

29th October, 2009

Dear Minister Foster,

I am glad of the opportunity to respond, through your consultation process, to IREP's report on DETI policy and Invest NI's delivery since the agency's inception in 2002. As you are aware, I am an interested party in the report's conclusions and, if that requires the Minister to retain a proper skepticism, I hope that it will also allow her to lend some weight to the views of a practitioner who was in place throughout the period under review.

The Report is a weighty document and the result of much collation and drafting during the summer. It makes some interesting points and recommendations. However, in my opinion it is flawed in several ways. These appear to flow from:

- an inadequate analysis of the productivity trends in Northern Ireland over the last few decades;
- an account of the economy's productivity that relies too heavily on those in work as opposed to the working-age population and, consequently, provides an inadequate counterfactual for lower-wage employment. I appreciate that this appears to weaken PSA1. However, PSA3, also a DETI/Invest NI responsibility, has an effect on the economy's total productivity;
- poorly supported claims about the additionality of project support and a failure to appreciate the "real-world" competition for mobile capital;
- little appreciation of the ways in which innovation is already being supported and of the fact that the whole thrust of Invest NI's interventions are aimed at increasing exports and enhancing export capacity;
- an overestimate of the strength of the investment proposition offered by Northern Ireland compared with others that are available;
- failure to recognize the timescales that would be required to bring about transformational change and, despite acknowledging the role of other supply-side actors, the apparent ascription of Northern Ireland's whole productivity outcome to Invest NI, whose budget amounts to some 0.6% of GVA;
- a willingness to repeat propaganda about the vision, flexibility and professionalism of economic-development agencies based in relatively successful economies as a counterpoint to the bureaucracy and process orientation of Invest NI, without being in any position to validate the comparison other than by anecdote;
- certain internal contradictions mar the report and sometimes facile recommendations are made for change.

## **Productivity**

The Report points out that, from the early 1970s broadly until 1997, NI's low productivity was catching up with GB but that, since then, it has essentially held its own. The main boost to productivity during this time came from a significant reduction in people employed in manufacturing, as production moved towards the Far East, while NI manufacturing sales continued to grow in absolute terms. You will know that the vast majority of NI's highly productive companies are Invest NI clients and that this cohort is around 35% more productive than NI business as a whole.

In fact, manufacturing in NI is now no less productive than in GB. The economy's overall lower productivity derives from very high rates of economic inactivity and a relatively low-value sectoral mix, within which the tradable-services sector's small size is a weakness. During the review period, financial, business and IT services have grown considerably and most of this has been as a result of investment by externally owned companies. Much of the software-related job creation in financial, telecommunications and business services has been above median salaries. The larger job numbers have been in business processing, using the format of call centres, and many of these positions have lower salaries than the median.

It is apparent that, while the services sector is being built up, the larger numbers of call-centre jobs will depress average salaries per employee. As their skills grow, staff should become more valuable and more marketable. However, at present they are being paid what the market determines they are worth. Since the employees of call-centre companies, in accepting these positions, obviously view them to be of value, it follows that they actually increase value added per citizen to the extent that workers would otherwise be unemployed or earning less. The third alternative would be emigration, which may or may not increase productivity per employee but would not be a sensible objective.

Since early 2007, higher-value service-sector expansion has been slowed down by the banking crisis and, although opportunities like Citibank, Liberty and NYSE will re-emerge, it is likely that they will start quite small. This is a function of NI's labour-market size. Graduates with the right skills and potential exist in small numbers compared with many locations. This implies that certain very large companies are unlikely to consider it worthwhile to establish high-value services operations at the size NI can satisfy quickly. The observation does not seek to deny that under-employment exists within NI and that some of it falls within business services. Unfortunately, many of the degree subjects or experience levels that are on offer do not suit people for the particular niche of higher-value employment that the market sees NI as satisfying. In the absence of further qualifications, such as accounting or post-graduate business and IT degrees, many generic graduates will struggle to find employment that stretches their basic abilities. This is particularly true for a small region which has very few companies indeed with head-office functions and lacks a sophisticated financial-services tradition. Dublin has more easily been able to sell itself as a European headquarters. Tax, labour-market size, regulatory compatibility, air connections, and perceived quality of life are the key attractors.

It is important to emphasize the difficulty of boosting NI productivity per employee since the IREP report shows no feeling for these issues. The higher-value FDI jobs recently gained have, indeed, been largely in technology areas and they require people with particular training or qualifications. Market liquidity for such skills has been tested in recent years. For people with lower qualifications,

there is little doubt that manufacturing has provided higher salaries. Unfortunately, unless the competitive situation changes (sterling devaluation will have helped), NI will struggle to attract manufacturing investment other than in niche areas, as will most western European countries. Since business services is an area in which our region has shown that it can compete, to argue that there are too many such positions and that higher-salary jobs are required misses the point. People who lack high-value experience or qualifications need jobs. The market determines where they can be economically employed, not Invest NI.

Consequently, the road to higher-value service jobs in significant number is a marathon, not a sprint. This is especially true since NI has no forcing mechanism in the short term. The Republic of Ireland had Export Profits Tax Relief in the late 1950s and has had super-low corporation tax since the 1980s. While the ROI did much to establish the necessary supply-side conditions for receipt of FDI, the sufficient condition was low corporation tax. This option is not currently open to NI and so its discussion may seem academic. However, the IREP report, while mentioning that low corporation tax would be nice to have, shows no appreciation of its crucial role as a forcing agent for FDI both in terms of quantity and quality. Job quality amounts to productivity since very profitable companies, such as pharmaceuticals, financial-services providers and semi-conductor manufacturers, can save more money in tax than the premium they may pay for employees.

An aspect of productivity that, as far as I can tell, is absent from the Report is the profits component of multinationals in NI; this is close to zero since multinationals maximize profits in lower-tax jurisdictions. In addition, GB-based companies, belonging to the same tax jurisdiction, do not transfer profits into our regional economy, so their profits are absent from regional GDP accounting. In the case of foreign-owned companies, the dominant component of value-added that is accounted for as “belonging to” NI is wages and salaries. NI value-added is, thus, understated compared with national entities and, in particular, low-tax regimes. It is conceivable that, were consolidated profits allocated to NI operations in proportion to average firm margins, the recent growth of services FDI would have increased value-added per employee. This possibility would require much more research than has been undertaken.

Since productivity depends on the quality of investment by high-value companies, either overseas or locally owned, it is appropriate to ask why there is not more of it and whether Invest NI’s interventions are necessary for its realization in whole or in part, sooner rather than later. This relates to the additionality of support.

### **Additionality**

One sentence in the Report tells the story of the Panel’s mindset on additionality. To paraphrase: that it is difficult for Invest NI to determine ex ante whether its interventions are needed. The implication is that it is easier to tell ex post. Indeed, if it were not easier ex post one should question the whole exercise of trying to assess it in this way. This is because anyone acquainted with Invest NI DETI and DFP casework procedures and practice will know “additionality” is a criterion that must be satisfied for each and every intervention. For the exercise to be as meaningful ex post, one would have to believe that its assessment methodologies are at least as robust as the negotiating and review process that pits the client executive against the client and the casework committee against the client executive in real time.

It is, indeed, sometimes difficult to assess additionality ex ante and the entire circumstances of the project's genesis, attractiveness, alternative locations and negotiation path are essential bases for its evaluation. Unfortunately, everyone I know who has worked in economic development realizes how undependable are the methodologies used for ex post evaluation. There are essentially two: to survey recipients afterwards and ask whether they would have made the investment anyway, either at all or to the same scale or timetable; and, to undertake an econometric analysis suggesting the extent to which outcomes would have been achieved as a result solely of the economy's own momentum and characteristics.

The first fails several tests. Psychology entails that people tend to delude themselves about reliance on outside help. Those who are ruthlessly honest do exist but seem rare. One finding that supports this belief is that such surveys suggest declining additionality the longer after the intervention the question is posed. As far as I am aware, the IREP panel put this question to a very small number of larger clients. Such surveys need to be representative and scientific if they are to have any value at all.

The econometric analysis derives wholly or in part from the earlier SFA evaluation completed by Professor Hart. I recall Professor Hart's having hedged his conclusions in respect of additionality very substantially. His hesitancy stemmed from the weakness of the methodologies available and from certain characteristics of regional evaluation that fail to capture all the elements of economic outcomes. Near the core of the problem is that SFA, an instrument designed to create employment, has increasingly been used by Invest NI to support projects that both create employment and bring something strong or distinctive to NI. SFA is tied to job creation and its metrics reflect this. However, it is generally used in conjunction with other services and programmes, such as Business Improvement and R&D/Innovation. In addition, where first-time investors are recipients, indeed where existing investors are expanding, Invest NI usually works with a range of providers, such as DEL, the education institutions and consultants to ensure that the supply of people, property and other expertise are available. This brings considerable collateral benefits to skills development and other factors that the econometric analysis does not capture.

I am not an economist and can only bring some experience and common sense to bear on the methodology itself. However, I am struck by the logic employed as much as by the outcomes measured. Additionality is looked at from the perspective of jobs added and of economic outcomes that can serve as proxies for productivity. I have some concerns about the application of the methodology used to estimate additional jobs supported over and above those that "would have" come into being, due to the autonomous growth of the UK economy. First, the methodology takes no heed of the case-by-case application of additionality by Invest NI in project assessment. Invest NI's view would be that either none or few of the jobs supported would have come into being simply because of general economic growth. That is the point of its intervention. If we take the weaker case that **some** would have occurred in any event, then it may be unreasonable to assume that these projects would have generated jobs in the absence of support at the same rate as projects in the general UK economy. Presumably there are **some** projects that would not have come into being at all. This seems particularly true of safeguarded jobs, which are supported for the obvious reason that they are at risk. In IREP's calculation of jobs ascribed to Invest NI, these are reduced by the same factor (about 50%) as new jobs.

Turning to productivity effects, at one key stage the assessor, in seeking to measure the “additional” sales generated by SFA and concluding that, while employment grew, sales did so very little thereafter, at least hedges his conclusion by referring to the lags between investment and economic outcomes. He wonders whether adequate assessment periods had been measured. This is certainly an important caveat whose impact remains unexamined. However, I have difficulty in understanding the measure’s relevance to the effectiveness of SFA. If SFA is “buying” employment for NI (or indeed other benefits such as new economic functions), it is hard to see why it should bear the additional burden of accelerating a firm’s sales beyond the activity carried on by the new hires. One might as well say that R&D projects supported, while apparently more additional, have not yet resulted in any major employment growth. They have had impressive results in terms of new product sales (particularly Centres of Excellence, despite IREP’s odd remark about them), but this is what they are for. SFA is primarily for employment creation and safeguarding. As noted earlier, this does improve NI’s productivity compared with the real counterfactuals, which are unemployment, economic inactivity and emigration.

In considering the application of the “additional sales” methodology to SFA within the NI context, I become more puzzled. As noted earlier, the allocation of sales to operations within a region for a British-based parent is little more than an accounting convention. For a multinational based in another jurisdiction it reflects transfer pricing. In each case, NI investments are cost centres and I do not understand what data the assessor used to measure additional sales when these, if provided, are just an allocation in the first place. Some companies may not produce local branch profit and loss accounts. Financials would simply be management accounts that reflect the choice of metrics deemed suitable to measure the effectiveness of a unit. Frequently, these would be cost and efficiency oriented.

In Chapter 4 IREP puzzles over why safeguarded jobs, most of which were in manufacturing, fell in 2008/09. It views this as a welcome sign but wonders why the number did not rise during a recession. I cannot be certain why this is so, but one possible explanation is that jobs lost were not safeguardable since their loss reflected a dramatic decline in sales or orders. Invest NI does not simply subsidize wages so that labour can be hoarded and neither can, nor should, try to offset the economic cycle. If this is the explanation or part of it, it does not portend a welcome or unwelcome sign. It simply reflects the state of corporate health and Invest NI’s policy remit.

We are now obtaining a picture of ex post additionality assessment that is severely flawed both in principle and in application. I know of no practitioner who ascribes much value to it, although academics have struggled manfully to wring meaning out of the data. The IREP report alludes to the difficulties and, then, continues to repeat its preconceptions about the low additionality of Invest NI interventions. These flower into the judgement that job creation has been “expensive” without providing any framework for reaching the conclusion or determining what would be cheap. This is hardly surprising since, without any knowledge of the negotiating circumstances, it is impossible to tell what was necessary. Of course, necessity is not the only factor, but it is a critical one in making such a judgement. The use of comparative SFA and RSA support levels throughout the UK is very questionable since, to the best of my knowledge, local authorities in England and Wales provide additional incentives that are not captured and for which no data base exists (or, at least, used to).

The presumption of expensive SFA then leads to the statement that innovation interventions are more additional and should be increased. I might almost as logically judge that the Bell Labs would be an excellent addition to NI's innovation infrastructure, but would not argue that any conceivable amount of money could move it from New Jersey. More to the point are my comments on innovation support in the following section.

The final observation I would make about additionality is that, despite Invest NI's arguments, IREP has decided that any SFA support for an existing investor is "repeat assistance" and that this is bad. I understand why it has formed its conclusion, but the rationale is based on an idealized model that refuses to accept business realities. It also discounts the value offered to assisted areas across the EU by State Aid legislation, the embodiment of policy objectives.

IREP's most basic misjudgement is to ignore the options that multinationals have to choose among investment locations. Each large reinvestment or expansion is typically subjected to internal competition among alternative sites. This does not imply that a company will ignore its sunk-cost investment or preside easily over its decay. However, forward-looking investment decisions will weigh the salvage value of existing plant and the transferability of key skills together with lower alternative operating and, sometimes, capital costs against the upheaval costs of moving. On many occasions, Invest NI's interventions have been crucial in ensuring the retention and expansion of existing plants. Other jurisdictions are at least as eager to do likewise. It is a fact that existing investors employ workers at higher skill and seniority levels than most new investments. Therefore, their loss can be quite devastating to productivity, whether measured per employee or per citizen. Invest NI carefully assesses whether the economic benefits are worth the cost and in some painful cases, such as Seagate Limavady, has concluded in the negative. This relates to safeguarding existing operations.

Some of our highest-value facilities will disappear if they do not adapt to new technologies and products. Again, multinationals run international competitions to decide where to build the new expertise. In such cases, Invest NI has defined allowable support cases as those where employees will do very different jobs involving new "work packages". In its view, this is not repeat assistance, which would amount to simply incentivizing the same projects twice. An obvious example is Bombardier's current reorientation, which brings entirely new technology to an operation whose whole future depends on the transformation it will bring. It would be hard to argue that the application of SFA to various Bombardier work packages does not involve innovation, notwithstanding Invest NI's use, alongside it, of innovation programmes. However, IREP continued to argue that only Innovation and Trade programmes support R&D and exports. The panel has remained confused between the original design of instruments available to Invest NI and the projects to which they are applied.

## **Innovation**

In reading outside reports on Invest NI practices, I frequently suffer from *déjà vu*. This derives from recommendations that the agency should do what it has been doing for years, together with the dark thought that the writer will later congratulate himself once his recommendation has been judged to have been adopted. So it is with the injunction that Invest NI should prioritize innovation and R&D more aggressively; that it should focus more on prioritizing exports; and that it should seek to integrate SMEs into the supply chain.

Much of IREP's logic in this seems to flow from the mechanical allocation of budgetary categories to intent and method ("Innovation/R&D and trade promotion accounted for only one quarter of all offers of financial support"). However, even if we were to look at budgetary categories, we would find a huge increase in specific Innovation expenditure. As far as I remember, R&D support has doubled since 2007/08; innovation expenditure two years ago was running at Pounds 39 million, last year it was Pounds 44 million and in 2009/10 the expectation is that it will approach Pounds 60 million, with a further increase in the following year. As you appreciate, such growth depends on significant effort by innovation and client executives to identify and approve good projects years in advance. This does imply that R&D/innovation have been prioritized for some time.

IREP is keen on setting up an institute analogous to Finland's VVT in order to fund and accelerate the development of technology. Invest NI has already looked at this. VVT is part of an R&D ecosystem that includes TEKES and other bodies, benefiting from Finland's historical focus on mathematics, science and technology. It is unlikely to be effective without the other elements. The cost of such a body for NI would be prohibitive and it is unclear what it would accomplish over and above the support that is already provided by Invest NI. Finland is about three times more populous than NI and it is the base for some of the world's larger companies. NI has none. In my experience, once promising R&D projects are identified, they have received quite generous early-stage funding from Invest NI's own programmes, usually in grant form. Recent trends have been encouraging, as the rapid climb in R&D programme support and SME expenditure on R&D demonstrate. The latter is acknowledged by IREP. Unquestionably, our region suffers from a paucity of companies that are sufficiently large to fund, commercialize and exploit R&D and this size dynamic is inadequately reflected in IREP's report. It seems unlikely that an institute, without an infrastructure of sizeable companies to work with, could be properly exploited. Better value for money is likely to come from sectoral centres of excellence, such as ECIT and Bombardier's composites unit.

IREP's suggestion that R&D should be funded from support allocated to existing investment blends an apparent ignorance of what has been happening with the ghost of repeat funding, revealing the Panel's prejudice against expansion of strong companies in favour of the acquisition of new investors. It also repeats the confusion between budget categories and the actual type of project being funded. As noted in the previous section of my letter, SFA support, though designed to increase and safeguard employment, is not without innovation impact. Client executives have been encouraged to upgrade the quality of projects for years and this criterion is built into casework appraisal and evaluation techniques. In fairness, this assessment would require more detailed knowledge than an outsider could hope to acquire in a short time.

The suggestion that exports are not adequately prioritized strikes me as downright foolish. The whole premise of an Invest NI client designation is that companies supported should be existing or potential exporters (or external sellers). This principle was strongly challenged by Professor Andrew Scott during formulation of the current Corporate Plan and eventually justified on the grounds that the NI internal market is so small that companies unable to export could not achieve the critical mass needed to develop value-added products. This is an explicit productivity rationale. The policy concern about displacement in the case of purely domestic sellers, while important, was secondary.

It is possible that IREP bases its conclusion about export emphasis at least in part on the relative smallness of Trade Division's budget. This seems to reflect the fallacy that all expenditure is the

same rather than qualitatively different. Trade is an advisory, research and promotional function that is people-rather than capital-intensive. It is critical for Invest NI's clients but does not stand alone within the client-team matrix any more than do other Divisions. There is no sense from the Report that IREP understands the power of the agency's matrix structure.

I am quite sure that it is possible to devise more ways to support exporters and that these will evolve across the organization, linking innovation, through product development, efficiency improvement, management and leadership development with incentives to spend the capital and recruitment funds that are needed. What is not apparent to me is why IREP thought it was necessary to become more "professional". Greater professionalism is always a goal to embrace, but there seems to be a specific criticism here that is not properly developed or justified. IREP should, for instance, explain why the introduction of a charging regime would result in greater professionalism.

IREP's paragraph E18 treats us to a panegyric of successful regions that place "intense focus on attracting, retaining and embedding anchor institutions". The intensity of anyone's focus may be in the eye of the beholder, but the criticism of Invest NI's lack of focus on anchors sits a little awkwardly with IREP's complaint that 30% of historic support went to 10 companies. These companies are a Who's Who of blue chips. Presumably, while the likes of Intel, Wyeth, IBM and Microsoft are anchor companies for ROI, Bombardier, Seagate, Citibank, NYSE, Caterpillar and Allstate are not for NI? It would be helpful to know the criteria that distinguish them. As to the quantity of support awarded, I turn to the fairly obvious notion that you give them as little as you can to be sure of obtaining the investment. The quantity of support is entered into a specified calculation measuring net project value to the economy, as a check that it not exceed the economic benefits to be gained. This is true for any company; if the ten biggest need more, the result falls out of necessity and project size rather than a generous spirit. Most business people would understand this.

I note that, in 1989, the IDA offered Intel Pounds 87 million to invest in Leixlip. While spread over 10 years, this represented 80% of the agency's capital grant in that year. Concentration is inevitable and, without it, insufficient "game-changing" investments would be attracted.

As to the need to integrate SMEs into the supply chain, it would be helpful to know what more IREP would suggest. Invest NI has employed a supply chain specialist for years and works with outside consultants, including the Centre For Competitiveness. Some multinationals in NI are very backward-integrated, an outstanding example being Bombardier. It is true that local supply chains need to be better developed and that, in some ways, this is becoming more difficult given the pattern of recent FDI, which is largely services-oriented. I do not know whether the Panel considered whether further embedding FDI investors would represent repeat assistance, of which it disapproves, or if embedding consists entirely of supply chains. Investor longevity is presumably one of the benefits that supply chains help to achieve. Correlatively, time helps to enable development of greater links with indigenous suppliers. Surely a larger operation is less marginal to its parent than a small one and therefore more "sticky" when rationalization decisions have to be faced? If so, expansions leading to critical mass have value beyond their increment.

To conclude on R&D support, perhaps the greatest conundrum, as yet unsolved, is why scientific discoveries emanating from NI and developed into new products would be produced here. There is no compelling tax reason to do so and the labour-cost component of such products is generally less

significant. If production were relatively straightforward, it would probably seek the lowest-cost location; perhaps it should be explicitly recognized that local production of products and services derived from intellectual property requires an act of faith. I feel that the Report overlooks the propensity of some local owners to invest here because of their attachment to “place”. The emphasis on FDI, while important, is somewhat overstated compared with the challenge of finding more Sir Allen McClays and Sean Quinns.

### **The NI investment proposition**

IREP believes that this is strong and that concerns over political and security stability have gone away. Consequently, less financial incentive is needed than is provided. NI has certainly improved in many ways since the bad times and it is now easier to sell as a place to live and invest.

On the other hand, we live in a very competitive world in which NI’s assets are more widely replicated than before. I would describe the investment proposition relative to many other regions as moderate, except in some niche areas where it is quite good. We have, indeed, a cost advantage over certain UK regions and more prosperous areas of the US and Europe. However, our position compared with much of the Far East, the sub continent, eastern Europe and Latin America is weak and it is becoming less tenable to describe our niche as higher-value than their simpler products and processes. China’s R&D expenditure is now larger than Japan’s.

Some London-based banks still view the Irish Sea as a ditch rather than a channel and are more comfortable with the prospect of placing back offices in Manchester or Leeds, as a result. Our marketers still have mountains to climb just to place Belfast or Londonderry on the short list. Incidentally, IREP should be asked on what grounds it has recommended that overseas representatives need intensive marketing training, given its acknowledgment that NI has gained more than its share of FDI.

IREP seems to view NI as having a significant reservoir of untapped scientific and innovation talent waiting to be commercialized. We have several areas of academic and fewer areas of industrial capability that are world -class. As the Report itself acknowledges, the number of Ph Ds per thousand of population is low by UK standards and, as it does not point out, the absolute number of advanced degree holders is extremely low. This is significant since it discourages some companies from viewing NI as a viable centre for R&D, having no critical mass in most areas. While Invest NI sells our two universities as “world-class”, investors generally speak well of their graduates, and certain subjects are highly regarded, the rankings even within the UK context fall well short of headline-grabbing, as illustrated by certain measures such as the Sunday Times table.

Compared with many countries, our broadband connectivity is widespread, but slow (although now improved for business by the transatlantic cable connection), our air routes are hugely better, but limited, and the image of NI abroad retains some of its former disadvantages. On the whole, the conclusion that the region can substantially sell itself is very unrealistic.

Consequently, financial incentive will remain as important for FDI as it has been. Criticism of the use of SFA as a tool that will go away seems illogical; the agency’s strategy has been to maximize its use (within the bounds of value for money) while it is available and associate it increasingly with “horizontal” support such as BIS, R&D programmes and property assistance, as these evolve into the

main instruments. It is, therefore, unclear to me why the Panel would have concerns that some of the large-company SFA support levels used historically are above the level that State Aid rules will soon allow, except to the extent that we would all prefer not to be constrained in future.

### **Timescales for the challenge and comments on other suggestions in the Report**

I will not devote much space to the general point that IREP, although acknowledging the role of other departments and economic actors, seems to ascribe much of the deficit that it sees in NI's business performance to Invest NI. It underestimates the extent to which macro-economic policy change is required to "tilt the playing field" more in the direction of business and that transformational change is not within Invest NI's gift except, perhaps, in the very long term. Indeed, it is largely within the power of national government.

The implication that transformational change has been achieved by economic-development agencies in what the Panel views as successful economies is a gross exaggeration. People can only sell the product they have and, in my opinion, IREP misunderstands the NI product's appeal. Neither is IREP in a position to judge how well Invest NI has played the cards it was dealt and it should have been more circumspect in making contentious and superficial judgements. A theme that recurs at several points is the "process orientation" of Invest NI compared with the "outcome orientation" of agencies such as the IDA. Invest NI's relative risk aversion is also claimed. There are several popular myths and confusions buried in these unexamined comparisons which have been gained, as IREP has said, from "respondents".

### *Comparison with the IDA*

First, IDA is explicitly an FDI agency and does not deal with local companies from whom claims of complicated process generally come. It is hardly surprising that they do arise from this source since most local companies are of micro size; they require far more help with business plans and greater application of risk judgment than the typical FDI investor. In addition, IDA is selling essentially a low-tax product and has consequently attracted large multinationals seeking, inter alia, to shelter corporation tax in an English-speaking EU country. It is hard to see how doing so involves much risk-taking. Invest NI, on the other hand, with the exception of a number of FDI investors and a few larger domestics, has a much higher-risk portfolio of predominantly smaller companies. It could hardly be otherwise since its additionality criterion for supporting projects includes access to finance. Commercial financiers are sometimes reluctant to lend without Invest NI's participation. On other occasions, commercial finance is unobtainable at all, or in sufficient quantity.

To the extent that IREP does not really mean "risk", but ease of working or marketing panache, such judgements are necessarily based on the experience of some and the anecdote of others. I know of examples where FDI investors have felt Invest NI was more hungry than its competitors and could not have been more supportive of the investment decision. I'm sure there are others where it could have done better, but I know of none where its marketers did not show perseverance.

There is no doubt that IDA, for example, has benefitted for years from a large presence in key markets like the US. This has been supported far more by its politicians and locally based sympathisers than has been possible for NI. The reasons for this are well known and only recently redressed. My own disposition would be to boost Invest NI's US presence to some extent and to try

and develop more niche marketing propositions. However, this is an operational matter for Invest NI management and it is my understanding that the issues are well recognized. I believe that innovation advisors are being introduced to this market.

#### *Staff incentivisation*

As to the suggestion that staff compensation should be skewed towards results (bonuses), the agency has looked at this in depth. While the change has simply not been possible within public-service pay strictures, it is not clear that it would add much to motivation or effectiveness in any case. For one thing, many overseas staff whose job is to market FDI are not on permanent contracts and the penalty for underperformance is much more severe than missing a bonus. It is termination. While bonuses arguably incentivize business-getting in the private sector (not always happily) it is unlikely that they could be struck at a sufficiently high level in the public sector to do more than support morale for an unusually well-done job. Different people are motivated by different things and my experience is that entrepreneurial public servants (I can assure you that they exist) are driven more by a sense of accomplishment and by management recognition than by pecuniary reward.

#### *Time to outcomes*

On timescales, I believe that Invest NI's Third Corporate Plan provides as realistic an estimate of the likely time to outcomes as I have seen.

#### *Industrial property*

IREP can find no reason why industrial property should any more require government intervention than other property sectors. The reason is very simple. It is worth much less than residential or commercial property and, therefore, offers a smaller uplift in value to developers. Developers have tended to "sit on" land banks that were not originally zoned as residential in the hope or expectation that their status would change. Consequently, there has been a clear market failure in the provision of industrial property in NI. This rationale is well known and it is surprising that IREP was unable to find it out by, for example, asking Invest NI's PSU. IREP seems to think that Invest NI's properties are largely for FDI companies and questions why they would need such help. As you know, they are open to all worthy projects on a competitive basis, and most of the allocation during Invest NI's lifetime has been to locally owned companies. It is also likely, though may need to be confirmed, that property will qualify as "horizontal" support under the amended EU State Aids rules and needs to be retained as SFA is phased out for large companies.

#### *Venture capital*

Turning to the section of IREP's report on venture capital, it is difficult to understand how the recommendations survived editorial review. There several bizarre contentions. The first is that Invest NI's venture capital interventions may have crowded out the private sector. It is common knowledge that private externally based VCs view nearly all transactions in our market as too small to fund.

Where they have been large enough, VCs from London and Dublin have participated. Invest NI's policy and practice for some years had been largely to co-invest with local funds on a subordinated basis to the private equity. Anyone who imagines that subordination could do other than gear up the returns of private investors and thus incentivize them to invest has an idiosyncratic view of finance. It is certainly not likely to have acted as an impediment to private-sector investment. This structure is not unique to NI and has been used in GB in an attempt to offset market failure. The fact that subordination represents State Aid seems to IREP to be a disadvantage rather than an inevitable consequence of the rules. Of course, it is legal State Aid.

Invest NI's recent steps, through NISPO, to provide much more than seed-corn finance by paying for the advice and expertise of leading practitioners is a bold innovation whose significance has not been recognized in the IREP report.

IREP lists as an apparently negative aspect of Invest NI's support for VC funds the fact that restrictions are placed on deal size. The funds have been set up precisely to offset the market failure in those particular deal sizes. In the absence of such restrictions they could, indeed, crowd out private providers. Clearly, therefore, they do not. There is no competition between Invest NI as a VC provider and private financiers since the agency has avoided transaction sizes where financiers are willing to participate. Invest NI also makes considerable efforts not to invest direct equity in competition with local VCs for whom deal sizes can be much smaller than for London participants.

It has sometimes been claimed, and IREP repeats the charge, that Invest NI grants have a chilling effect on the development of VC. This is based on musings upon potential reasons for our small VC sector rather than on actual examples. The financial interventions that Invest NI makes on behalf of small companies are always tested against the likelihood that they could raise commercial capital. Additionality also allows the "could or would" test. There are occasions where a family-owned firm, for example, will not entertain the concept of equity from a financial investor. However, it may have an attractive economic project that requires outside non-debt finance to get off the ground. Invest NI's intervention in such cases through the provision of grant could not be said to crowd out VC finance.

It would be possible to adopt a policy that early-stage financing can never be in grant form. Whatever the potential outcome for long-term behavioural change, this is very unlikely to push companies into the arms of private-equity investors. It would be more likely to stop or slow down the project or, potentially, to require repayable finance (in a form of equity or subordinated debt) from Invest NI. Since Invest NI's purpose is to build the economy, it can seek returns in the form of economic outcomes. The main reason to provide repayable finance would be to prepare the company for the harsh world of commercial returns later on. Sometimes this is appropriate; often it is neither optimal nor practical.

The whole argument used here by IREP assumes that, but for government, private equity would stand ready to finance early-stage projects (often not even incorporated). In addition to merely repeating an old and unsubstantiated charge about crowding out, IREP does not show appreciation for the fact that, having got a fledgling private equity market off the ground by supporting domestic commercial managers (a process started by the IDB and Ledu), Invest NI has now moved closer to seed-corn provision. This finance is practically absent commercially anywhere since it is very high-risk. It would be enlightening to know which investors feel squeezed out of such projects.

Perhaps the most odd criticism of VC support is that special-purpose funds partially capitalized by Invest NI restrict overseas investment and that this crimps the funds' growth. IREP may not appreciate that Invest NI operates under an industrial-development mandate and is not permitted to make purely financial investments. I doubt that the agency would wish to test the appetite of elected representatives for investing taxpayers' equity in overseas companies.

#### *Financing expansion projects*

Outside the realm of venture capital, IREP makes a recommendation on financing expansion projects that is unclear, puzzling and naïve. Expansion financing that does not involve innovation and R&D should, in IREP's view, be through co-investment with others and in the form of subordinated debt or equity. First of all, substantially all of the projects being supported have some degree of innovation to the company and/or the NI economy. IREP's addition of the term "R&D" to "innovation" makes the intent of the recommendation unclear. Perhaps the sense is to be read as "or". Apart from the difficulty of striking a judgment about the relative degree of innovation along a continuum from a lot to a little (since, in principle Invest NI should probably not support projects with none), it is quite difficult to understand the point of using sub debt or equity. Presumably, the idea is to remove all element of subsidy from pure expansion projects. Would NI be content to forgo expansion projects if grant aid would cause them to occur? What if salaries offered were well in excess of the median?

I also note that the idea of co-investment adds little to existing policy since Invest NI never supports 100% of a project's funding needs. Non-R&D projects receive significantly less. Further, does IREP intend this recommendation to apply only to SFA grant? Other programme grants for specific purposes have very different co-funding limits.

Quite apart from the impracticality of insisting upon financial instruments that will often be refused by owners, I wonder whether IREP has appreciated the logistical and policy complications of Invest NI's holding potentially large numbers of stranded investments. Illiquid equity is not an asset sought by any commercial investor seeking an eventual exit. It is hard to see that it makes sense for a government agency, either, other than in true seed corn where the risks and potential rewards are particularly high.

Furthermore, equity investments can bring difficult regulatory and conflict-of-interest issues to which Invest NI needs to remain sensitive and into which it would not want to be boxed by rigid policy preclusions.

#### *Client designation*

One of IREP's most prominent recommendations is that the Invest NI "client" designation be scrapped and that its services be open to all. This strikes me as an egregious misunderstanding of the state of things and of the purpose of the client concept. The general point is that many of the agency's services are available to everyone in NI (indeed to anyone in the world who has access to the internet) for free. Other valuable programmes and events are open to non-clients in NI. The

DETI/Invest NI policy framework, which IREP supports and feels should be further emphasized, is to support financially and by tailored service companies that sell externally to NI today, or reasonably soon. It is clear intuitively that many will not meet this criterion. In fact, Invest NI clients are not a static cohort and there is a healthy turnover as client executives constantly seek new companies and let others drop out when they are no longer ambitious or have failed to perform. Also, clients have contractual agreements with Invest NI which entail legal and financial obligations on both parties, frequently for many years.

Essentially, the intensity of engagement required for companies that can add value to our economy entails that Invest NI people prioritize their time effectively. I see no other way to do this than through a form of selection with clear, but flexible criteria. Enterprise Ireland, for example, is more ruthless than Invest NI in selecting and supporting only certain companies. Invest NI's view has been that our business sector is somewhat less developed and requires a more supportive model.

It may be possible to make more services available to a wider range of local companies, for example with greater use of technology. To my mind, this would be an optimization of the present platform, while to scrap wholesale a mechanism like the "client" designation would both send the wrong signal about the thrust of government policy and be completely impracticable.

#### *Programme simplification*

Rather than continuing with a long list, I might limit myself to three more observations. First, a prominent IREP recommendation is to reduce further the lengthy suite of programmes available. IREP acknowledges that these have already been pruned but wants to do more. In my view, while simplification is desirable, the need for and impact of this is exaggerated by IREP. As you know, Invest NI's services have been grouped into five generic themes for several years. From the outside world's point of view, these are entirely intuitive and simple. Some of the more complex programmes have been in the R&D area, but these are now notified as one single programme.

#### *Reorganisation*

Secondly, IREP suggests that Invest NI reorganize itself in certain ways. I believe that such matters lie within the proper domain of the Executive and Board of Invest NI and that it is not possible for outsiders performing a necessarily desk exercise to make well informed judgments. However, some observations about two recommendations are called for. IREP would like to see Invest NI organized along industry lines. In fact, it has been since a few months after its formation.

IREP would also like to see the establishment of a small-business unit. Small businesses do need different things than large companies and the bulk of Invest NI's work is, in fact, with small businesses. Almost everyone in the regional network, for example, deals exclusively with small and micro businesses. Many of the staff have years of experience and possess as much expertise as is to be found. In addition, the Global Starts team has developed particular knowledge and skill in helping to accelerate companies with high growth ambitions. Invest NI is developing the capability of taking company scaling further, enlisting the cross-cutting advice of ICD and of qualified client executives in a focused effort. I am unsure of how this has progressed since my retirement. However, it is not clear that the formation of a small business unit would be helpful compared with delivery organized

through a matrix that enables small-company specialists to leverage the organisation's broad expertise.

*Role of Invest NI board*

Thirdly, there are governance recommendations, some of which strike me as welcome. However, I do not understand the suggestion that the Invest NI Board should withdraw from operations and focus on strategy. The Board is not involved in operations except to the extent that members participate in a relatively small number of caseworks that reach Board delegation levels, and that Invest NI has several Board advisory committees (plus the statutory Audit and Remuneration committees). I would say that being an effective Invest NI board member is difficult in view of the agency's size and remit. Casework is, to my mind, an indispensable way for Board members to gain a feel for the agency's business and its complexity. While Board advisory committees can become a burden on executives, they can also be a useful way to obtain value from members who have considerable outside experience and seek the opportunity to apply it. Members need to use these advisory meetings with care.

I would support the view that the Invest NI Board could be used more effectively to inform government economic policy in the round ( including supply-side factors) and would suggest that thought be given to using it more formally. DETI does, indeed, seem to be a sensible place for policy development but, without a closer appreciation of delivery in the field, it will find value-added policy innovations difficult. Secondments to Invest NI would be one possible way to address this.

This letter has become rather long and I apologize for that. I hope it provides some substance to assist you in taking forward the IREP report and consultation responses. As you can see, there are areas on which I feel strongly and I suppose it would be surprising if it were not so. Thanks again for the opportunity to participate in your written consultation and please accept my best wishes for success in the critical work that you are doing.

Yours sincerely,

Leslie Morrison

Cc Invest NI:

Chairman

Chief Executive

Managing Directors

Director, Strategic Management and Planning

DETI:

Permanent Secretary

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