture and type of SME may have more effect on innovation levels than size.

[18] This relates to the positive externalities of investment in research: since firms may not be able to internalise all the benefits from research, they are likely to under-invest in R&D.

[19] *Northern Ireland draft regional economic strategy*, DFPNI, 2007.

[20] *Innovation in the UK: indicators and insights*, DTI, 2006.

[21] These factors were identified in research commissioned by DETI in 2004, largely from qualitative evidence. How far these barriers apply in other economies was not explored. *Research and development business expenditure in Northern Ireland: a comparison with the UK and other international regions*, Arthur D. Little, 2004.

[22] Ibid, 2004.

Higher education research and development

Higher education innovation

5.13 Higher education innovation is now understood to be a key driver of economic growth.[23] Higher education institutions are not simply sources of competitive advantage through the supply of skills to business – in a knowledge economy they also have a direct role in innovation and the commercialisation of basic research. One of the key concerns for Northern Ireland's universities is the low level of funding that comes from external sources to support their research. Income from industry to Northern Ireland's two universities is just 48 per cent of the UK average, overseas income is 33 per cent of the UK average and income from research councils and UK charities is 41 per cent of the UK average. In part this reflects the low absorptive capacity[24] of the economy – that is that fewer R&D intensive industries will have lower requirements to make of universities generally – but it is also a result of peripherality and the political instability that has historically made external fundraising difficult. Northern Ireland's universities are therefore more heavily reliant than elsewhere on government for their core funding.

Commercialisation of research

5.14 One of the key concerns of respondents to this Review relates to the ability of Northern Ireland's universities to generate income through commercialisation of research. Here Northern Ireland's universities have a mixed record. According to the most recent data, Northern Ireland's universities had the fewest spin-off companies of any UK region and were ahead of only the North East and Wales in spin-offs lasting more than three years. While the numbers of patent applications and disclosures are in line with the UK average, the number of patents granted (perhaps a better measure of the quality of commercialisation) is among the lowest in the UK.[25]

5.15 There are a number of potential general causes for the relative weakness of technology transfer from higher education to business. The first relates to the amount of available funding, and financial incentives, for researchers to commercialise research. Secondly, lack of financial awareness or skills, in terms of intellectual property understanding and management, might hold back technology transfer. Finally, the lack of R&D-intensive industries in itself means that universities are not stimulated to innovate further, so no virtuous circle of technology transfer occurs. Many of these issues have been acknowledged in Northern Ireland, and Northern Ireland's universities are in some respects ahead of others in addressing them. For example, both universities have long-established technology transfer offices.

Relationships between higher education and business are good

5.16 One concern raised repeatedly by respondents to this Review was that relationships between universities and businesses were poor, although this does not seem to be borne out in comparisons to other UK regions or Ireland. It is certainly true that the total financial value of university contract research is the lowest of any UK region.[26] However, Northern Ireland higher education institutions assist in some form 90 per cent of the firms they cover (the number of businesses in their sub-region), compared with 70 per cent on average across the UK.[27] In the

[23] *The race to the top – a review of Government's science and innovation policies*, Sainsbury, Lord D., HM Treasury, 2007.

[24] "Absorptive capacity" can be defined, broadly, as the "ability to assimilate and manage knowledge in order to improve innovation performance and competitive advantage." It will be determined, among other things, by the skills, management capability and organisational structures of a business. On an economy-wide level, the absorptive capacity will be heavily determined by the industrial structure: the more innovation-intensive an industry, the more capacity it is likely to have to absorb innovation from elsewhere. *Absorptive capacity and regional patterns of innovation*, Abreu, M. et al, 2008.

[25] *The UK Patent Office Annual Review 2005/6*, UK IPO 2006.

[26] *Higher education-business and community interaction survey 2007*, Higher Education Funding Council for England, 2007.

[27] *Research and development business expenditure in Northern Ireland – a comparison with the UK and other international regions*, Arthur D. Little, 2004.

academic year 2005-06, on average Northern Ireland institutions engaged with 226 businesses per institution, compared with 75 per institution in England, 95 in Scotland and 39 in Wales. In addition, both Northern Ireland universities rank "regional strategies" and "response to company demand" as the most important factor determining their priorities compared with only 50-60 per cent of universities UK-wide.[28] And interactions with industry are good – for example the number of Knowledge Transfer Partnerships[29] is higher than in many UK regions. Research has suggested that high levels of economic support have contributed to the level of interaction between business and universities, including through university-supported incubators and research charged to companies at below market cost.[30] However, despite this positive evidence, submissions to the Review did suggest that there may be potential to do more to improve these relationships even further.[31]

The importance of further education colleges

5.17 Given Northern Ireland's industrial structure, interaction with further education (FE) colleges is likely to be just as significant for its businesses as interaction with universities. While larger, R&D intensive industries tend to collaborate with universities, SMEs often tend to develop forms of innovation, particularly business innovation, alongside FE colleges. In addition, FE colleges will also support the flow of skills at technician level that are also crucial to R&D intensive industries. The *Regional innovation strategy* (detailed in Box 5.1) has recognised this, as has the *FE means business strategy*. However, the existing reforms of FE, including curriculum reform, are not as yet explicitly aligned in terms of skills provision or priority areas to the *Regional innovation strategy*.

Aligning research with the needs of the economy

5.18 More broadly, there was concern from respondents to the Review that the research efforts of the universities are not aligned with the needs of the economy. There is often a tension between universities undertaking basic research, on which discoveries and reputations are built, and near-market research that is much more relevant to immediate business needs. Basic research is also an important source of innovations that may be truly groundbreaking and have the most significant commercial applications. A sensible balance needs to be struck here.[32] Nonetheless, there are concerns that while the universities, government and business have good forms of communication, the strategic balance has not been resolved. For example, the stated priority areas for the *Regional innovation strategy* are in information and communication technologies, life sciences, aerospace technologies, nanotechnologies and agri-food. However, these are not areas where Northern Ireland's universities are necessarily world leaders, and the overlap between priorities is not necessarily a best fit.

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[28] *Higher education – business and community interaction survey 2007*, Higher Education Funding Council for England, 2007.

[29] Knowledge Transfer Partnerships (KTPs) are a UK-wide scheme, in which recent graduates join a company for one to three years to help introduce a new product, process or service, in association with a university or other institution.

[30] *Research and development business expenditure in Northern Ireland: a comparison with the UK and other international regions*, Arthur D. Little, August 2004.

[31] Business Alliance, Federation of Small Businesses, and DETINI submissions to the Review, February 2008.

[32] *The race to the top: a review of Government's science and innovation policies*, Sainsbury, Lord D., HM Treasury, 2007.

Collaboration preferable to competition

5.19 Finally, it was noted by Review respondents that competition between the two universities in Northern Ireland may hinder their level of commercial activity and interaction with the business community and government. There is potentially a good argument that, in a small economy, collaboration should be preferred over competition in order to establish economies of scope and scale. This could apply equally to the all-island innovation infrastructure. A mapping study by InterTrade Ireland of research and technology development centres suggested that greater integration could indeed support the growth of the R&D base and the potential for technology transfer.[33]

POLICY RESPONSES

Regional innovation strategy

5.20 The importance of innovation to the Northern Ireland economy has been clearly recognised. A £21 million fund for innovation and tourism was announced in 1998; and more recently, following the additional funding for science and innovation provided by the UK and Irish Governments in the May 2007 package, the Northern Ireland Executive's 2008 Budget sets out a £90 million innovation plan to support a range of investments.[34] Belfast's potential as a science and innovation-led city has also been identified by external commentators.[35]

5.21 Further, in many respects, Northern Ireland is ahead of UK-wide policy on innovation and of many UK regions and Ireland. The Northern Ireland *Regional innovation strategy*[36] has been in place since 2003 and this addresses many of the issues outlined above. Indeed, the innovation policy landscape is comprehensive, with a number of interventions covering each policy area. The strategy appears to be moving Northern Ireland in the right direction and this Review endorses its objectives. To improve even more in the future, however, further thought could be given to the level of focus of the strategy, its implementation and the clarity of its understanding of the links between universities, government and business. The original strategy had four priorities, supported by eight aims, which in turn had 103 deliverables under which there were 106 individual targets.[37] The *Action plan for 2004-06* focussed on 25 action points. A key issue for the Executive will be ensuring that priority in funding and focus is given to the biggest challenges where the most difference can be made.

33 *Mapping study of research and technological development centres on the island of Ireland*, InterTradeIreland, 2008.
34 *Budget 2008-11*, DFPNI, 2008.
35 *An analysis of university technology and knowledge transfer activities*, Library House, 2007.
36 *think|create|innovate: the regional innovation strategy for Northern Ireland*, DETINI, June 2003.
37 Ibid, 2003.

Box 5.1: *The Regional innovation strategy*

think|create|innovate: the regional innovation strategy for Northern Ireland (RIS) was published in June 2003 to "create a culture and environment within which Northern Ireland will prosper by using its knowledge, skills and capacity to innovate".

The strategy identified four key priorities:

- **create a coherent innovation and R&D infrastructure;**
- **enhance the use of R&D and innovation by the business sector;**
- **develop a culture of innovation and enterprise; and**
- **sustain the regional innovation system.**

The strategy set out a vision with defined contributions from the private sector, academia and government. The strategy was updated in March 2005, and has been delivered through three action plans so far. Notable initatives emerging from the strategy include:

- the launch of MATRIX, Northern Ireland's Science-Industry panel, a business driven advsiory group, bringing together academic, private and public sectors, which leads on horizon scanning and guiding science and innovation strategy;
- the emergence of Northern Ireland's niche technology areas (information and communication technologies (ICT), life sciences, aerospace technologies, nanotechnologies and agri-food technologies);
- the establishment of Northern Ireland's Higher Education Innovation Fund to encourage higher education institutions to increase their research commercialisation capabilities, and the Proof of Concept fund pilot to provide seed funding to early stage commercialisation projects; and
- the formation of a further 18 research and technological development centres to develop joint public and private sector centres of expertise in market-driven research.

More recent developments have included the launch of a Higher Education Further Education Collaboration Fund, a scheme to enable HE and FE sectors to collaborate in meeting the needs of business, one of the first of its kind in the UK, and the development of a regional innovation voucher scheme, which will be launched this year, enabling SMEs with little history of R&D collaboration to commission subsidised research from research institutions.

Focus on areas of world class expertise

5.22 In order to increase levels of innovation further, Northern Ireland's support for world-class innovation excellence must be a sustained, long-term priority. In pursuit of this goal, the Review has some concerns that the five niche technology areas currently prioritised by Northern Ireland are not necessarily areas in which either Northern Ireland's universities or businesses have clear global competitive advantage.[38] While this Review does not see its role as suggesting alternatives, **it is worth the Executive, through the MATRIX group (see Box 5.1), taking note of other successful models that have begun with clustering around centres of world-leading expertise and built out from there** (for example, the Midlands Medici model, or BioDundee, which were identified in previous research for the Department of Enterprise, Trade and Investment[39]). It will also be important to ensure that economic development policy should not become so rigidly determined by niche priority sectors that opportunities to develop new industries around new technologies get missed.

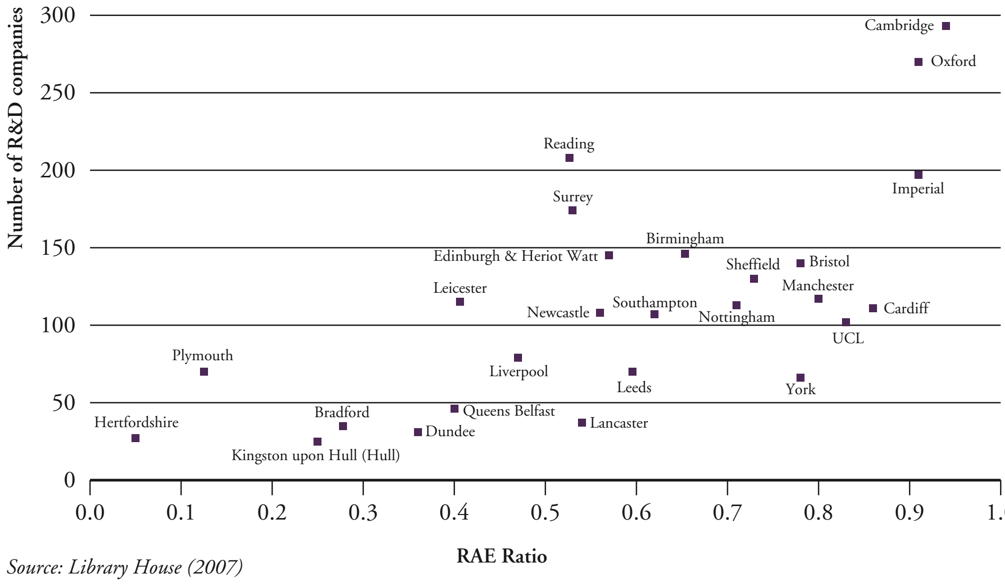
[38] Submissions to the Review, February 2008.

[39] *An examination of higher education research and development and knowledge transfer in Northern Ireland*, Hewitt-Dundas, N. et al., DELNI, 2005.

Supporting research excellence in universities

5.23 There is an increasing amount of evidence that suggests that high-quality private innovation is driven by the quality of university research expertise. Chart 5.1 plots the proportion of R&D intensive companies against a measure of research quality of their universities.[40] It is increasingly evident that, in a knowledge-driven economy, the key to unlocking the economic benefits of innovation is the pursuit of excellence. As the Sainsbury Review states: "having many companies in one city does not in itself create a high-technology cluster. A cluster grows out of the research excellence of a university."[41] In this respect, the recent commitment to increase the number of PhD students in Northern Ireland by 300 is very positive. However, other economies are not standing still. Ireland has committed to doubling its number of PhDs by 2013 (albeit from a low base[42]). While there may always be some debate around the role of universities in an economy and how much their expertise should drive that economy's focus, **there will clearly be a need for Northern Ireland to continue investing in and supporting areas of world-class university research excellence**.

Chart 5.1: RAE[44] vs. R&D companies



Source: Library House (2007)

Stimulating private research

5.24 A successful innovation-driven economy will ultimately depend on industry. While government and universities can do much, businesses will be at the heart of transmitting ideas into tangible products or services. The tax system provides incentives for business investment in R&D by allowing companies to set their expenditure on R&D against their taxable profits. For SMEs, enhanced deductions of 150 per cent of eligible spending can be applied and for large companies,

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40 *An analysis of UK university technology and knowledge transfer activities*, Library House 2007.

41 *The race to the top: a review of Government's science and innovation policies*, Sainsbury, Lord D., HM Treasury, 2007.

42 In 2001 Ireland had 125 PhDs per million population, compared with 239 in the UK. *Strategy for science, technology and innovation 2006-13*, Department for Enterprise, Trade and Employment, 2006.

43 The RAE-ratio is the ratio of university departments achieving top marks (5 or 5*) in the 2001 Research Assessment Exercise to the total number of departments assessed. The Research Assessment Exercise (RAE) is conducted in the UK by the higher education funding bodies (HEFCE, SFC, HEFCW and DELNI) to produce quality profiles of research conducted in each institution. This information is then used to determine the grant for research that the institution should receive. www.rae.ac.uk.

from April this year, 130 per cent.[44] As noted above, an Economic Research Institute of Northern Ireland study into R&D tax credits in Northern Ireland[45] showed a lack of awareness of such financial support in Northern Ireland, with only 24 per cent of firms in the region claiming R&D tax credits during the period 2000-04. Combined with the overall low levels of R&D in Northern Ireland, this suggests that increased awareness and take-up of the tax credit might incentivise more businesses to undertake R&D.

5.25 **This Review therefore suggests that the Northern Ireland Executive works with Invest NI and HMRC to address further the take-up of R&D tax credits.** Work has already begun here: the recently opened Northern Ireland Corporate Tax office has a role in providing information about the R&D tax relief among its other functions. However, evidence given to this Review suggests that there may be some specific misunderstanding in Northern Ireland about the different combinations of state support for R&D which can be sought, including the best combinations of grant schemes and R&D tax credits for different types and sizes of business.[46] Further efforts should therefore be made by HMRC and Invest NI to inform companies about the different support mechanisms available, and about R&D tax credits more generally. This could be done through a mix of marketing, particularly using Invest NI to access foreign companies, or through the Higher Education Innovation Fund or Higher Education Further Education Collaboration Fund (these bodies are discussed in more detail below). This Review finds that such policies would be preferable to the proposed enhanced tax credits for inward investors to Northern Ireland that are discussed in Chapter 4, and would also benefit domestic businesses that would otherwise be discriminated against by such proposals.

Improving business-research community collaboration

5.26 As stated above, considerable effort has gone into opening university R&D "pipelines" to commercial exploitation over recent years, including the establishment of a Northern Ireland science park, the Higher Education Innovation Fund, and establishing specific points of contact for SMEs within the universities. The argument has been made that more needs to be done to stimulate the demand from the private sector for R&D – increasing the "pull" from industry – given this considerable investment.[47] One scheme to encourage greater engagement is the innovative R&D voucher scheme, to be implemented in Northern Ireland this year, which will enable firms with little previous experience of R&D to have first-time engagement with a research

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44 In addition, where SMEs are loss-making for tax purposes, losses generated by qualifying R&D expenditure can be surrendered in return for a payable cash credit of 24 pence in the pound of the unenhanced losses. Further enhancements have been announced for SMEs in recent Budgets, including a doubling of the thresholds under which a company is considered an SME and an increase in the enhanced deduction to 175 per cent. Both of these changes are subject to approval from the European Commission, and will be made effective by Treasury Order once that approval has been received.

45 *Assessing the case for a higher rate of R&D tax credits in Northern Ireland*, ERINI, 2006. No comparison regions were surveyed.

46 Companies cannot receive more than one Notified State Aid per project. Most of the businesses claiming R&D tax credits in Northern Ireland are SMEs. The R&D SME tax credit scheme is itself a Notified State Aid, but the grants given to the SME businesses through Invest NI are also Notified State Aids. Consequently, the company must choose to receive either the SME R&D tax credits or the grant. However, companies that have been prevented from claiming the SME tax credit can claim under the less generous large company scheme, should they desire, provided the only reason their SME claim was denied was because of the grant exclusion. However, it is suggested that a significant number of such companies may not be aware of their potential eligibility to claim under the large company scheme and thus they may not be taking up support to which they are entitled.

47 *Northern Ireland draft regional economic strategy*, DFPNI, 2007.

body at reduced cost.[48] Nonetheless, there is some concern that relying on increased private sector demand will be insufficient to achieve Northern Ireland's ambitions. Northern Ireland's industrial structure, with a lack of R&D-intensive businesses, may set limits on the amount of business-driven R&D that can be generated. More still may need to be done to support public and university-driven R&D to encourage economic growth.

5.27 In this respect, developments in Northern Ireland to support increased commercialisation from HE and FE are to be welcomed. In addition, a pilot Proof of Concept Fund, designed to provide financial incentives and support for very early stage ideas, has been initiated, which is in advance of the similar recommendations of the recent UK-wide White Paper on innovation.[49] Of particular note, given the potentially key role for the FE sector in supporting innovation, is the Northern Ireland HE-FE Collaboration Fund, which again presages a similar commitment in the latest Department for Innovation, Universities and Skills White Paper and may be the first of its type in the UK. Further, the Northern Ireland Higher Education Innovation Fund should form the basis for an established "third stream" of funding for university knowledge transfer activities alongside core grants for teaching and basic research (the first and second streams). **This Review supports such a funding commitment, and suggests that the Northern Ireland Executive should prioritise embedding a permanent third stream of finance for universities**.

Alignment of the education and training system

5.28 Alignment of the regional education and training system to the needs of the economy is an issue that has been raised repeatedly by respondents. This is discussed in general terms in Chapter 3. In relation to innovation, evidence suggests that the provision of high-calibre graduates may be less of an issue than the supply of technicians. The concern is therefore to ensure that the FE sector is also aligned with the *Regional innovation strategy*. As noted above, it is noticeable that the current priority skills areas do not take into account the niche technology areas set out in the *Regional innovation strategy*, and there is no explicit link between the skills requirements of the innovation strategy and the FE strategy. **This Review therefore suggests that the current FE reforms should ensure that FE skills provision clearly supports the *Regional innovation strategy*.**

The limits to regional collaboration

5.29 Given the structure of the Northern Ireland economy, it is questionable how far regional university-business collaboration alone can be expected further to drive up the overall level of innovation in the economy. While it is true that local universities will tend to be the first port of call for the universities in other regions, higher education research is now increasingly operating on a global stage. Such interactions can support the Northern Ireland economy, both through generating income for its universities and through potential spillover effects that feed back into the local economy. For example, Queen's University Belfast has undertaken significant research on industrial catalysis. The principal users for this research are not in Northern Ireland or Ireland. Instead, a recent research contract with Petronas, the Malaysian Oil Company, has generated more than £5 million in contracts over the next three years. Conversely, some Northern Ireland industries may benefit from expertise that does not exist in Northern Ireland universities, and that would be more appropriately sourced from elsewhere.

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[48] Based on a scheme begun in the Netherlands, the scheme is likely to operate in the same way as the Irish innovation voucher scheme and with reciprocal arrangements. Under the Irish scheme, eligible companies receive a voucher for €5,000, which they can use towards the purchase of research from approved providers into a particular problem or project that they have to set out when the voucher is applied for. Once implemented, Northern Ireland and Irish companies will be able to use the vouchers on an all-island basis.

[49] *Innovation nation*, DIUS, March 2008.

The internationalisation of science and technology

5.30 The increasing globalisation of science and research, and the consequent need for wider inter-regional collaboration is a key concern of the Sainsbury Review.[50] A key characteristic of successful innovation-led economies is that they are outward looking, with both companies and universities looking beyond their regional boundaries to generate innovation.[51] This issue has been recognised in the *Regional innovation strategy* and Ireland's *Strategy for science, technology and innovation*, which bring forward a number of initiatives to support business-to-business, business-to-university and university-to-university networks, and involvement in EU-supported collaborative networks.

5.31 In the first instance, this means building strong links to both Ireland and the rest of the UK. There are already some very good initiatives underway, including the Centres for Science Engineering and Technology Programme, a competitive scheme operated by the Science Foundation Ireland which funds scientists who collaborate to develop internationally competitive research clusters allied to industry. It has been agreed that the next call for proposals will operate on an all-island basis. In addition, Intertrade Ireland manages a number of schemes, including the All Ireland Software Industry Network, Networks BioMed Ireland and Innova, that have yielded some impressive successes. Northern Ireland research centres are already demonstrating their willingness to look outwards. Research by Intertrade Ireland into research and technological development centres[52] reported that 66 per cent of respondents had already collaborated at least once with a centre in Ireland. This compares with 46 per cent of those based in Ireland having collaborated on a cross-border basis.

Inter-regional partnerships

5.32 The Executive, working with UK and Irish partners, should ensure that it provides sufficient support to enable Northern Ireland's universities and businesses to develop links with the rest of the UK and Ireland. For example, the recent UK White Paper on innovation announced a strategic programme worth £1 billion over three years to support innovation. The Department of Enterprise, Trade and Investment, Invest NI and the MATRIX group, through their relationships with the Technology Strategy Board (TSB), should ensure that Northern Ireland businesses and universities are aware of, and given an opportunity to be closely involved in, TSB programmes. This Review understands that Northern Ireland's new innovation voucher scheme, due to commence this year, will be operated on a reciprocal basis with Ireland, where such a scheme (without including Northern Ireland) is already in place. **The Executive may wish to consider whether these arrangements could be expanded further, to allow Northern Ireland businesses to also access research support in the rest of the UK.**

UK and Ireland partnerships as a springboard to international innovation

5.33 Beyond these inter-regional initiatives, it is important that R&D and innovation operate on an international plane. By ensuring that Northern Ireland makes the most of its links to Ireland and other UK research bases, it can benefit from those regions' existing partnerships in Europe, the US, and China and India. Research suggests that collaboration between universities and other research institutes offers economies of scale and scope that can support Northern Ireland's research, commercialisation and technology transfer efforts.[53] The all-island US-Ireland R&D Partnership, a three-way collaboration between researchers in a small number of priority areas, which emerged from the US Ireland Business Summit in 2002, is a good example of how such ambitions can be realised. This Review welcomes the ongoing support for the R&D Partnership from the Irish Government and the Northern Ireland Executive and supports further investigation of the

[50] Ibid, 2008.

[51] *Research and development business expenditure in Northern Ireland: a comparison with the UK and other international regions*, Arthur D. Little, August 2004.

[52] *Mapping study of research and technological development centres on the island of Ireland*, InterTrade Ireland, 2008.

[53] *University collaboration on technology transfer: an all-island feasibility study*, InterTrade Ireland, 2006; Ibid, 2008.

potential for broader collaboration. However, it is important that the existing mechanisms are taken into account before creating new ones, and aligning mainstream funding is preferable to creating separate funding streams. Aligning existing mechanisms, including peer review and mainstream funding, is acknowledged to be difficult, although some examples exist.[54] **To improve further the level of international technology transfer and collaborative research, this Review suggests that the UK and Irish Governments and research funding bodies should engage in dialogue to explore how mainstream science funding and strategy can be aligned.**

[54] The UK Economic and Social Research Council and the Irish Research Council for the Humanities and Social Sciences have a bilateral agreement that allows for joint applications to be supported through existing structures.

6 Enterprise

Enterprise – the creation and growth of firms – increases ideas, knowledge and skills and provides incentives for others to innovate through raising competition.

There are few significant differences between the level of business start-ups in Northern Ireland when compared with the rest of the UK once Northern Ireland's industrial structure is taken into account, although failure rates are slightly lower. The proportion of small and medium sized enterprises (SMEs) among Northern Ireland's businesses is the same as that in the rest of the UK, although the contribution they make to the economy in terms of employment and turnover is significantly higher. This is due to a relative lack of large, high-turnover companies. Northern Ireland exports are lower than the UK average.

Northern Ireland has aspirations to increase the number of large firms through growth, and in particular the number of firms which export, recognising that these are often key to growth within an economy. It should also aim to increase the number of start-ups in order to guarantee the future flow of large, exporting companies.

Building on its current approach, the Northern Ireland Executive should consider the following in order to help deliver this:

- with Invest NI and the Department for Business, Enterprise and Regulatory Reform, investigate the causes of the low uptake of the Small Firms Loan Guarantee and whether there is a case for further intervention to support the scheme;
- a review of forms of financial assistance to ensure that they do not have a market distorting effect and which considers possible reforms of assistance to further reward performance rather than expenditure;
- examine in more detail the barriers to growth faced by businesses in Northern Ireland to ensure that its interventions are tailored to their particular concerns. Where these issues are shared with businesses in Ireland, Invest NI and Enterprise Ireland should work together to develop interventions; and
- keep regulatory burdens on Northern Ireland businesses to the minimum necessary, working where appropriate with the UK Government.

INTRODUCTION

6.1 Enterprise – the creation and growth of firms – increases ideas, knowledge and skills, and provides incentives for others to innovate through increasing competition. Entrepreneurship is dynamic. In the competitive process of improving and developing new products and services, as they enter new markets or compete with new entrants, firms increase their productivity and the overall productivity of the economy. This is key for long-term economic growth. The main factors contributing to high levels of entrepreneurship are an appropriately skilled workforce, access to start-up capital and a favourable business environment, including appropriate levels of regulation.

ENTERPRISE IN NORTHERN IRELAND

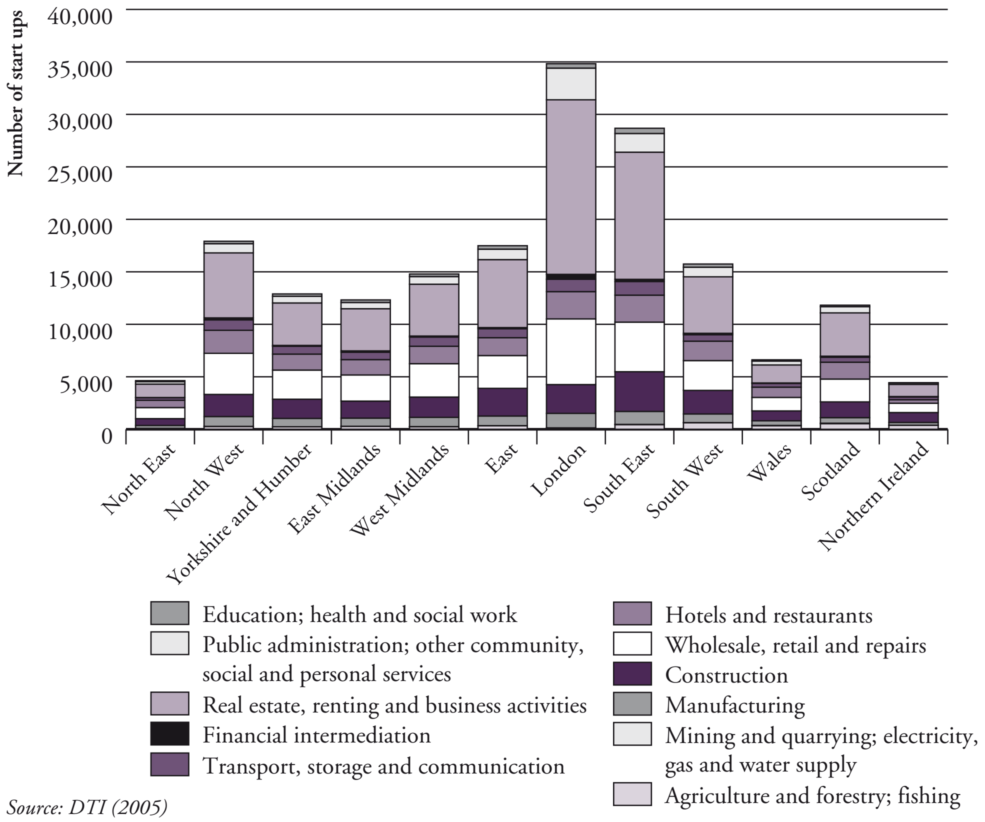
The level of entrepreneurial activity

Entrepreneurial activity in line with the UK average

6.2 The proportion of people involved in early stage entrepreneurial activity in Northern Ireland, at 4.9 per cent, is just below the UK average of 5.6 per cent.[1] This has increased from 3.7 per cent in 2006, and the gap has been narrowing over the past five years. This should be put in the context of the UK's level of entrepreneurial activity, which, while ahead of many European competitors, is noticeably behind the US and, on this measure, Ireland.[2]

6.3 Another way of measuring entrepreneurship is through business start-up rates, as measured by VAT registrations.[3] The start-up rate for businesses in Northern Ireland is also slightly below the UK average, at 33 companies per 10,000 residents, compared with the UK average of 37. This puts Northern Ireland in the middle of all UK regions.[4] However, research suggests that the majority of this difference can be explained by the sectoral make-up of existing industry, as Northern Ireland is dominated by industries where start-up rates tend to be lower generally. This can be shown by controlling for the sectoral difference between UK regions.[5]

Chart 6.1: Business start up rates by broad industry sector and region



Source: DTI (2005)

[1] Early stage entrepreneurial activity measures what proportion of individuals in the population are involved at the very early stages of starting a business, up to the first 42 months of a business's life. *Global Entrepreneurship Monitor*, Small Business Research Centre, Kingston University, 2007.

[2] *Enterprise: unlocking the UK's talent*, HM Treasury and BERR, March 2008.

[3] VAT registrations do not include the very smallest businesses who will be below the VAT threshold.

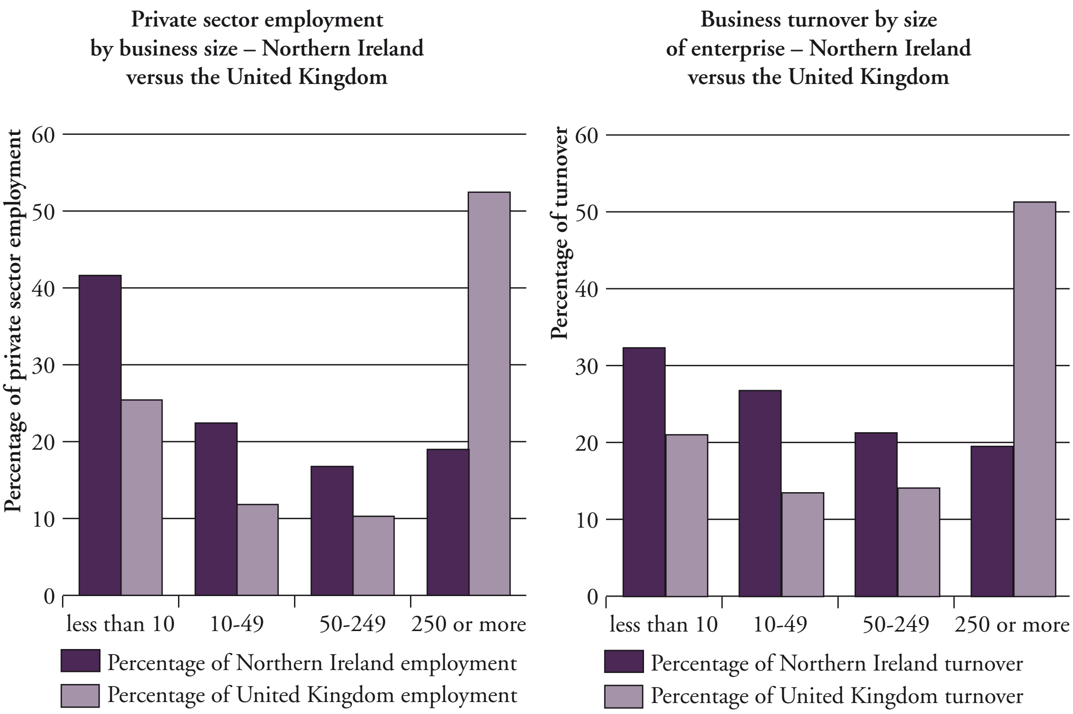
[4] *Regional competitiveness and state of the regions*, DTI, 2007.

[5] *Why do some regions have fewer young firms?,* Cowling, M, Institute for Employment studies, research for BERR, 2007.

Low failure rate 6.4 However, despite the similar entrepreneurial activity and start-up rates, the failure rates for businesses in Northern Ireland suggest there is less "churn" among Northern Ireland enterprises, with a survival rate above the UK average – 78.5 per cent compared with 71.3 per cent.[6] This has been attributed by many Review respondents to the lack of competition in many Northern Ireland industries.[7]

"Predominance" of SMEs 6.5 Northern Ireland is often described as a small and medium-sized enterprise (SME) dominated economy. In fact, the total proportion of SMEs is in line with the UK average: 99 per cent of businesses employ fewer than 250 people in both Northern Ireland and the UK as a whole, and the proportion of sole traders and businesses with fewer than 50 employees are also broadly in proportion.[8] It is perhaps more accurate to describe the Northern Ireland economy as marked by an absence of large, high-turnover businesses. Large businesses account for only 19 per cent of employment and 19.5 per cent of turnover in Northern Ireland, compared with 41 per cent of employment and 49 per cent of turnover on average across the UK.[9] In Northern Ireland, there are 45 businesses with more than 500 employees – in the UK as a whole there are 4,510, a difference of a hundredfold, even though the UK population is only around 34 times higher than that of Northern Ireland.

Chart 6.2: Employment and gross value added by size of business



Source: DTI (2005)

[6] *Regional competitiveness and state of the regions*, DTI, 2007. Data relates to 2002.

[7] London has the lowest survival rate.

[8] A total of 69 per cent of Northern Ireland businesses have no employees, compared with 73 per cent across the UK, and 30 per cent have 1–49 employees, compared with 26 per cent across the UK (the figures are closer still if London and the South East are excluded). Northern Ireland businesses also have a similar proportion of businesses employing between 1 and 9 employees – 25 per cent compared with 23.6 per cent for the UK. *SME Statistics*, DTI, 2005.

[9] Large businesses in the North East of England account for 37.7 per cent of employment and 47 per cent of turnover. Ibid, 2005.

Relative lack of large, export-led firms

6.6 The lack of larger firms tends to depress the export rates of a region. Northern Ireland's export rates are slightly lower than similar UK regions. Exports to the EU are worth 12.2 per cent of Northern Ireland gross value added (GVA), compared with 13.1 per cent for the UK as a whole.[10] Northern Ireland exports totalled about £5.2 billion in 2006, about 20 per cent of GVA,[11] compared with UK exports which totalled approximately £243.8 billion in the same year, approximately 21 per cent of GVA. Given the importance of exports to growth, particularly in a small economy, it will be important for Northern Ireland to focus on increasing exports.

Small and large firms make distinct contributions

6.7 There is very little evidence on the optimum balance between small and large companies: while large companies are able to generate the efficiencies of scale and critical mass that often support exports, small firms bring the productivity benefits of competition and can be among the most innovative. Increasingly, many small companies are able to engage in international activities right from birth, without relying on achieving critical mass in their home markets.[12] Furthermore, evidence suggests that SMEs have been integral in Northern Ireland in driving employment growth over the past decade.[13] The predominance of SMEs, therefore, should not be seen, *prima facie*, as a cause for concern. Nonetheless, the Northern Ireland economy has a very different structure to the rest of the UK. This raised concerns among some respondents to the Review that this reflected an inability of businesses in Northern Ireland to grow, especially outside their borders, and therefore an environment that was not conducive to growth.

6.8 There is currently little evidence on regional differences in business growth rates, and the different factors that influence business growth across regions, so it is difficult to be certain whether this is a particular problem for Northern Ireland businesses.[14] However, given the low proportion of large businesses, it is likely that there is greater unrealised potential for growth within indigenous companies, as well as potential to attract large multinational corporations.

Barriers to starting and growing businesses

Access to finance

6.9 Problems with access to finance are often considered by entrepreneurs to be among the biggest barriers to starting or growing a business.[15] While some submissions to the Review pointed to risk aversion on the part of banks, and low rates of venture capital financing,[16] there is little evidence that there are particular market failures leading to difficulties in financing businesses in

[10] *UK regional trade in goods statistics*, HMRC, 2007; *Public expenditure and statistical analysis*, HM Treasury, 2008.

[11] *Regional and sub-regional GVA estimates*, ONS, December 2007.

[12] *Enterprise: unlocking the UK's talent*, HM Treasury and BERR, March 2008.

[13] *Start ups and economic development: job creation in Northern Ireland*, Bonner, K., et al, ERINI 2007.

[14] In fact, the evidence that does exist suggests, albeit very tentatively, that growth is not a major issue for Northern Ireland firms. The latest survey of small businesses in the UK reports that 59 per cent of businesses intended to grow, compared with the UK average of 56 per cent, but this does not include evidence of the size of growth or the success rate. *Small business service – annual survey of small businesses: UK*, Institute for Employment Studies, 2005.

[15] There is extensive discussion of market failures in the market for finance, mostly in relation to "information asymmetries" between lenders and borrowers (but the issue arises also in equity finance). See, for example, www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr03/assoc_docs/prebud_pbr03_adsmall.cfm.

[16] Between 2004 and 2006, Northern Ireland consistently had the lowest venture capital investment – for example in 2006, £13 million was invested in Northern Ireland compared with £61 million in Wales, the next lowest region. *Report on investment activity*, BVCA, 2006.

Northern Ireland compared with elsewhere in the UK.[17] Surveys suggest that around the same proportion of businesses fail to access finance on their first attempt.[18]

An "equity gap"?

6.10 For a minority of SMEs, particularly young or risky SMEs, debt finance (through bank loans, for example) is not appropriate and risk capital, through equity finance, is more suitable. However, many venture capitalists are reluctant to invest small amounts in companies for a variety of reasons including high fixed transaction costs, a shortage of available exit options and a perceived greater risk associated with investing in early-stage companies. This reluctance has translated into what has been described as an "equity gap", where businesses find it hard to access equity finance below a certain level. Across the UK, Government has sought to plug this gap using a number of vehicles, including Regional Venture Capital Funds, which have counterparts in Northern Ireland, and are administered by Invest NI.

6.11 Northern Ireland has the lowest rate of venture capital financing of any UK region and a lower volume of funds than Ireland. However, evidence that this small private equity market reflects particular or heightened market failures (as opposed to the "equity gap" seen across the UK) is inconclusive.[19] Research into the possible reasons behind low demand for equity funding in Northern Ireland highlighted three factors: a lack of wealth-creating culture, dominance of family-run businesses and the availability of government grants.[20] Such issues seem to reflect those found elsewhere – the issue of maintaining owner-control seems ubiquitous across the UK, for example, with 20 per cent of SMEs suggesting that reluctance to dilute ownership was the main reason for not seeking equity. Northern Ireland is also well served by a number of funds which are set up or supported by the public sector, including the NITech fund, Viridian and Crescent Capital II, in which Invest NI acts as a partner.

6.12 To the extent that barriers persist in the market for finance, they may exist around the demand for equity finance, as opposed to supply-side constraints, which have been addressed in recent years. Potential market failures might include problems around investment readiness and the costs of accessing support for a young business, or risk aversion on the part of enterprises.[21] More research is required to establish the extent of these market failures.

Good access to debt finance

6.13 The lack of information available to banks on the viability of a business when making a lending decision can often create a market failure, whereby businesses with otherwise viable propositions but no collateral can be refused loans. While there is a perception of risk aversion on the part of Northern Ireland banks, interest rates offered appear to be highly competitive with comparator UK regions and Ireland,[22] and Northern Ireland SMEs have the lowest overall outright rejection rate for finance (1 per cent). However, Northern Ireland does have the highest discouragement rate (the proportion of SMEs that do not seek funding because they do not believe they will secure it) at 14 per cent, compared with 4 per cent in the UK generally, suggesting that there may be some issues on the demand side. To deal with market failure in debt financing, the UK established the Small Firms Loan Guarantee Scheme, which provides guarantees to lenders to enable firms that have viable business propositions but lack collateral to access debt finance. Take-

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17 Submissions to the Review, February 2008.

18 81 per cent of businesses in Northern Ireland obtain finance without difficulty at their first attempt, in line with the UK average of 79 per cent. *Small business service – annual survey of small businesses: UK*, Institute for Employment Studies, 2005.

19 This is made problematic by the very small numbers of SMEs that use equity finance generally and even smaller numbers that use formal venture capital (estimated at 3 per cent and 1.3 per cent respectively).

20 *Financing for Growth*, Ulster Society of Chartered Accountants, 2001.

21 *Enterprise: unlocking the UK's talent*, HM Treasury and BERR, 2008.

22 *SME finance NI*, Ulster Society of Accountants, 2001.

up of this by Northern Ireland businesses seems lower than expected.[23] Businesses in Northern Ireland are reported to be less aware of the scheme than in other parts of the UK, and banks have been less likely to promote it, but this may simply be a reflection of the availability of other types of financing, limiting the need to look elsewhere.

Consequences of government funding

6.14 However, the availability of public funding (both equity and debt) may have a number of unintended consequences. It may limit the attractiveness of Northern Ireland as a market for private investors, who see smaller potential returns to investment as they are effectively competing with government. At the same time, government support may serve to cushion Northern Ireland businesses from competitive pressures that create "churn" and ultimately drive productivity. According to the latest data, Northern Ireland enterprises receive, in total, the same amount of UK regional financial assistance as those in the whole of England.[24]

Non-financial support

6.15 In general, non-financial support from government is also often important for enterprises. Businesses, especially those in deprived areas, can often find the cost of access to information prohibitively high, and often lack the support and information networks required to encourage them to set up or to grow. This may be particularly acute for companies seeking to expand into foreign markets. Recently, concern in the UK has focussed around the complexity of business support packages and in response the Government is leading a programme of business support simplification to reduce the number of programmes UK-wide from over 3,000 to fewer than 100.[25]

Different attitudes to risk

6.16 Finally, one possible cause for lower levels of enterprise raised by respondents is that attitudes to risk in Northern Ireland may compare unfavourably with the rest of the UK. Available evidence suggests that fewer people in Northern Ireland believe they have the skills to set up in business compared with all other regions of the UK and that fear of failure has consistently been higher in Northern Ireland than elsewhere in the UK, as shown in Chart 6.3. This may be partly influenced by cultural attitudes to employment in Northern Ireland, which many Review respondents saw as favouring stable public sector jobs and those in the professions. However, one of the interesting findings from the *Global entrepreneurship monitoring survey* is that when people from Northern Ireland who have located elsewhere are included in research, entrepreneurial activity is on a par with the rest of the UK.[26] This suggests that the level of "entrepreneurial spirit" may be no different within the Northern Ireland population than elsewhere, but that Northern Ireland's entrepreneurs have a higher propensity to move elsewhere to pursue their plans. This finding implies that the entrepreneurial deficit may not lie in the education system and the absence of entrepreneurial skills but in the conditions for budding entrepreneurs to stay in or return to Northern Ireland.

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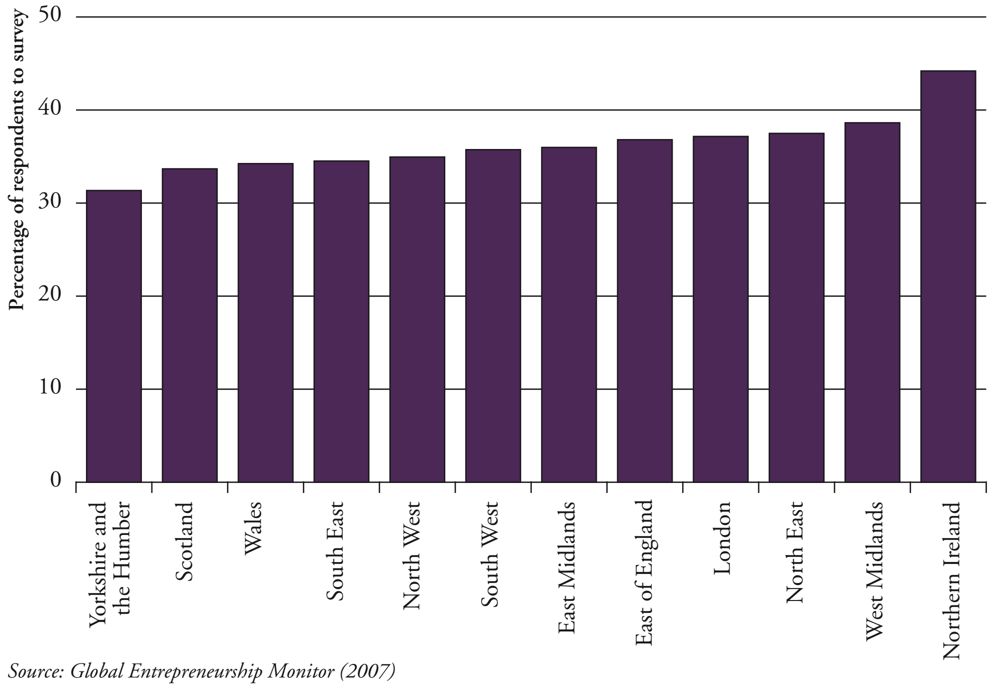
[23] *Small Firms Loan Guarantee: Annual Report to Parliament, 2006-07*, BERR, 2007.

[24] This excludes some other sources of funds, so the figures may not be directly comparable. *Regional Trends 39*, ONS, 2006.

[25] The Business Support Simplification Programme is set out in *Simple support, better business: business support in 2010*, BERR, 2008.

[26] *Global entrepreneurship monitor*, Small Business Research Centre, Kingston University, 2007.

Chart 6.3: Fear of failure as a barrier to starting a business



Source: Global Entrepreneurship Monitor (2007)

POLICY RESPONSES

Role of the UK Government

6.17 As discussed in Chapter 1, many of the policy levers for promoting enterprise in Northern Ireland are controlled by the UK Government. The UK Government published the report *Enterprise: unlocking the UK's talent*[27] alongside Budget 2008, which set out how the Government will encourage further business start-up and growth, focusing on SMEs. More details on the strategy are set out in Box 6.1. In addition, there is much that can be achieved by the Executive, both through policies that support enterprise directly, including skills and innovation, and through the work of the Department for Enterprise, Trade and Investment (DETI) and the Northern Ireland enterprise and investment agency, Invest NI. In addition, Enterprise Ireland, the Irish enterprise agency, shares similar aims to Invest NI: supporting and developing innovative, high potential companies with an export focus.[28]

[27] *Enterprise: unlocking the UK's talent*, HM Treasury and BERR, 2008.

[28] *Transforming Irish industry – Enterprise Ireland strategy 2008-2010*, Enterprise Ireland, 2008.

Box 6.1: The UK Government's enterprise strategy

The UK Government published the report *Enterprise: Unlocking the UK's talent* alongside Budget 2008. Focusing on SMEs, this set out a new policy framework for government action to encourage further business start up and growth, and identified five enablers of enterprise (culture, knowledge and skills, finance, innovation and regulatory framework). Key measures set out in the strategy include:

- improving access to finance for SMEs, including enhancing the Small Firms Loan Guarantee Scheme and Enterprise Capital Funds;
- a consultation on the introduction of regulatory budgets, which would cap the new, annually-recurring cost of regulation for business, including whether to pilot this approach for SMEs or a particular sector;
- an increased focus on minimising the impact of regulation on SMEs;
- an independent review of regulatory guidance to reduce compliance costs;
- further development of enterprise education in secondary schools and extension of it, where possible, into primary and further education (underpinned by a £210 million funding package, as agreed at the 2007 Comprehensive Spending Review); and
- establishing a National Enterprise Academy.

Access to finance

6.18 There is a general case for intervention in debt and equity finance where market failures exist. However, as discussed, there is little evidence that problems around access to finance are any more acute for Northern Ireland than for the rest of the UK. It is therefore important to assess whether Northern Ireland's support is in line with best practice. Northern Ireland is fairly well served by publicly backed equity finance. In recent years the Crescent Capital Fund, Northern Ireland Technology (NITech) fund, Proof of Concept Fund and University Challenge Funds have all sought to plug funding gaps which have been identified elsewhere. In addition, Northern Ireland's businesses are able to apply to UK-wide funds, including the Enterprise Capital Fund.[29] Access to government-backed debt finance also appears to be on a par with the UK as a whole and Ireland, although, as described above, there seem to be some issues with penetration of the Small Firms Loan Guarantee. In order to address the latter, **the Executive, Invest NI and the Department for Business, Enterprise and Regulatory Reform may wish to investigate the causes of the low uptake of the Small Firms Loan Guarantee and whether there is a case for further intervention to support the scheme**.

[29] Some research has suggested that the supply of equity finance could go further, creating an "over-supply" to stimulate the market, which some commentators have suggested was the approach taken in Ireland.

6.19 One of the key issues for Northern Ireland is the extent to which the various sources of public funding interact and, potentially, conflict. It is possible that the level of public financing crowds out private or quasi-private investment to some extent. It might also serve to distort competitive pressure. The amount of financial support available under EU rules will decline after 2013, limiting this effect. This Review is aware of existing good practice within Invest NI's support programmes, where grant payments are "triggered" by the achievement of certain objectives. However, Invest NI, and any other bodies giving financial support should consider further whether there is a possibility that grant programmes act as a disincentive to focus on private investment. **This Review therefore recommends a review of forms of financial assistance to ensure that they do not have a market distorting effect, and which considers possible reforms of assistance to further reward performance, not expenditure**. This should include consideration of whether grants that reward expenditure should be converted, where possible, to other financial products that may create fewer perverse incentives.

Enterprise Zones

6.20 Some representations to the Review have suggested that there is a case for Enterprise Zones to support economic development, in which various fiscal incentives, including lowered or zero business rates are offered to businesses setting up there. While research supports the general principle of creating a physical environment for businesses to come together, it suggests that the reduction in rates paid by businesses is offset by an increase in rents that landlords feel they are then able to charge.[30] This means that the benefits largely accrue to land owners or owner-occupiers. Smaller businesses, which are in the majority in Northern Ireland, tend to rent rather than own their properties, so they are unlikely feel the benefits of any rate freeze. This suggests that such a scheme will have little impact on the rates of business creation and growth among SMEs.

Non-financial support

6.21 With respect to non-financial support, the Review has not received any evidence that Invest NI's suite of support schemes are more or less effective than those operating in the rest of the UK or in Ireland. Most recent evaluations have concluded that Invest NI's programmes for targeting business support have broadly achieved their objectives. However, there remains a lack of compelling evidence in relation to the barriers that businesses in Northern Ireland face in starting up or growing, nor sufficient evidence of the economic effectiveness of existing interventions as measured against best practice. **The Review suggests that Invest NI examine in more detail the barriers to growth faced by businesses in Northern Ireland, to ensure that its interventions are tailored to their particular concerns. Where these issues are shared with businesses in Ireland, Invest NI and Enterprise Ireland should work together to develop interventions**.

Supporting exports

6.22 Lastly, as discussed in paragraph 6.6 above, growth in exports should be an important part of Northern Ireland's economic strategy in the future. Partly, this will be achieved through the measures to increase enterprise and grow firms, as discussed in this chapter. More fundamentally though, a key driver of increased exports is increased productivity – research shows that countries' exports are positively correlated with the relative productivity of their firms.[31] Therefore, the overarching objectives and proposals of this Review, to increase productivity and competitiveness through improvements to employment, skills or innovation, should simultaneously help Northern Ireland firms increase their levels of exports by focusing on the economic fundamentals that should help those businesses grow and succeed.

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[30] *The relationship between National non-domestic rates and rents on commercial property: empirical evidence from Enterprise Zones – A Final Report for HM Treasury and HM Revenue and Customs*, Cambridge Econometrics February 2008; *Investigation into a small business rate relief scheme in Northern Ireland*, ERINI, March 2008.

[31] *The happy few: the internationalisation of European firms*, Mayer, T. and Ottaviano, G, 2007.

6.23 More specifically, regions can support specific companies to start or increase exports. Both Northern Ireland and the UK have export support programmes, run by Invest NI and UKTI respectively, which assist exporters through information, advice and trade missions overseas. Similarly, Enterprise Ireland works to support export-focused businesses in Ireland. As Northern Ireland grows, the importance of such support to exporting businesses is likely to increase and the Executive will want to ensure that it remains in line with global best practice. In the future, Invest NI will want to maximise opportunities to work jointly with UKTI and Enterprise Ireland on shared trade missions and sharing international resources and networks.

Reducing regulatory burdens

6.24 Regulatory burdens place a significant cost on businesses. Companies in Northern Ireland, as part of the UK, benefit from some of the lowest barriers to entrepreneurship among all OECD countries. The UK Government recently announced its plans for further reducing regulatory burdens in the Budget. UK regulation policy affects areas that are reserved, but there are important areas of regulation that are the responsibility of the Northern Ireland Executive. **This Review urges the Northern Ireland Executive to keep regulatory burdens on Northern Ireland businesses to the minimum necessary, working where appropriate with the UK Government.**

Section C: Public sector

7 Public sector reform

Public expenditure in Northern Ireland constitutes 67 per cent of gross value added (GVA), compared with 45 per cent in the UK as a whole. This reflects both a relatively small private sector and an historic over-reliance on the public sector. While reform of the public sector offers no guarantee of growth in the private sector, this Review believes that reform of the public sector could both improve value for money in the delivery of public services and release productivity improvements that would benefit the whole economy.

The public sector faces challenges with respect to its size, its scope and its efficiency.

Average public sector wages are around 20 per cent higher than those in the private sector. This potentially creates a distortion in the local labour market, limiting the potential for the private sector to attract sufficient skilled workers at the right cost.

Relative to other parts of the UK, the Northern Ireland public sector presides over a large volume of assets. The Review is concerned that these are not always being administered to maximise public value. Some assets appear to have no clear economic or social rationale for remaining in the public sector. Other services that exist in the private sector elsewhere are in public ownership in Northern Ireland. Releasing some of these assets could provide scope for reinvestment in core public services. Critically, they could also stimulate growth of the private sector.

The public sector workforce represents 28 per cent of total employment in Northern Ireland, compared with 20 per cent in the rest of the UK. In part this reflects the range of activities the state undertakes in Northern Ireland, but it additionally relates to the efficiency of administration. Many services have the potential for further value for money savings.

The public sector has an important role in investing in infrastructure, which plays a key role in attracting foreign direct investment. Investment in infrastructure will be boosted by an £18 billion investment plan over the next decade, but it is critical that this supports economic growth.

To improve public sector efficiency, the Northern Ireland Executive should consider the following:

- continuing with value for money programmes and the reform of central government agencies as set out in the Review of Public Administration, and reviewing the number of Executive Departments;
- look at how it could use the public sector pay process to reduce the public-private sector pay differential over time, so that public sector pay reflects better the local labour market;
- further asset disposals where there is no clear economic or social case for retaining them, in order to deliver more efficient services as well as releasing extra funds for investment;

- whether some services, currently delivered by the public sector, could be more productive if they were in the private sector. These include, in particular, public car parks, the Driver and Vehicle Agency, ownership of the housing stock and Belfast Port; and
- how public services might be more efficiently delivered through different types of delivery model, including the potential for greater contestability, and explore reform of procurement policy so that small and medium-sized companies can benefit where this provides value for money.

The Review believes that the emphasis on infrastructure investment must be maintained through effective implementation of the *Investment strategy*. To achieve this, the Review believes that:

- the priorities for infrastructure investment should be clearly aligned to support economic development. It is therefore important that Northern Ireland's overall investment approach, while recognising the need for social and environmental investment, prioritises economic development; and
- in order to achieve more capacity for infrastructure investment, the Executive should consider areas in which there is a case to reduce the level of government intervention and bring in investment from the private sector.

The Review recommends that the UK Government confirm existing incentives and provide further incentives for the Northern Ireland Executive to achieve this in the following ways:

- confirm that the Northern Ireland Executive has flexibility to use its public sector pay process to reduce the public-private pay differential over time, so that public sector pay reflects better the local labour market, with savings being retained in Northern Ireland;
- confirm retention of further value for money savings beyond those in the Comprehensive Spending Review;
- offer similar arrangements to those which apply in Great Britain for dealing with overhanging debt if the Northern Ireland Executive should decide to transfer the Housing Executive to a Registered Social Landlord;
- retention of the proceeds of the sale of Belfast Port if the Northern Ireland Executive were to decide to sell the port; and
- introduce further flexibilities to allow retention of the proceeds of increased sales of surplus land and similar assets.

INTRODUCTION

7.1 The gross domestic product (GDP) of any economy is split between the public and private sectors, and across the world the relative proportion of these varies considerably. "Public spending" covers a very wide category of spending, including spending on essential public services such as health, education, and social services, spending on the administration of government, and grants or other payments to private individuals or businesses. While there is no consensus on the optimum split between the two, it is broadly agreed that to be successful an economy needs a thriving private sector that can drive and sustain growth. In parallel, citizens want public spending to be as efficient as possible, in order to make the best possible use of available resources.

7.2 There is a direct link between the sizes of the two sectors, in part because the workforce must be employed in one or the other. One consequence of a large public sector is therefore a restriction on the availability of workers to the private sector, which can constrain the ability of businesses to grow. This can be particularly exacerbated if the average private sector wage is lower than that available in the public sector, as this, along with other conditions and benefits such as pensions, can tend to make the public sector the employer of choice.

7.3 Public investment serves an important role in enhancing productivity. Infrastructure developments, which are often delivered through public investment, help support other economic activities, for example by facilitating the movement of goods and services or supplying energy. Transport, in particular, is an important enabler of sustained economic prosperity.[1] More broadly, investments in public capital, such as education and health services, can underpin the development of those services, which in turn support productivity growth through an educated and healthy workforce.

THE PUBLIC SECTOR IN NORTHERN IRELAND

The size and value for money of the public sector

Northern Ireland has a large public sector

7.4 According to GVA estimates, public spending in Northern Ireland accounts for 67 per cent of regional GVA, compared with 45 per cent in the UK as a whole.[2] Public spending per capita is always likely to be greater in poorer regions, with higher levels of social need (especially in an area that has undergone social unrest such as Northern Ireland), and in economies that have lower output. However, the differences between public spending shares can only be partly explained by the size of the economy and social need – overall spending per head is still 14 per cent higher than the North East, which has a similar GVA per head. The relatively high levels of public spending and lower GVA mean that the region as a whole has a net fiscal deficit of £7 billion,[3] suggesting circumstances that, without reform, will be highly unbalanced and potentially unsustainable over the long term.

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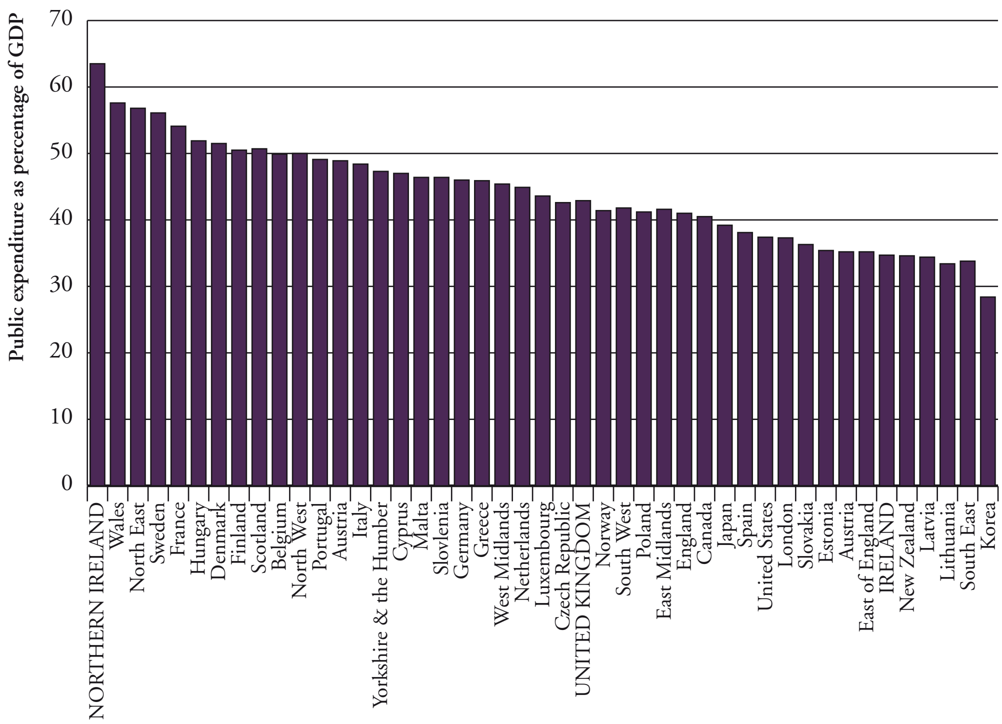
1 For example, the Eddington Review estimated that a 5 per cent reduction in travel time for all business and freight travel on the roads could generate around £2.5 billion of cost savings – some 0.2 per cent of GDP in the UK. *The Eddington transport study*, Eddington, Sir R., December 2006.

2 Analysis based on *Public expenditure statistical analyses*, HM Treasury, 2008.

3 *Review of tax policy in Northern Ireland*, Varney, Sir D., 2007 cites a Northern Ireland Executive submission to the Review, July 2007.

7.5 Looking internationally, the share of GDP[4] accounted for by public spending in Northern Ireland is also much greater than that in other European countries, as illustrated in Chart 7.1.[5] Using GDP estimates, for the purposes of international comparison, figures show that the public sector in Northern Ireland accounts for around 63 per cent of GDP, compared with 43 per cent in the UK as a whole– the highest of any region in the UK – and 34 per cent in Ireland.[6]

Chart 7.1: International comparison of public expenditure



Source: Centre for Economic and Business Research (2006, 2008).
Note: The figures for the United Kingdom regions are revised for 2006–07.

There is a risk of "crowding out" the private sector

7.6 One implication of such a large public sector is that it "crowds out" the private sector – that is, that it limits the latter's success through attracting the highest-skilled workers. This is seen as a particular problem because the average public sector wage in Northern Ireland is 19 per cent higher than the average private sector wage.[7] This would tend to support the views of a number of respondents to the Review, who claimed that the public sector is very much the employer of choice in Northern Ireland, attracting the most talented graduates and leaving the private sector with a smaller pool of talent or inflated wage costs. In addition, this headline figure masks an interesting distribution of the wage differential, particularly within the civil service. Analysis of certain jobs which are roughly comparable between the public and private sectors shows that at lower skills

[4] The GDP and GVA estimates used here are not directly comparable. At a regional level, output in the UK is measured in GVA (GDP minus taxes). Regional GVA can be used to compare different elements of public spending across regions. To make international comparisons, regional GVA is scaled up to estimate GDP, which makes GDP estimates somewhat less robust.

[5] Care should be taken when comparing public expenditure as a proportion of gross domestic product (GDP) within regions to that of entire countries, as a wide range of expenditure may occur across on the regions of those other countries.

[6] *Forecasting eye special*, CEBR, 2008.

[7] *2007-08 Pay and workforce plan*, DFPNI, July 2007, Annex E (updated using ASHE 2007 figures).

levels (below middle and senior management) the differential in favour of the public sector is only about 3 per cent, but rises to as high as 22 per cent at senior civil service levels.[8]

May represent poor value for money

7.7 A further problem frequently cited as a concern is the efficiency of the public sector. The size and administrative complexity of the public sector is seen to be a major cause of this. For example, government in Northern Ireland is large – there are currently 26 local authorities in an area of only 1.7 million people, 81 Non-Departmental Public Bodies (NDPBs) (excluding those related to health and education) and 11 Government Departments. The public sector in Northern Ireland accounts for 28.3 per cent of all jobs, compared with 19.6 per cent in the rest of the UK.[9] Almost all respondents to the Review agreed that the public sector was unnecessarily large, and was failing to deliver value for money.

7.8 One further component of public sector inefficiency may be poor management of assets. This can include failing to make best use of assets held, and failing to manage the public sector's balance sheet actively. As a result the public sector may be holding surplus assets and may not be taking advantage of opportunities to improve efficiency through increased private sector involvement, or to release resources to support investment in new priorities. It is notable that the Northern Ireland Executive owns significantly more assets per capita than the UK Government.[10] This includes major infrastructure assets such as buses, railways and water, which are operated privately in England but remain publicly owned in Northern Ireland.

Reasons for the large public sector are complex

7.9 The reasons for the present structure of the Northern Ireland economy, and in particular the ongoing significance of the public sector, are complex, but are likely to reflect historically low levels of private sector investment and development during the years of the Troubles, and the subsequent high level of public sector investment aimed at supporting economic recovery. It is important to recognise that some other regions of the UK have economies that are also heavily reliant on the public sector, although, as the comparison with the North East of England in paragraph 7.4 above shows, this is not to the same extent as in Northern Ireland.

Public investment in infrastructure

Low level of investment in infrastructure

7.10 Northern Ireland has a huge capital asset base and the highest levels of public sector investment per head in the UK. But the rationale for the allocation of resources between different investment programmes is not always clear. For example, Table 7.1 shows the effects of different levels of investment in Northern Ireland and the UK as a whole across a range of different transport measures.[11] Capital investment on transport is lower in Northern Ireland than the other areas of the UK: over the six years up to 2006-07 Northern Ireland's capital expenditure was £386 per head while in Wales it was £677 per head and in England and Scotland it was over £700 per head.[12]

8 Ibid, 2007. These figures to do not mirror the headline differential because they only consider a few categories of job that are directly comparable between the two sectors.

9 *2007-08 Pay and workforce plan*, DFPNI, July 2007.

10 *The national asset register 2007*, HM Treasury, January 2007. This gives an indication of the difference in scale, although approximations must be made due to the fact that only assets over £1million are included in the register. According to the register, the Northern Ireland Executive owns approximately £21,550 fixed assets per capita, whereas UK central government owns approximately £4,940 fixed assets per capita. However, these figures are not directly comparable because local government in Great Britain owns further assets which are not counted in these figures. Nonetheless, the figures do give some indication of the scale of the difference.

11 *Northern Ireland draft regional economic strategy,* DFPNI, 2007; DRDNI submission to the Review, February 2008.

12 *Public expenditure statistical analyses*, HM Treasury, 2007.

Furthermore, sewerage, water and energy networks have all received relatively low levels of investment in comparison to Great Britain. On a practical level, there are concerns about how some of these services are operating: for example, it is claimed that the Dublin to Belfast rail link is only five minutes faster than it was in 1948 when steam engines were running. Energy prices for households and businesses are significantly higher than the rest of the UK.[13]

Table 7.1: Investment in transport infrastructure

	Northern Ireland	Great Britain
Capital expenditure on transport per capita 2001/2 – 2006/7 (£)	386	746
Motorway density (kilometres of motorway per square kilometre)	0.84	1.5
Rail density (kilometre of passenger route per square kilometre)	1.5	6.2
Stations (per million population)	12.6	41.6
Passenger kilometres per capita rail usage	150	767
Percentage of people who use a car to commute to work	84	71

Source: PESA and Department of Finance and Personnel Northern Ireland calculations (2007)

7.11 The causes of low investment in some aspects of infrastructure in Northern Ireland are generally attributed to the lack of economic focus during the years of the Troubles. It could be suggested that low levels of investment are partly a result of the continued ownership of many parts of Northern Ireland's infrastructure in the public sector, in contrast to the rest of the UK. Whatever the causes, submissions to the Review cited the relatively low levels of transport infrastructure investment as having seriously inhibited the ability of Northern Ireland to grow its economy over past years as much as it would have liked. More broadly, Northern Ireland has generally focused its investment in areas that are less directly related to growing the economy compared with the UK and Ireland.[14]

POLICY RESPONSES

7.12 Many in Northern Ireland accept that the current economic structure is unsustainable over the long term. In order to reform, the size and inefficiency of the public sector will need to be tackled, which will have the positive effect of unlocking resources to allow the Executive to invest in measures to continue to improve vital economic infrastructure and public services, and could potentially help to stimulate growth in the private sector.

Value for money programmes

Increasing value for money

7.13 Across the whole of the UK public sector, there is a drive to increase value for money, and all UK Departments have value for money targets built into their Comprehensive Spending Review (CSR) settlements. The Northern Ireland Executive is similarly committed to value for money savings of at least 3 per cent per year, with reductions of at least 5 per cent a year in administrative cost controls.[15] This is being delivered through initiatives on procurement, transactional and corporate services. Such a programme should help to drive out some administrative inefficiencies

[13] For example, for small and medium-sized enterprises, electricity costs are 21 per cent higher than in Great Britain and 5 per cent higher for large companies. Northern Ireland Executive submission to the Review, February 2008.

[14] See for example *Comprehensive study on the all-island economy*, British-Irish inter-Governmental conference, 2006.

[15] *2007-08 Pay and workforce plan*, DFPNI, July 2007.

within the system and lead to further reductions in the size of the civil service workforce. The Executive is clearly committed to the value for money agenda, and has recently announced the establishment of a new Performance and Efficiency Delivery Unit within the Department of Finance and Personnel, which will monitor Departments' progress against targets in the Programme for Government and work with them to improve delivery and value for money. Nonetheless, given the far higher public spending per head in Northern Ireland described above and the scope for increased efficiencies identified in this report, **the Review urges the Northern Ireland Executive to push to exceed these agreed value for money commitments where possible, and that any additional savings made in the CSR period should be retained by the Executive to invest in improved front line delivery.**

7.14 In particular, potentially substantial savings may be available as a result of normalisation and the peace process: for example in terms of reducing the costs arising from duplication of public services for different parts of the community, and reducing the costs of law and order, due to be devolved to the Northern Ireland Executive in due course. There may also be more innovative public service value for money reforms which Northern Ireland can trial, in which the region might become a showcase for the rest of the UK. For example, the Executive is currently discussing with Ofcom and the UK Government the possibility of a single contact telephone number for all Northern Ireland public services. Should such a policy prove successful the rest of the UK might be able to learn from Northern Ireland's best practice.

Reducing the size of the public sector

The Review of Public Administration

7.15 However, such value for money programmes will not provide the step change that the economy needs to address some of the problems highlighted above. There is a pressing need for Northern Ireland to reduce the size of its public sector, and this is accepted by many in Northern Ireland. Nonetheless, implementation remains a challenge, particularly given the region's unique political situation. For example, in 2002, the Executive commissioned the Review of Public Administration (RPA) to advise on the future of the Northern Ireland public sector. This review proposed major changes such as the reduction of local councils from the existing 26, a considerably smaller Department of Health, Social Services and Public Safety with health boards and trusts to be reduced in number, and the remaining 81 public bodies to be reduced to 54 (in the main by merging bodies or transferring functions). In addition, the Bain and Appleby Reviews, of education and health respectively, considered in detail a number of further reforms.[16]

There has been progress in some areas but more is required

7.16 There has been some progress in certain areas: for example, five new Health and Social Care Trusts replaced the previous 18 in April 2007, and the Executive recently announced its plans to reduce the number of local councils to 11. However, since devolution was restored, the Northern Ireland Executive has not yet responded to the RPA in full, and there remains scope for further reform, including further proposed structural changes to the health service. In addition, there is a case, given the small size of the Northern Ireland population, for the Northern Ireland Executive to go further than the recommendations of the RPA and to reduce the number of Executive Departments down from 11. Finally, it could be argued that the number of Members of the Northern Ireland Legislative Assembly (MLAs) – 108 – is also unnecessarily large.

7.17 Public sector reform is always challenging. However, if Northern Ireland wishes to drive productivity and grow the economy so that the whole population can benefit from increased gross

[16] *Schools for the future – funding, strategy, sharing: the independent strategic review of education,* Bain, Professor Sir G., December 2006; *Independent review of health and social care services in Northern Ireland,* Appleby, Professor J., August 2005.

domestic product, it must take some tough decisions now in order to improve the situation for the future. **This Review therefore urges the Northern Ireland Executive to implement rapidly and fully the Review of Public Administration (or its alternative reform plans), the Bain review of education and the Appleby review of health, and to consider its view on the merging of Executive Departments.**

Resolving high wage differentials

There is a large wage differential with the private sector

7.18 A second aspect of public sector efficiency, and one that is cited as a check on private sector growth, is the relatively high average wage paid to public sector workers. As described above, the average private sector wage is significantly lower than that in the public sector. Adjusting for occupational mix, a comparison of equivalent jobs shows that the public sector in Northern Ireland still pays on average 19 per cent more than the private sector – in contrast the public sector pays on average 1 per cent less in the UK as a whole.[17] Further, as described above, there is a particularly high wage differential at more senior civil service levels. The difference is largely due to the fact that private sector wages in Northern Ireland are below UK levels, while public sector pay tends to follow UK public sector average.

7.19 This implies that the public sector is paying a wage much higher than is necessary to get the workers it needs, especially given the geographical constraints which make it unlikely that most public sector workers would switch to jobs outside Northern Ireland if the wage differential were reduced over time. While the precise dynamics of the relationship between private and public sector pay are complex, it is clearly inefficient for the public sector to pay wages that are higher than necessary.

Consequences for private sector

7.20 Such a high differential has serious consequences for the private sector, reducing its attractiveness to workers, and particularly to the most talented and highest skilled in senior level jobs. Ultimately, workers will, to a large extent, choose jobs on the basis of the wages offered, and a differential of the size that exists in Northern Ireland, combined with other public sector benefits such as flexible hours and pensions, make it more difficult for the private sector to compete for the most highly skilled workers. Consequently, Northern Ireland firms may stay relatively low skilled and less productive than they could be.

7.21 If this problem is to be tackled, the Northern Ireland Executive needs to look seriously at the role of public sector pay, especially as, in the past, public sector pay deals have tended to be as high if not higher than those in Great Britain. The Executive currently has the power to set its own public sector pay, although recently has opted to become part of the UK-wide pay review body process in some sectors (for example health). While this Review is not in any sense seeking to break up such new arrangements, it is important that the Northern Ireland Executive uses its various roles in the different sectors' pay-setting processes to ensure maximum value for the public sector. To support this, the Review suggests that **HM Treasury confirm that the Northern Ireland Executive has flexibility to use its public sector pay process to reduce the public-private sector pay differential over time, so that public sector pay reflects better the local labour market, with savings being retained in Northern Ireland**. In particular, given that differentials increase significantly at senior levels, this should include a focus on senior civil service pay. Not only should this help assist the private sector to grow, but it would give the Northern Ireland Executive extra resources to invest in other areas in the years ahead.

[17] The headline differential is 23.2 per cent, but controlling for occupational mix the differential is 19.2 per cent. The controlled comparison figure for the UK is –1.4 per cent. *2007-08 Pay and workforce plan*, DFPNI, July 2007, Annex E (updated using ASHE 2007 figures).

Better management of public assets

Management of public sector assets

7.22 UK public sector assets are worth more than £800 billion[18] and each year this stock is added to and replaced through investment and procurement decisions. Improving the quality of these decisions is an important part of ensuring that the taxpayer gets value for money. However, it is equally important that assets are actively and efficiently managed over their entire lifetime, and that those assets that could be run more efficiently in the private sector or are surplus to public sector requirements are sold at the right price.

7.23 This policy has been actively followed across many parts of the public sector in the UK over the past 25 to 30 years. In addition to the liberalisation and increase in investment that have come from the transition of telecommunications, gas and electricity, water and much of the transport system into the private sector, since 1997 the sale of surplus assets has lead to the realisation of over £80 billion of receipts for re-investment by all tiers of the public sector.[19]

Need to ensure value for money

7.24 Given the size of the public sector in Northern Ireland, there is a strong case for the Northern Ireland Executive to consider systematically the value for money case of continued ownership of public assets and thereby ensure that all public assets are either contributing to the delivery of public services or, if not, and if their sale represents value for money to the taxpayer, are released in order to realise the maximum possible resources for the Northern Ireland Executive to re-invest. In addition to offering a new set of investment opportunities, this policy may create a means of growing the total value of the private sector in Northern Ireland, and help to narrow the pay gap with the public sector.

Northern Ireland has agreed to asset sales

7.25 The Northern Ireland Executive has accepted much of this rationale, and has agreed with HM Treasury that it will sell £1.1 billion of fixed assets (excluding public corporations) in the period to 2010-11. This agreement allows the Northern Ireland Executive to keep these proceeds as part of its settlement. This gives the Northern Ireland Executive an incentive to press forward in this area in order to gain extra capital to invest in infrastructure and other means of improving the economy. A report by the Capital Realisation Taskforce to the Northern Ireland Executive[20] aimed to support the Northern Ireland Executive in meeting this target, indicating where it could best focus its efforts. This report suggests that an additional £290 million of assets could be found for sale over the next three years. **This Review urges the Executive to press forward with these sales, and to ensure that receipts are specifically used for investment in infrastructure or other areas that will benefit the economy in the future.**

Potential for further asset sales in Northern Ireland

7.26 Notwithstanding current plans, however, submissions to this Review, and the experience of the UK Government in selling assets, suggests that the Northern Ireland Executive should press hard to seek asset disposals in all areas where the Northern Ireland Executive may currently be holding more assets than are needed to deliver that service at best value for money for the public. Examples of such assets are set out in more detail below. The Northern Ireland Executive should seriously consider sales in these areas, subject, of course, to taking advantage of best market conditions, to ensure value for money.

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18 *United Kingdom national accounts – the Blue Book*, ONS, 2007.

19 Since 1997, asset sales have been over £80 billion. This is split between £52 billion fixed and £30 billion financial assets.

20 The report is not publicly available, but the above details were announced by Peter Robinson in a Northern Ireland Assembly debate on Tuesday 29 January 2008. This is available from www.theyworkforyou.com.

7.27 As well as those assets owned by the Northern Ireland Executive, better management of public assets involves improving the management of those assets in Northern Ireland that belong to the UK Government. In order to ensure that disused military and police sites are utilised effectively, close working is required between the Northern Ireland Executive, Ministry of Defence and Northern Ireland Office on the disposal of such assets.

7.28 In addition, in order to maximise the value from public sector assets, the Review recommends that consideration should be given to applying the lessons from the *Callcutt Review of housebuilding* – which discusses how developers, housebuilders and the public sector can work together – in Northern Ireland.

Social housing

7.29 There are a number of further areas in which the Northern Ireland Executive should seriously consider different models of service delivery, and the consequent sale of assets. One particular area in which Northern Ireland holds significant public assets is housing. This is a very complex policy area, mainly due to the peculiarities of land economics and concerns about the distribution of such an essential amenity. In Northern Ireland, the majority of social housing is provided by the Northern Ireland Housing Executive (NIHE), although there are a small number of housing associations. It is acknowledged that Northern Ireland has a shortage of housing, estimated at 2,000 units per year,[21] which is leading to rising waiting lists and more people in housing stress and homelessness.

7.30 In England, roughly half of the social housing stock is outside the public sector, mainly provided by the third sector through Registered Social Landlords (RSLs). The contribution of RSLs has grown significantly in recent years as a consequence of many local authorities transferring their council housing to associations, and the funding of new-build social housing being routed through the RSL sector rather than through local authorities. This reflects the ability of private sector RSLs to lever in significant levels of private finance alongside any public sector investment, increasing the level of stock improvements or new-build that can be delivered. The need for a significant increase in Northern Ireland's social housing stock thus provides an incentive for the Northern Ireland Executive to consider a significantly greater role for housing associations in both owning and managing the existing stock and developing new social housing.

7.31 The Northern Ireland Executive has recently announced a new housing strategy, including provision for building over 5,000 more homes in the next three years and extending schemes to allow social housing tenants to buy stakes in their homes.[22] **However, this Review recommends that further consideration be given to how the ownership and day-to-day management of housing assets could be separated out from strategic policy on housing, potentially through a transfer of assets to a Registered Social Landlord.** The Northern Ireland Executive would want to consider how various equity, rent control and other tenant concerns could be met under such a structure. **This Review suggests that HM Treasury should support such a policy by offering similar arrangements to those that apply in Great Britain for dealing with overhanging debt if the Northern Ireland Executive should decide to transfer the Housing Executive to a Registered Social Landlord.**

[21] *Review of affordable housing*, Semple, Sir J., 2007; *Northern Ireland Housing Executive* – www.nihe.gov.uk.

[22] Through changes to the co-ownership scheme. *Review into affordable housing final report*, DSDNI, Spring 2007; *Budget 2008-11*, DFPNI, 2008.

Belfast Port

7.32 Another set of assets whose ownership structure the Northern Ireland Executive should urgently reconsider are Northern Ireland's trust ports, and, in particular, Belfast Port. This is an infrastructure asset of huge economic importance: it is the busiest ferry port in Northern Ireland, and handles 60 per cent of the region's seaborne trade. The past decade has witnessed a difficult debate about the merits of increasing the involvement of the private sector in the port. While a review in 1997 concluded that the port should be transferred to a successor, private sector company, the Executive has no current plans for its sale, although it is looking into other ways of reforming its operation.

7.33 **However, this Review believes that there are compelling arguments for the Northern Ireland Executive to consider again whether Belfast Port should be moved into private ownership, including appropriate mechanisms to ensure that it continues to be operated in the public's best interest.** Greater commercial freedom, via private ownership, would increase the port's ability to raise equity and debt, allowing it greater freedom to invest, enable the port to enter more easily into efficient joint ventures, and give the port greater freedom to diversify its activities in order to meet users' increasingly varying needs. These effects, combined with operational efficiency, should mean greater investment and value for money. It is, of course, important that any new ownership structure protects the public interest. But there is wide experience in the UK of regulating infrastructure assets to guard against adverse outcomes: most notably, regulation of private ports and airports. If such a decision were made, HM Treasury should confirm their agreement that Northern Ireland would retain all proceeds from the sale that it could re-invest in the economy.

Box 7.1: The potential for asset sales: road transport

There are certain services that, the Review believes, might most benefit from transfer out of public ownership. These include two road transport-related assets: public car parks, and vehicle testing.

Public car parks present a very compelling case for sale. Northern Ireland Roads Service has over 20 individual car parks listed in the National Asset Register,[a] although there may well be many others valued at less than £1 million (the minimum for the register) or owned by local government. There are some clear and positive economic benefits from sale of car parks out of public ownership, with effective regulation. Given suitable protection from any immediate fall in current revenue that might arise from loss of income from charges, the Northern Ireland Executive's finances would benefit through no longer paying cost of capital charges (3.5 per cent of value, per annum) on the value of the car parks.

There are also strong arguments to consider a sale of vehicle testing in Northern Ireland. Vehicle testing in Northern Ireland is undertaken by the Driver and Vehicle Agency, and tests must be carried out by agency employees on agency premises, for which prices are fixed. There have historically been long delays in waiting for tests. Conversely, in the rest of the UK tests are provided by private garages that operate under government licence, with the content of the tests and maximum fees set by the Government. Providers compete on price with only 30 per cent charging the maximum, tests are usually available immediately and a regulatory system (including "mystery shopping") prevents mis-selling. A move to the Great Britain system could have a number of benefits for the people of Northern Ireland, including the benefits of competition leading to shorter waiting times, higher standards of service, and shorter travelling distances to their testing centre.[b] Further detailed consideration would have to be made including into likely changes to the price of a test.

Finally, with respect to roads more generally, this Review suggests that the scope for introducing **tolling of roads** should be considered, drawing on experience from Ireland and the aspirations for the UK as set out in Budget 2008.[c]

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a. *The National asset register 2007*, HM Treasury, January 2007.
b. At present Great Britain has one testing centre per 3,100 people, whereas Northern Ireland has one per 113,300 people, a factor of 37.
c. *Budget 2008 – Stability and opportunity: building a strong, sustainable future*, HM Treasury, 2008.

7.34 **Finally, this Review recommends HM Treasury should support and incentivise this process by introducing further flexibilities to allow the Northern Ireland Executive to retain the proceeds of increased sales of surplus land and similar assets.**

Potential for further reform

7.35 **In addition, the Northern Ireland Executive should consider carefully whether some public services are best kept in public ownership at all.** There are a number of public corporations, agencies or NDPBs delivering services that, if delivered by the private or third sector under sensible regulation, could be more efficient, offering better services to the public at lower cost. These areas are all complex and further work would need to be carried out on the exact details of their merits and risks. However, again, there are significant potential gains from increased efficiency and investment.

Public corporations

7.36 The Northern Ireland Executive should seriously consider whether it should privatise many of its large public corporations, including buses, railways and water (which has been the subject of much previous debate). While these are politically controversial areas, the introduction of competitive markets could drive operational efficiencies and help stimulate private sector growth. However, there are clearly complex equity, infrastructure and competition questions involved. The Review has not considered rail or bus ownership in great detail, although, as noted in the infrastructure section below, services need significant investment, and there may be potential to link up further with Irish infrastructure reforms.

7.37 The former Northern Ireland water agency has now become a government owned company (GoCo). It is expected that this will lead to improvements in efficiency and effectiveness. However, it is not clear at this stage whether these improvements will enable the GoCo to match the performance and efficiency expected of privatised water companies such as those in England and Wales. This Review recognises that the Northern Ireland Executive has no current intention to privatise the company. The Review does, however, recommend that the Northern Ireland Executive should keep all options under review in the medium term, which might include a "Customers' Company" as proposed by the Independent Water Review Panel, or eventual privatisation.

Involving the private sector in public service delivery

Private sector delivery of public services

7.38 One further way to increase the value for money of the public sector, and to help stimulate the private sector, is to increase the role of the private sector or third sector in delivering public services, while retaining full control in the public sector. Again, this can take many different forms, but most examples will be of two types. The first is competitive tendering, where a public sector body that cannot or no longer wants to deliver a service itself puts the service out to tender and asks private companies to bid to deliver the service. The second is quasi-markets, where public spending follows the consumer, such as is happening in different parts of the English National Health Service at present.

7.39 While this Review has not been able to look in detail at this question, and received very few submissions on the issue, some anecdotal evidence has been put forward that on the first area of competitive tendering there is much more potential for Departments to go further and use the private sector or third sector to deliver basic services at better value for money. Much of this should be included within the value for money programmes tied to Departments' 3 per cent value for money targets, but as the Northern Ireland Executive is reviewing that and looking to see whether it can go further this Review would encourage it to look particularly at this question. With respect to quasi-markets, the Executive should consider in more detail and for specific sectors the experiences of Great Britain and the rest of the world in exploring the potential for improved outcomes and efficiencies through such mechanisms. Such a move could then stimulate a more mixed pattern of provision of public services.

7.40 Government procurement can play an important role in driving SME innovation and growth. On a UK-wide level, the Government will reform the Small Business Research Initiative, and recently published guidance on how to procure innovative solutions, using mechanisms like innovation challenges and competitions of ideas. The Government will also introduce a free three-month trial for new firms registering on the public procurement portal supply2.gov.uk and is exploring ways to reduce the barriers to SMEs competing for public sector contracts. These schemes are open to Northern Ireland companies. The Northern Ireland Executive has the flexibility to develop its own suite of policies through its Central Procurement Directorate, which, for example, has released guidance for SMEs on public procurement.

7.41 A number of respondents to the Review have noted how public contracts, for example in IT, tend to be given to large, multinational companies. There may be further opportunity to achieve value for money by breaking down large contracts, or by linking contractors with sub-contractors more effectively, to make it easier for small companies to win business. **Therefore, this Review recommends that the Northern Ireland public sector explore reforming public procurement policy, subject to EU law, so that small and medium-sized companies can benefit where this can still give value for money.**

Infrastructure investment

Investment strategy for Northern Ireland

7.42 With respect to infrastructure investment, the Northern Ireland Executive is already committed to action, as demonstrated by the *Investment strategy for Northern Ireland*, published in January 2008,[23] with the objective to ensure that Northern Ireland is a more attractive destination for investment and can better support existing firms to compete in overseas markets, as well as to support the economy as a whole. This plan promises over £18 billion of investment to 2018, of which over 20 per cent is network spending.[24] This includes important commitments such as increasing significantly the Northern Ireland motorway and dual carriageway network, developing a Belfast rapid transit system, and investment in trains, including across the whole island, jointly with the Irish Government. There will also be collaboration on a single electricity market for the island.[25]

Box 7.2: The Strategic Investment Board and the *Investment strategy for Northern Ireland*

In May 2002 the Chancellor announced a major package of reforms known as the Reinvestment and Reform Initiative to strengthen investment in Northern Ireland. As well as providing the Northern Ireland Executive with a special borrowing facility of £200 million a year, this initiative introduced the Strategic Investment Board (SIB). The SIB is a non-departmental public body under the remit of the Office of the First Minister and deputy First Minister. The SIB was set up to deliver major infrastructure projects quickly and to create links between the public and private sectors in generating confidence to stimulate market interest. As part of their role, the SIB developed the *Investment strategy for Northern Ireland 2008-2018* and the framework for its delivery.

The *Investment strategy for Northern Ireland* sets out why investment in infrastructure is important and the Northern Ireland Executive's investment objectives of: growing a dynamic and innovative economy; delivery of modern, high-quality and efficient public services; promotion of tolerance, inclusion, equality and regional balance; tackling social disadvantage; and protection and enhancement of the environment and natural resources. Over the next ten years, £20 billion of Northern Ireland Executive funds (supplemented by receipts from disposal of assets and third party investment) will be invested in improving Northern Ireland's infrastructure. The investment will be directed through the Executive's investment pillars – networks (transport, energy, etc), skills, health, the environment, and social and productive areas of the economy (such as regeneration and housing; and enterprise, public sector reform and tourism).

23 *Investment strategy 2008-2018*, Northern Ireland Executive, 2008.

24 Ibid, 2008. Network spending includes spending on roads, public transport, gateways (ports and airports), telecommunications and energy.

25 Ibid, 2008; *Comprehensive study on the all-island economy*, British-Irish inter-Governmental conference, 2006.

7.43 This strategy is an excellent example of the infrastructure investment that Northern Ireland will need to make to ensure that it can compete in the future and expand its economy. Furthermore, the *Investment strategy* is a good example of Northern Ireland bringing together multiple investment priorities and seeking to direct public resources in a meaningful and strategic way. It sets out six investment pillars – networks, skills, health, social, environment and productive – and aligns them under three objectives – economic, societal and environmental. Such an approach enables capital projects to be organised and prioritised in a way that should maximise the whole portfolio. This is to the Executive's advantage, and compares favourably with other countries and regions, which lack such coordination. **This Review would urge the Executive to make implementation of this strategy a priority.**

7.44 Further, this Review would urge the Executive and the Strategic Investment Board to ensure that, once investment projects are delivered, there is clear responsibility in government for ensuring the investment is properly utilised. Care must be taken to avoid a repeat of the lack of take-up of broadband, where Northern Ireland was one of the first regions in Europe to get 100 per cent broadband capability, but may not have capitalised on this as much as it could have done.

Investment must support economic development

7.45 **Finally, this Review is concerned that the emphasis on investment that supports economic development be maintained.** The Eddington Transport Study[26] highlighted the need for investment to be targeted on those parts of the system where networks are critical to supporting economic growth. This Review acknowledges that investment is driven by a number of, often competing, priorities. **However, it is important that Northern Ireland's overall investment approach, while recognising the need for social and environmental investment, prioritises economic development. The Northern Ireland Executive should also consider how it can maximise its resources to support investment in more inventive ways.** For example, this Review would urge the Executive to consider all types of delivery mechanisms, including whether use of initiatives such as public-private partnerships or the private finance initiative can deliver higher value investment. As detailed above, this should also entail further consideration of the appropriate delivery mechanisms for transport infrastructure such as bus and rail.

[26] *The Eddington transport study*, Eddington, Sir R., 2006.

A Tax policy issues – R&D tax credits and training tax

INTRODUCTION

A.1 The *Review of tax policy in Northern Ireland* examined the case for enhanced tax allowances in Northern Ireland for business expenditure on a number of activities, including capital investment, research and development (R&D), training and marketing.[1] The Review concluded that there was not an overwhelming case for differential tax policy in these areas for Northern Ireland.

A.2 Representations to this Review have requested that further consideration be given to two specific tax proposals relating to enhanced tax credits for R&D expenditure and a tax credit for training.

ENHANCED R&D TAX CREDITS

A.3 The *Review of tax policy in Northern Ireland* examined proposals for increasing the R&D tax credit available for businesses in Northern Ireland. The review concluded that such a policy would be inconsistent with the basic rationale and principles that underpin R&D tax credits. Such a policy was also found to be questionable on value for money grounds; that resource constraints in Northern Ireland could present impediments to the effectiveness of an enhanced credit; and that offering an enhanced credit only in Northern Ireland could encourage tax avoidance and displacement of activity from other parts of the UK.

Enhanced R&D tax credits, but only to inward investors

A.4 Submissions to this Review have suggested a variant of earlier proposals for an enhanced R&D tax credit. Rather than offering a blanket enhancement for all R&D expenditure in Northern Ireland, this approach would apply an increased credit of up to 300 per cent, but only to R&D investment by non-UK companies already located or newly locating within Northern Ireland. In addition, such a measure could be time-bounded for five to ten years.

UK R&D tax credits

Market-based approach

A.5 The UK's R&D tax credit is market-based. It provides support to all R&D companies but leaves the decisions of what R&D activities to undertake, how to do the R&D and where to do the R&D entirely up to the company. This is based on the basic understanding that the market is the most efficient mechanism for allocating resources to the most efficient and productive R&D areas. In making any changes to the R&D tax credit, it is essential that this basic market-driven premise is not compromised.

1 *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury, 2007, Annex D.

Three principles

A.6 The design and delivery of R&D tax credits are shaped by the three underlying principles of simplicity, consistency and certainty:

- a **simple** scheme so that companies can understand the scheme, estimate the value of the relief to them and claim what they are entitled to, and so the credit's value is not eroded by unnecessary compliance costs;
- a **consistent** scheme so that companies can build confidence in the support they expect to receive and the consistent delivery of the scheme so the administrative burden reduces year on year as familiarity increases; and
- a **certain** scheme so companies can build the value of the credit into their future R&D investment decisions.

A generous existing scheme

A.7 The tax system provides incentives for business investment in R&D by allowing companies to set their expenditure on R&D against their taxable profits. For small and medium sized (SME) companies, enhanced deductions of 150 per cent of eligible spending can be applied and for large companies, from April this year, 130 per cent. In addition, where small and medium sized companies are loss making for tax purposes, losses generated by qualifying R&D expenditure can be surrendered in return for a payable cash credit of 24 pence in the pound of the unenhanced losses. Further enhancements have been announced for SMEs in recent Budgets, including a doubling of the thresholds under which a company is considered an SME and an increase in the enhanced deduction to 175 per cent. Both of these changes are subject to approval from the European Commission, and will be made effective by Treasury Order once that approval has been received.

A.8 While international and academic literature suggests that tax incentives can be effective in boosting business R&D, there is no evidence that suggests the current rates of relief provided by R&D tax credits in the UK are too low and should be increased. The long-term evaluation of R&D tax credits aims to explore the effectiveness of the scheme and findings from a large-scale survey of R&D companies suggested some encouraging early findings.[2]

A.9 The 2005 consultation exercise on R&D tax credits emphasised the importance of the tax credit's basic market-driven premise and its three underlying principles of simplicity, consistency and certainty.[3]

2005 consultation rejected targeted approach

A.10 The consultation raised the question of additional support for particular industry sectors. However, in conclusion, the Government agreed with responses to the consultation that "there is no strong rationale for a sectoral approach to the structure of the tax credit" as "it has always recognised that a sector-targeted approach would introduce unnecessary complexity".[4] The same argument applies to geographical and other forms of targeting. Such targeting is not only inconsistent with the basic principles of simplicity, consistency and certainty but also risks undermining the tax credit's basic market-driven premise.

A.11 Enhancing R&D tax credits for Northern Ireland, or indeed other forms of targeted enhancement, would undermine the basic market-driven premise and underlying principles of the R&D tax credit scheme. As a result, such a change would risk distorting the efficient allocation of R&D in the UK as well as damaging the policy's success as a simple, predictable and transparent measure.

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2 *Research and development tax credits survey*, BMRB Social Research, HMRC Research Report 12, December 2005.

3 *Supporting growth in innovation: next steps for the R&D tax credit*, HM Treasury and HM Revenue and Customs, December 2005.

4 Ibid, 2005.

Legal issues

A.12 Offering an enhanced R&D tax credit to inward investors in Northern Ireland would raise a number of potential EU law and administrative difficulties.

A.13 One drawback associated with an enhanced R&D tax credit in Northern Ireland identified by the *Review of tax policy in Northern Ireland* related to the incentive such a measure would create for businesses to shift R&D spending from the rest of the UK to Northern Ireland.[5] This would not necessarily involve a movement of real activity, but could also occur through artificial diversion (if a sufficiently robust administration could not be put in place). Such a diversion could substantially increase the Exchequer cost of an enhanced credit.

A.14 A large UK company undertaking R&D expenditure can claim the R&D tax credit wherever in the UK or the EU such expenditure takes place. Offering a more generous R&D credit in Northern Ireland would encourage companies with UK or EU R&D operations to establish subsidiaries in Northern Ireland and claim the R&D tax credit there. However, this would not require any transfer of actual R&D activity to Northern Ireland. Hence, taxpayers would have to bear a potentially substantial cost with no corresponding benefit to the Northern Ireland economy.

A.15 Submissions to this Review have argued that this artificial diversion could be avoided by offering the enhanced credit only to R&D investment by non-UK companies already located or newly-locating within Northern Ireland. Such an approach would prevent UK companies from taking advantage of an enhanced credit in Northern Ireland. Given the principles underpinning UK R&D tax credits set out above, it is highly unlikely that the Government would consider it appropriate to discriminate against established UK businesses in such a way. In addition, the discrimination implicit in such a selective scheme would also fall foul of EU freedom of establishment rules.

Applying only to inward investors would be discriminatory

A.16 These rules mean that Member States must modify national laws that restrict freedom of establishment, or the freedom to provide services, and are therefore incompatible with these principles. This includes not only discriminatory national rules, but also any national rules that are indistinctly applicable to domestic and foreign operators. Offering an enhanced credit only to new or existing inward investors in Northern Ireland would discriminate against UK-owned companies, but also against companies from the rest of the EU with R&D operations in Great Britain.

Cost implications

A.17 In discussing the legal issues around a lower rate of corporation tax in Northern Ireland, the *Review of tax policy in Northern Ireland* highlighted the European Court of Justice (ECJ) decision of the Portuguese Republic versus the Commission of the European Communities, the so-called "Azores" case.[6] This decision laid down the principles under which it is possible for more than one corporation tax rate to be applicable within the territories of a Member State without such a regime necessarily constituting an illegal State Aid.

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5 *Review of tax policy in Northern Ireland*, Varney, Sir D., HM Treasury, 2007, Annex D.

6 Ibid, 2007.

Three criteria

A.18 The court described the criteria under which regional differences in corporation tax rates within a Member State would be in compliance with EC law. These criteria can be paraphrased as follows: [7]

- the region must have the political and administrative authority to introduce its own tax rate;
- the national government must have no authority to influence such a decision; and
- the region must bear the full fiscal consequences of introducing its own tax rate and in particular must not be compensated by the national authorities for a loss of tax revenue.

A.19 Although the ECJ decision was made in the context of a government seeking to offer a differential rate of corporation tax in one region, the ruling also applies to differential tax measures. Hence, as a consequence of the Azores ruling, the cost of offering an enhanced R&D tax credit in Northern Ireland would have to be borne by the Northern Ireland Executive. The ECJ decision also implies that the Northern Ireland Executive would have to be given competence to set the R&D tax credit rate, were such a policy to satisfy the first Azores criteria.

TRAINING TAX CREDITS

A.20 For employers, all educational and training expenditure is already fully deductible from taxable income. Going further by providing a subsidy through a training tax credit would be possible. Its cost would obviously depend on the scope of the scheme, for example, what qualifications were accredited to the scheme, whether it applied to all training or to only some definition of "additional" training, and the estimate made of the social return from training and corresponding size of the credit.

Market failure in skills

A.21 There is a strong market failure case for skills intervention, especially for low-skilled employees. But the question is whether a tax mechanism would be as effective as a direct grant mechanism, which could deliver the subsidy to any firm in a simpler, more targeted way. In particular, a tax credit would carry risks of high deadweight. Firms already invest significant sums in training (some £33 billion a year[8]), and a spending instrument can be more easily focused than a tax measure on employees who do not currently benefit from that investment. The advantages of grant mechanisms are:

- **they are simple** – the value of the subsidy is instantly apparent to the recipient, and red tape can be kept to a minimum;
- **they can be paid up front**, to alleviate credit constraints (especially for individuals and small firms). If the aim were to provide individuals with marketable skills, and so maximise social returns, some kind of clawback mechanism for providers could be built in, linking funding to the attainment of a recognised qualification;

[7] The relevant paragraphs are 56, 57, 63, 64, 65 and 68 of Case C-88/03.

[8] *Skills in England*, Learning and Skills Council, 2007.

- **they are quick to set up and flexible** – it would be reasonably simple to change the conditions attached to funding; to target particular types or levels of training; or to make funding contingent on matched contributions from employers, for example; and
- **they are an effective way to incentivise participation in training**, by making the level of subsidy transparent, and giving learners/employers more purchasing power (for example the Employer Training Pilot model).

Deadweight cost

A.22 Depending on how it is defined, a training tax credit carries the risk of high levels of deadweight cost, in terms of subsidising activity that would have occurred anyway. It would also be difficult not to discriminate against companies whose circumstances made it difficult to take advantage of tax reliefs. This would include companies currently making losses and therefore having no taxable profits against which to offset a tax credit.

A.23 Moreover any proposal for employers to use Pay As You Earn/National Insurance to claim tax relief would be by no means simple or straightforward for businesses to operate, or for HM Revenue & Customs (HMRC) to monitor and police. This has the potential to be resource-intensive for HMRC and would raise difficulties around coordination of tax inspectors and the role of the Department responsible for skills policy. Further, the benefits of targeting through the tax system at all rather than through a grant-based system – as set out above – are not clear.

Leitch Review of Skills

A.24 The Leitch Review of Skills, the most recent analysis of UK skills needs, did not call for tax credits.[9] Instead, it suggested most progress could be achieved by building a better market in skills with a shift to demand-led funding through Train to Gain and Learner Accounts, freeing up the supply side, ending the micro planning of provision and ensuring that vocational qualifications deliver the skills which employers and individuals need.

A.25 The evidence suggests that a direct subsidy regime, closely targeted on low skills and market failures can be effective in tackling skills problems. This approach is supported by the following statistics:

- 1.75 million people have achieved their first Skills for Life qualification since 2001 (meeting the Government's target of 1.5 million people by 2007 early);
- 74 per cent of adults in the workforce are now qualified to at least Level 2. A total of 1.14 million adults have up-skilled since the end of 2002 (meeting the target of one million people by 2006); and
- apprenticeship completion rates are up, from 24 per cent in 2001-02 to 63 per cent in 2006-07.

A.26 Further grant-based schemes to subsidise training would most likely be within the power of the devolved Northern Ireland administration (although State Aids approval from the EC might be needed depending on the design of the scheme).

[9] *Prosperity for all in the global economy – world class skills*, The Leitch Review of Skills, Leitch, Lord S., December 2006.

CONCLUSION: TAX POLICY ISSUES

A.27 The findings of both the *Review of tax policy in Northern Ireland* and this Review suggest that targeted tax policies are generally an inappropriate tool for delivering region or company-specific incentives.

A.28 The UK's R&D tax credit scheme is based on a market-driven approach, underpinned by the three principles of simplicity, consistency and certainty. Introducing a regional or other form of targeted enhancement is inconsistent with this market-based approach and would undermine the underlying principles. Such targeting would inevitably make the tax credit scheme much more complex for both companies and HMRC to operate (with reduced incentive effects as a result), as well as risk encouraging unintended behaviours and distortions. It would also be both legally and practically difficult, and would discriminate against both indigenous Northern Ireland companies and firms with R&D operations in the rest of the UK.

A.29 As Chapter 3 recognises, a highly skilled workforce in Northern Ireland is key to increasing productivity and in particular enabling firms to make use of new technology and produce high-value goods. The Review does not believe that a training tax credit is the most effective means of raising skill levels in Northern Ireland.

B List of respondents

The Review would like to thank the following individuals, organisations and individuals within them who, over the course of the Review, submitted evidence, met with Sir David, or met with or assisted the Review team.

We have endeavoured to ensure that all individuals and organisations that have contributed to the Review are listed below, except those who requested anonymity. If we have made an inadvertent omission from this list, please accept our apologies.

Respondents

Alliance Party

Department for Innovation, Universities and Skills

Department of Business, Enterprise and Regulatory Reform

Department of Enterprise, Trade and Employment

Department of Finance

Department of Foreign Affairs

Department of the Taoiseach

Dundalk Chamber of Commerce

Economic Research Institute of Northern Ireland

Enterprise Equity Fund Management Northern Ireland

Federation of Small Businesses

First Trust Bank

HM Revenue & Customs

HM Treasury

Institute of Chartered Accountants in Ireland

International Centre for Innovative Developments

InterTrade Ireland

Invest Northern Ireland

Irish Congress of Trade Unions

Irish League of Credit Unions

Londonderry Chamber of Commerce

Momentum NI

Northern Ireland Assembly Committee for Agriculture and Rural Development

Northern Ireland Assembly Committee for Culture, Arts and Leisure

Northern Ireland Assembly Committee for Enterprise, Trade and Investment

Northern Ireland Assembly Committee for Regional Development

Northern Ireland Business Alliance

Northern Ireland Executive (DFPNI, DRDNI, DETINI, DELNI, DSDNI and DCALNI)

Northern Ireland Manufacturing Focus Group

Northern Ireland Public Service Alliance

Office of the First Minister and deputy First Minister

Oxford Economics Ltd

Price Waterhouse Coopers

Queen's University Belfast

Sinn Fein

Sir George Quigley

Strategic Investment Board

UK Trade & Investment

Ulster Bank

University of Ulster

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