HOUSE OF COMMONS

Public Administration Select Committee

Oral evidence: Whitehall: capacity to address future challenges, HC 669

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Watch the meeting

Members present: Mr Bernard Jenkin (Chair), Mr Nigel Evans, Paul Flynn, Mrs Cheryl Gillan, Kelvin Hopkins, Greg Mulholland

Questions 204-296

Witness: **Sir Nicholas Macpherson**, Permanent Secretary, HM Treasury, gave evidence.

Q204 Chair: May I welcome our witness to this session of our inquiry into future challenges facing the United Kingdom and could I ask our witness to identify himself for the record, please?

Sir Nicholas Macpherson: Yes. I am Nicholas Macpherson and I am Permanent Secretary to the Treasury.

Chair: Thank you. You might feel you are becoming rather a regular attender, having helped us with our impartiality inquiry, which we hope to report on shortly. I do not think we have any further questions on that subject but, if we have any time, one or two colleagues might want to follow up with one or two questions. Can I start by just saying we have got quite a lot to get through? If you can keep your answers crisp, we will endeavour to ask crisp and short questions. Could I start by asking Kelvin Hopkins to open the questioning?

Q205 Kelvin Hopkins: I am most interested in economic forecasting. You were Permanent Secretary to the Treasury through 2008 and—I have to say this as an old-fashioned leftist Keynesian—I thought there was a problem with debt at that time but somehow the Treasury did not see it. If we had the OBR in place at that time, would that have made a difference, do you think?

Sir Nicholas Macpherson: My experience of economic forecasters—and I have been involved in economic forecasting, in one shape or form, for about 30 years—is that they are very good at forecasting in the good times, or indeed the bad times, if there is a steady trend. The Treasury won all sorts of forecasting awards back in the 1980s and in the early 2000s. What forecasters are generally very bad at is forecasting inflexion points. You get some forecasters who are always forecasting ruin, and they make their reputation by being the person who forecasts the next disaster, but they tend to be people who are always forecasting disaster. Similarly, you get forecasters who always think we are about to enter some new promised land. Look, the Treasury did not predict the downturn; there were huge lessons for it in that, but then it is fair to say very few other forecasters did too.

Q206 Kelvin Hopkins: Some forecasters get it right. I am of an age to remember all sorts of early crises. I was around for the 1967 devaluation but also, in 1990, *The Sunday Times* produced a table of success in forecasting, and the Government's favoured forecasting organisation was the London Business School. *The Sunday Times* gave them nought out of 10 for their forecasts. The Government's least favourite forecaster was the Cambridge Economic Policy Group, and they got six out of 10, but the Government, Mrs Thatcher in particular, was so annoyed with them that she took away their funding. Forecasters sometimes get it right, but if they offend the prevailing orthodoxy and the prevailing ideology, if one likes, they are dismissed. Is that not the case?

Sir Nicholas Macpherson: I do vaguely recall the period you are talking about and I can remember issues with the National Institute as well, in the 1980s. You could argue that the same thing has happened with the Treasury, because the Treasury no longer does the forecast; the independent Office for Budgetary Responsibility does. I can understand people's frustration at poor forecasting.

Q207 Kelvin Hopkins: In the 1960s I remember—again, I am a certain age—the Government did split economic policy from finance, with the DEA. George Brown and Peter Shore were the guiding genius of all of that. Quickly the Treasury grabbed it back and put it back into the Treasury, but is there a case for separating those functions?

Sir Nicholas Macpherson: There are countries that separate economic Ministries from finance Ministries and, in a number of them, they work very well, Germany being one example. You would expect me to be biased—I come from the Treasury—but I would have concerns about messing about with the machinery in the Treasury. The experience of the Department of Economic Affairs was not a happy one. In the end, especially in a crisis, the really big issues come back to the Treasury, whether you like it or not. Indeed, the issues in the 1960s were all about managing the exchange rate, dealing with public finances and so on, so the Department of Economic Affairs never really got a look in. It produced a plan, but that plan was obsolete pretty much from the moment it was published. In any case, and I am sure this Committee looks at machinery of government from time to time, there is quite a big cost in rearranging the deckchairs, so my general advice would be to set quite a high bar before trying to create the ideal Whitehall structure.

Q208 Kelvin Hopkins: Has not the reality been that there have been two competing ideologies throughout this period? It is not just me saying this; *Financial Times* journalist Philip Stephens suggested in 2013 that the Treasury should be shut down. He is taking a very extreme view. He is complaining about the Treasury's devotion to "fiscal fundamentalism and untrammelled markets" and that there should be a much more active role for Government in industrial economic strategy. That strikes me as harking back to the post-war Keynesian view of the world. Is that not the problem—that there has been this division of two competing ideologies or philosophies?

Sir Nicholas Macpherson: It is fair to say that Philip Stephens is not a friend of the Treasury. Fortunately, there are some other people in the *Financial Times* who are a bit more impartial in their approach to the institution. Your point is an interesting one. The Treasury, because it is responsible for public finances, does worry when deficits get quite high, but I worked under Gordon Brown and Alistair Darling, and it is fair to say that, in terms of the outturn under this Government, it is not totally dissimilar to the projections in

Alistair Darling's last Budget. Whether we would have secured the outcomes on the basis of Alistair Darling's policies is another matter, but it was fair to say that both Gordon Brown and Alistair Darling were seeking to address the deficit in the medium term. Now, this Government got in and decided to do that deficit consolidation rather quicker.

It is quite dangerous. There is a time and a place for Keynesianism but, speaking as a Treasury official, you really do not want to be relying too much on fiscal demand management when debt is getting to a high level of GDP.

Chair: We do not want to get too much into the eventualities or hypotheses.

Q209 Kelvin Hopkins: Let me just put to you one more question. If one looks at the immediate post-war period, when Keynesianism was at its height, we had a massive deficit after the Second World War, quite understandably, running a full-employment economy with heavy demand management over that period. The deficit dramatically reduced. Debt reduced and the deficit was low. Is that not a lesson for us? Has the problem not arisen since we have had globalisation, the abandonment of exchange controls, deregulation, the Big Bang and all that?

Chair: Very briefly, Sir Nicholas; it is not a machinery of Government question.

Sir Nicholas Macpherson: It is fair to say that inflation played its part in reducing the debt. Whether we can rely on inflation in the future is more open to doubt. Whether it is right to rely on inflation to reduce public debt is also another interesting question.

Q210 Chair: What effect has the OBR had on economic forecasting at the Treasury?

Sir Nicholas Macpherson: It has had quite a big effect. The OBR is not a fantastic forecaster. It gets things wrong, just like every other forecaster, reinforcing the point I made at the beginning. Where it makes a difference is that it is intrinsically unbiased. It may be that the individual members have a biased view of how the economy will evolve, but there is no political pressure placed on the OBR and politicians do not determine the assumptions that inform the forecast. I regard that as a positive development. It is good for the credibility of forecasting, but it has also changed the nature of the work of the Treasury. In former times, especially when the going was getting tough, a lot of discussion within the Treasury, and between the Treasury and No. 10, was about the forecast, because the forecast determined the extent to which you had a public finance problem. Now we have to take the forecast as read, so there is far greater debate about the contents of a Budget. I regard that as a positive development.

Chair: Can I just apologise to Cheryl Gillan? I meant to bring you in on that, but I do apologise. Can we go to risk and horizon scanning?

Q211 Mr Evans: Good morning. Looking at the National Risk Register, it deals with things like pandemic influenza, coastal flooding, catastrophic terrorist attacks and severe effusive volcanic eruptions abroad, but there is nothing there about financial and economic emergencies. Why do you think that is?

Sir Nicholas Macpherson: You probably have to ask the people who produced the plan. It probably reflects some theological view that potential economic disasters are so much a part of life that endless game playing around that might squeeze out the more important issues. There may also be a view that this is something that is for the Treasury and the Bank of England, and they should be left to get on with it.

Q212 Mr Evans: As far as things like horizon scanning are concerned, would they be dealing with things like, let's say, the Greeks leaving the euro and the impact that that would have, or indeed the price of crude oil falling below $40 a barrel?

Sir Nicholas Macpherson: Certainly Greece leaving the euro was identified—not Greece in particular, but the possibility of breakup of the euro—as a very strong focus of contingency planning across Government from 2010 onwards. The Cabinet Office co-ordinated work on that. Obviously the Treasury had a very big role within it. My recollection is that the Chancellor chaired various meetings involving various Cabinet Ministers precisely to discuss that, not least because it does bring in quite a lot of Departments. For example, the Cypriot crisis raised quite big issues like how you would pay the troops who were based in Cyprus if all the cash machines had run out, so obviously the Ministry of Defence had to be involved and so on. There was good machinery about that.

Markets are more difficult. Here, my emphasis would be on doing quite a lot of simulations around economic variables that are likely to lurch in some unexpected way. The extraordinary thing about the oil price is how it has held up for so long. What always happens—reminds me totally of the era before the crisis—is people then rationalise why the oil price is always going to remain above $100, and it is usually at that point that a smart person realises it is time to sell. The issue there is to be ready for it. For example, the Chairman referred to work on Scotland earlier. In the run-up to the Scottish referendum, we did quite a lot of simulations about what the impact on the Scottish economy would be if there was a sudden fall in the oil price. We were only talking about $20, but the reality is it would be more like $50 to $60.

Q213 Chair: Can I just place this conversation in context? We are not just talking about cash machines running out of money and practical problems like that. I am looking at a chart produced by the Bank of England, which shows what the trend line of economic growth was before the crash and what the trend line is expected to be now. We have permanently lost 10% of our output.

Sir Nicholas Macpherson: I would say rather more.

Q214 Chair: There we are. This is a catastrophe that has been described as being as bad as the cost of fighting a war of national survival, so I do not regard it as a waste of time to conjecture such possibilities. Surely it should be integral to your own purpose to conjecture about such possibilities, and waste time doing so.

Sir Nicholas Macpherson: I did not say that that would be a waste of time. The lesson of recent years is that we will be spending even more time thinking about potential risks to the economy and the impact that they would have. There is an active debate at the moment about whether the very slow productivity growth we have had in recent years will persist, or whether it is just a temporary problem. On this lie massive issues about whether the country is going to be able to afford certain levels of public sector services in the coming period. We need to have a very strong focus not just on the central forecasts but the potential drivers of economic activity going off course. Related to that, and this is something the OBR does every year, we need to do a very long-term projection around public finances and then simulate different assumptions about economic growth and so on.

Q215 Mr Evans: As far as the oil price is concerned and inflation today coming in at 0.5%, which is the lowest that it has ever been on record, what sort of horizon scanning is taking place in relation to that now?

Sir Nicholas Macpherson: We do a lot of horizon scanning around this. During the early part of this decade, we did a lot of analysis about whether Britain was going to end up like Japan—whether we were going to have a lost decade—and what would happen if the economy never grew and you started to have deflation. As it happens, I think you remember the point when the then Governor of the Bank of England made a speech implying that the economy might never recover, because the banks were in such a terrible state and the eurozone was in a terrible state. Pretty much from that point onwards, the economy has grown at 3% to 3.5% a year, which is again a reminder that, just when you have convinced yourself that it is all terrible or all wonderful, that is usually when it changes.

I am not defeatist about this. We can improve our analysis a lot more. I welcome this Committee's inquiry as a civil servant whose job, in my view, is not just to look to the end of this Parliament. Ministers decide—they determine strategy—but the job of the Civil Service is to be ready and to have the analytical structures in place to support Ministers in facing up to difficult choices.

Q216 Mrs Gillan: Can I just ask you a practical question? Deloitte has just recently done a survey of CFOs, and they see as the biggest risk to business in the UK the forthcoming general election. They are worried not only about the eurozone but about the potential of the UK leaving Europe, for example, and political complexity. What practical work is going on at the moment to look at the various scenarios?

Sir Nicholas Macpherson: At this point, first, Europe is a very sensitive issue.

Mrs Gillan: We cannot afford to be sensitive about it. We are talking about the economy and the Treasury.

Sir Nicholas Macpherson: I accept that, but it is an issue that I would always, as an official, approach with some caution. The Treasury needs, from a technical perspective, to be ready for whatever outcome there is to the election. Let us say, for the sake of argument, that there was a majority in Parliament that was determined to have a rapid renegotiation of our relationship with the European Union with a view to putting the British people in a referendum. The Treasury needs to be ready to inform that debate. We need to have people with technical knowledge who can do the work and the analysis that you are referring to. My job is to ensure that the institution is ready and prepared to deal with that. Just as before the last election you did not have to be terribly bright to realise that, whoever won the election, there was going to be a very difficult spending review, it is fair to say that the Treasury was prepared, in May 2010, for that eventuality.

Q217 Mrs Gillan: Your message to the businesses watching this Committee outside is that the Treasury has all these matters under control, in terms of their forward planning and their risk assessment.

Sir Nicholas Macpherson: That would suggest a level of complacency that would worry me. The idea that the Treasury can have all these matters under control when there are so many forces at work that are so manifestly beyond our control means that you have to be realistic. We could spend the next few months, and believe me we will not, speculating on the result of the election and trying to work out different scenarios to be prepared for each of those scenarios. My view is that that would be a waste of time. What would be a good use of time is thinking through how the work of the Treasury would change if there was a different sort of Parliament. For example, if there was a minority Government, my guess is that there would be a lot more meetings at the House of Commons rather than back at the Treasury, and the Treasury would probably be in a slightly more defensive role than it is when there is a majority Government.

Q218 Mr Evans: I am just wondering. You intimated that you are sharing horizon-scanning information from other Departments, and this is going on on a regular basis. How is that done?

Sir Nicholas Macpherson: The euro is a good example, where there was a great deal of analysis and work done. In that case, the work was chaired by a senior Cabinet Office official and it was shared across Government. There will be some issues that are so market sensitive that perhaps you may not be quite as forthcoming, because it could destabilise the markets. Say I was privy to very secret information about Ireland's intentions in the context of a breakup of the euro, it is quite dangerous for too many people to know about that, because people could then speculate against Irish bonds and make the event self-fulfilling. It is rather like how I am not privy to every last detail of defence planning.

Q219 Mr Evans: Are there any improvements that you would make in the current system of horizon scanning that would make a difference?

Sir Nicholas Macpherson: There has been a lot of progress on this front in recent years but, ultimately, the Cabinet Office is uniquely placed to push this agenda further. Sitting in the Treasury, I would support it in that endeavour.

Q220 Chair: Just to clarify, financial and economic emergencies are not factored into the Treasury's risk assessment.

Sir Nicholas Macpherson: Yes.

Chair: How are they integrated into your risk assessment?

Sir Nicholas Macpherson: They are classic high-impact ideally low-likelihood events. The Treasury reconfigured our approach to risk following the crisis. We have three groups. We have an economic risk group. We have a fiscal risk group and an operational risk group. The economic risk group will be continually reviewing.

Q221 Chair: Are these just officials?

Sir Nicholas Macpherson: These are officials, yes. They then inform how we report to our departmental board.

Q222 Chair: How do they invite external input?

Sir Nicholas Macpherson: Meetings of these groups are not public events. We invite external people in from time to time to talk to us. I would strongly encourage any Treasury officials not just to sit inside the Treasury all day talking to each other but to get out there and engage with people in the City and in wider society to get their views on emerging risks.

Q223 Chair: What do you think we mean by the terms "systemic risk" and "radical uncertainty"?

Sir Nicholas Macpherson: All I can do is look at it in the context of the financial sector. Systemic risk is risk that potentially is going to impact across the whole system in a way that could do considerable damage.

Chair: Radical uncertainty?

Sir Nicholas Macpherson: "Radical uncertainty" is not a term—

Chair: I sense that you are much more comfortable looking at trends and institutions you can see. You are not so comfortable looking at the unknown unknowns, because you cannot see them and you do not think about them.

Sir Nicholas Macpherson: I do think about them but, by their nature, they are less easy to identify.

Q224 Chair: What are you doing in the Treasury to improve management of systemic risk and radical uncertainty?

Sir Nicholas Macpherson: Funnily enough, we in our executive management team had a discussion about this yesterday. There are massive risks like banks collapsing, but where the Treasury tends to get surprised is with the more peripheral things that it tends to think are all under control but then is appalled to find out it does not have under control at all.

Q225 Chair: What happens if the next financial crash is of a completely different type?

Sir Nicholas Macpherson: It is bound to be different. The risk at the moment is that we all spend our time re-fighting the last war.

Q226 Chair: Yes, exactly. I wrote that down and then crossed it out, because I did not even think it was worth asking you and you have said it. You are at the same time assuring us that you are much better prepared than you were before 2007, aren't you? You feel that, don't you?

Sir Nicholas Macpherson: We are certainly a lot less complacent.

Q227 Chair: Okay, you are a lot less complacent, but what evidence can you provide to me that we are entitled to be more assured by your lesser complacency?

Sir Nicholas Macpherson: Let me give you a real-life example. Picking up on the point on the euro, when it had got into difficulties, we did a lot of analysis and contingency planning around the impact of a banking collapse on Britain. When one of the Cypriot banks got into difficulties, we basically put into practice that contingency plan. There are a lot of Cypriots living in this country and it worked pretty well.

Q228 Chair: We do not now expect a rapid spread of contagion across the eurozone—at least that is what I understand is the Government's view—from a Greek political crisis, but you have modelled what would happen?

Sir Nicholas Macpherson: We have.

Q229 Chair: How often do you do this kind of modelling?

Sir Nicholas Macpherson: I would not want to over-emphasise the importance of modelling. Modelling can be helpful, but a lot of this is about really thinking through what might happen and then having a culture where, when bad things happen—

Q230 Chair: Do you use red-teaming, tabletop exercises?

Sir Nicholas Macpherson: We have done tabletop. There was quite a high-profile tabletop.

Q231 Chair: How often do you do them in these committees that you have described as looking at the three risks that you are looking at?

Sir Nicholas Macpherson: First, we do simulations to get a better handle on the relationship between different variables. Secondly, we do what you have referred to as tabletop exercises about war gaming a particular crisis issue.

Q232 Chair: Do these involve other Government Departments as well?

Sir Nicholas Macpherson: Certainly they involve the Bank of England and other countries' institutions. For example, the Chancellor and Governor Carney did quite an in-depth exercise with the US authorities last autumn on a potentially systemic very large bank getting into difficulties.

Q233 Chair: I am still not clear how often you do this kind of exercise.

Sir Nicholas Macpherson: We do not have a protocol that says, "You will do X exercises a year." That is why I cannot give you—

Q234 Chair: Why not?

Sir Nicholas Macpherson: In operational areas, I think it is quite important. In the area of the Treasury that the money comes into every day and goes out every day, which from my perspective is perhaps the biggest risk—if there was some cyber attack, literally billions go through it—there are very regular exercises.

Chair: I am thinking more about economic and financial crises.

Sir Nicholas Macpherson: We set up something called the Financial Policy Committee in the Bank of England, which Treasury attends.

Q235 Chair: You are the lead Department for managing financial and economic crisis, aren't you?

Sir Nicholas Macpherson: Yes, we are.

Q236 Chair: It is ironic that monetary policy, macroprudential policy and microprudential policy—the 3-M regime—are all delegated by statute to the Bank of England.

Sir Nicholas Macpherson: We are responsible for the framework. If that framework is found wanting, we are in the firing line.

Q237 Chair: The Bank of England is responsible in turn directly to Parliament, rather than to the Treasury.

Sir Nicholas Macpherson: Yes, but we set the Bank of England's remit.

Chair: What they do is laid down in statute. You do not set their remit. It is laid down by Parliament in statute.

Sir Nicholas Macpherson: Parliament agrees the framework. Within that generalised framework, there are things like an annual remit letter from the Chancellor.

Q238 Chair: Haldane, the economist at the Bank of England, in November described how, in each of these areas, the Bank has "goal independence", "instrument independence", "committee-based decision-making" and accountability to Parliament. He did not mention the Treasury oversight.

Sir Nicholas Macpherson: There are people in the Bank of England who occasionally forget the importance of the relationship with the Treasury, not least because we have a memorandum of understanding that covers crises. At the point when public money is put at risk, the Bank is under an obligation to inform the Treasury. From then on, in a crisis, it is open to the Chancellor to direct the Bank of England. To answer the question, "Who is in charge in a crisis?" the Chancellor of the Exchequer is in charge at that point.

Q239 Chair: Do you not think that, given that the Bank of England appears to have forgotten the role of the Treasury, there is scope for some confusion about accountability for the management of economic and financial crises in the present set-up?

Sir Nicholas Macpherson: I am pretty confident that Governor Carney is fully apprised of these arrangements and understands them. Having worked with him very closely over the last 18 months or so, I am very confident that, in a crisis, he will know the boundaries of the Bank's role, as well as the role of the Treasury.

Q240 Kelvin Hopkins: I have just a quick question following what you said. One of the most important features of the Treasury in the past is that there has been a range of views within the Treasury. I know at the time of the 1967 devaluation there were people in the back room looking at the devaluation case, while the others were defending the value of the pound as it was. To what extent do you now accept that you need to have dissenting voices around, hear some dissident voices, some people putting alternative views? For example, there are things like the fact that we have a massive balance of trade deficit with the eurozone. Should we not look at the possibility of encouraging a depreciation of sterling? That is what normal economists would suggest.

Chair: That was more of a policy question than a machinery-of-government question.

Sir Nicholas Macpherson: It is very important to have dissenting voices. You really do not want a Stalinist monolithic line. Indeed, I can remember at one point earlier in this Parliament the Chancellor was quite keen to have in each meeting, when discussing macroeconomic policy, a devil's advocate, whose role it was to put a completely different view. I think that enhanced the quality of discussions.

Q241 Mrs Gillan: Just a very simple question: I have recently become aware of the 30-year record of the Institute of Risk Management, which is very keen on making sure that senior officials have risk management training. How many of your senior officials have formal qualifications in risk management and do you have an ongoing training programme to make sure that your officials are fully trained?

Sir Nicholas Macpherson: I am not aware of people having professional qualifications over and above specific qualifications from the Institute of Risk Management, but we have sought to embed risk management in pretty much everything we do. Our training and development reflects that.

Q242 Chair: How have you brought in external expertise on that, given that economists do not do risk management? They do trend analysis and closed systems.

Sir Nicholas Macpherson: I do not accept your charge against economists. The Government Actuary has come and given his view around risk management. I also should say that I chair a heads of analysis group across Whitehall, and the chief scientist is also quite a lively contributor to that process.

Q243 Chair: Given that started with "I don't know", could you send us a note about what formal training you do?

Sir Nicholas Macpherson: Yes, certainly.

Mrs Gillan: That was exactly the point I was going to make. I would like to know exactly what your training programme is and how many people you have within the Treasury who are qualified.

Q244 Greg Mulholland: Sir Nicholas, looking at the aims of the Treasury and ways of working, do you understand the criticism levelled at the Treasury that a lot of the aims and objectives seem to be very much focused on aims and objectives that do not necessarily have an end—ongoing things—focusing perhaps on "how" rather than "what"?

Sir Nicholas Macpherson: I see the point you are making. Generally in organisations, it is quite handy to have timeless overarching objectives but then, underneath those objectives, you want some time-limited sub-objectives or targets that will focus activity. For example, getting debt falling by a certain date, in my view, helps to concentrate minds.

Q245 Greg Mulholland: What would you say the Treasury's long-term objectives are?

Sir Nicholas Macpherson: The Treasury's long-term objectives are primarily around creating macroeconomic stability, supporting policies that improve the trend rate of growth of the economy and seeking to keep the public finances in a stable position.

Q246 Greg Mulholland: Do you accept any of the criticism and the suggestions going back to the idea of the difference between a finance and an economics Ministry? There are tensions there, and the Treasury should concentrate on one more than the other, and perhaps should relinquish some of those functions, for example to BIS, in terms of driving the economy. Do you accept that managing the finances is a very different job from building a competitive economy?

Sir Nicholas Macpherson: The issue that you have highlighted is whether you seek to internalise those tensions or externalise them. There are two perfectly good models. One is you seek to ensure that there are people who are concerned with economics Ministry objectives within the Treasury. Over the last 15 years, we have had something called the growth unit, whose primary focus is improving the growth of the economy and of productivity, and will seek to ensure that public finance decisions are taken in a way that is consistent with supporting economic growth rather than damaging it.

There have been, under both Labour and Conservative Governments, some quite important successes. To give you one example, when I was controlling public spending in the early 1990s, the Treasury did not distinguish capital from current spending. That meant that, when you had to cut public spending, there was a natural bias towards cutting capital. One of Gordon Brown's biggest reforms was separating out the capital budget from the current budget.

Similarly under this Government, the current Chancellor has put a huge emphasis on infrastructure and we now have a National Infrastructure Plan. It is possible for a finance Ministry to have quite a strong economics Ministry function within it, which can result in better public spending decisions. Of course there is a role for the Department for Business, and the Department for Business and the Treasury work quite closely together. To repeat what I said earlier, I am not convinced that rearranging the deckchairs in Whitehall will necessarily result in better outcomes.

Q247 Greg Mulholland: You reject the charge of fiscal fundamentalism?

Sir Nicholas Macpherson: Someone has to represent the taxpayer in trying to reduce the rate of growth of public debt. Some institution has to focus on trying to reduce debt as a percentage of national income. If that is fiscal fundamentalism, I am happy to own up to it.

Q248 Greg Mulholland: In terms of the Treasury's overarching role that it clearly has in the current structure, there has probably been a sense of that being a more dominant force than perhaps it has been in recent political history during this Parliament, due to the economic crisis. To what extent do you think the Treasury is able to break down barriers that clearly exist? Some of these issues clearly are cross-departmental, and yet the perception that we sometimes have is that the Treasury is simply looking at each Department and saying, "You can spend only this and you must not break these certain rules." How do you think the Treasury is able to and is actually dealing with those cross-departmental structures and able to break down some of those barriers?

Sir Nicholas Macpherson: The Treasury does have a role in seeking to do that and, indeed, perhaps one of the most important things both the Cabinet Office and the Treasury can do is to seek to address cross-departmental issues. To use an example that is quite current, the relationship between the National Health Service and local authorities that are responsible for social care is absolutely critical because, left to its own devices, you can squeeze one bit of the system, but the problem just re-emerges somewhere else.

The Treasury does have an obligation and duty to put these issues on the table and ensure that as part of processes like spending reviews they are squarely addressed. There have been experiments in pooling budgets across Departments to deal with specific issues. I would be in favour of extending those experiments. Ultimately, not least because of Parliament, someone has to be accountable for spending. Yes, you need to find cross-departmental structures that support the right decisions but, ultimately, one individual Department has to own the budget.

Q249 Greg Mulholland: My final question, Chair, is just to pick up on the reports from the National Audit Office in December last year, which noted that the Cabinet Office is seeking to influence a growing proportion of Government spending. Is that a change? Are there tensions there? Is the Cabinet Office seeking perhaps to dictate the role of the Treasury in a way that has not happened before?

Sir Nicholas Macpherson: It comes back to the point that you raised earlier about "what" versus "how". Ever since I can remember, you have needed some focus at the centre that is not only focused on efficiency but has some of the skill sets necessary to facilitate progress on efficiency. Those happen to reside in the Cabinet Office at the moment—IT, for example. I am wholly relaxed that the Cabinet Office should take the lead on that. There has been a good relationship between the Chief Secretary and the Paymaster General, Francis Maude, in ensuring joined-up working between the Treasury and the Cabinet Office. I am supportive. You have the Chief Executive of the Civil Service, John

Manzoni, coming before this Committee. You can see whether he thinks it is working, but I think it is.

Q250 Mrs Gillan: Just to go back to the question before the last that Mr Mulholland asked you, in my experience, and I am sure you would support it, cross-departmental working is always the most testing and trying, but you now have another dimension that is testing and trying, which is the changes that are taking place with devolution, and the fact that tax and spend is no longer entirely in your bailiwick. Are you working effectively with the devolved Administrations and would you say that there are increased risks because of the nature of the devolved matters, in the way it is developing? In fact, I am going to press you a bit further to say if you think, in some ways, you are in fact losing some valuable control.

Sir Nicholas Macpherson: My answer to that is that time will tell. I am thinking very much of Scotland and the Smith Commission settlement. If we can secure a really good funding framework, which the Smith party is committed to, this is potentially a big prize, because the role of the Barnett formula will be reduced considerably. Scotland will be responsible for funding far more of its spending through direct taxation on the Scottish people. That may enhance accountability in Scotland and may make our job easier. That is the sunlit uplands.

If we fail to negotiate the right funding regime, which then distorts behaviour and activity, then things could be worse. All of this is a long way of saying that getting that right is one of my biggest priorities.

Q251 Mrs Gillan: What you are really saying is that there are quite substantial increased risks from the road down which devolution is taking us at the moment.

Sir Nicholas Macpherson: I would say that there are increased risks, but also increased opportunities. If we get this right, we could solve a problem that I have been uncomfortable with ever since devolution, which is that the Scottish and Welsh Governments were responsible for allocating a huge amount of money but, unlike any other Parliament in the world, had absolutely no real responsibility for raising revenue. That in my view distorts behaviour. It is a bit like departmental behaviour when Departments spend their whole time focusing on how to get money out of the Treasury, rather than trying to make that money deliver something. It encourages inefficiency. There are opportunities for Scotland and also Wales. Northern Ireland has always been different, and the deal before Christmas was very positive. Inevitably, it involved the Treasury getting its chequebook.

Q252 Chair: Just before I bring in Paul Flynn, just to pick up on something you have said in this section, you are concerned about growth and productivity, and maximising the performance of the economy. Someone like Martin Wolf is concerned about this too, and about secular stagnation and chronic productivity inefficiency, which you also referred to, but then you say the Department is mainly about macroeconomic stability, which is delegated to the Bank of England, and public finance stability, which everyone would accept the Treasury does as a very clear top line.

Sir Nicholas Macpherson: I also said raising the potential growth of the economy.

Chair: My point is how you deal with that challenge. What are the mechanisms? It is a lovely aspiration to have, but what is the Treasury plan for raising productivity or dealing with secular stagnation, which is the sort of thing that Martin Wolf thinks is a major challenge?

Sir Nicholas Macpherson: First, a note of caution: every Government since the war has been determined to raise the trend rate of growth of the economy. The trend rate of growth has remained stubbornly stable, at around 2.25%.

Chair: The Treasury has remained the same as well.

Sir Nicholas Macpherson: All that said, what we have sought to do is to break down the individual components of potential growth. I mentioned infrastructure. Investment in infrastructure is one component, skills is another—it is easy to talk about, but very difficult to make a real difference—and competition. We have a framework. We have been very focused in recent years on issues around planning and housing, which have often constrained growth in economies. We regularly review this. We have a team in the Treasury that is solely focused on this. My colleague, John Kingman, who is the Second Permanent Secretary, has made his life's work this growth business, so it is prioritised and we do look at it.

Q253 Paul Flynn: The morning's papers carry news that Nuclear Management Partners is about to lose their £9 billion contract. Is this true?

Sir Nicholas Macpherson: I have not looked at this morning's newspapers.

Q254 Paul Flynn: Let us go into this a little. In 2008, I had a debate in the House criticising the award of the contract, which was made that year, on the basis that the risks were uninsurable and therefore had to be pooled by the public purse. Any profit would be taken by a private company and the whole set-up was unworkable. That was debated. I followed that up as recently as 24 February, when I put a dozen questions about the contract. This matter was taken up a little later, based on the same information, by the Public Accounts Committee. This is a £9 billion contract, which is predicted to fail and has failed, at a loss of an unknown number, certainly hundreds of millions of pounds, to the taxpayer. Do you feel some responsibility for that?

Sir Nicholas Macpherson: What I would like to do is write to you setting out our view on this issue. I have not come fully prepared to discuss this contract. In parenthesis, I would say one positive development in recent years has been whole-of-Government accounts, which force us to make provisions for nuclear decommissioning along with medical negligence. This has provided quite an important discipline to the Treasury, in thinking about this in an improved way.

Q255 Paul Flynn: Just as a general principle, are you happy for the public purse to take all the risk, as I pointed out as clearly as possible in 2008, and for the private company, a foreign company, to take any profit that will come out? Is that an abiding effort for the Treasury?

Sir Nicholas Macpherson: Put in those terms, I would never be happy with any contract like that. Ensuring that risk is borne in the right place is one of the biggest lessons of the financial crisis. I do not want to get into this individual issue, because I am not sufficiently informed about it.

Q256 Paul Flynn: I will take another contract, on which I am sure you are sufficiently informed, because it is a recent one, and that is Hinkley Point C, which is run by the French and the Chinese. British money was pulled out of it, quite sensibly. You have agreed to a contract, in this time of falling fuel prices, particularly with fracking in America and oil in the world, to guarantee a price of £92.50 per megawatt hour, which is twice the present going rate for electricity, and you have guaranteed it for 35 years. You have backed this up with a £10 billion loan of our money and you have guaranteed that price for that long period to the French and Chinese, who are running this. Is this sensible planning?

Sir Nicholas Macpherson: It is sensible planning to increase capacity in the energy sector, and it is also a sensible strategy to have a sufficiently diversified energy sector. Clearly there has been a very precipitate fall in the oil price over the last two or three months. The big issue is how long that is sustained for.

Q257 Paul Flynn: Could I put it to you that the most fragile way to produce electricity in the world is nuclear? After Fukushima, and these disasters take place about every 10 years, like Chernobyl and Three Mile Island, there is a loss of faith in nuclear, and 52 reactors were closed down in Japan. Reactors were turned down in Germany and many other countries because of a loss of confidence. We have two nuclear power stations being built in Germany, and one in Finland, which started to produce electricity in 2009. It has not produced enough yet to light a bicycle lamp and it is billions over budget. There is a second one at Flamanville, which I believe is five years out of date, which is similar—billions and billions of pounds overrun. If there is a disaster, those two power stations would probably never be allowed to generate. Do you really have faith, so much faith in this power source, that you are willing to give away £10 billion of taxpayers' money on a speculative venture and guarantee the price for 35 years? Is there any precedent for this?

Sir Nicholas Macpherson: I have not come here fully prepared to have a debate on energy policy, but I would be really pleased to come back to you on your main point, which is that, with the fall in the oil price, is it sensible to be guaranteeing an energy price at that level?

Q258 Paul Flynn: Just the final point: we have talked about the value of hindsight and foresight and horizon scanning. The reason why I shall offer myself as a candidate in the election next year is because I have the habit of being right on many of these issues, including the Afghan war, when many others were wrong. Would you agree that this proves that the abiding ethic of the Civil Service is the unimportance of being right? For those who said that this contract with Nuclear Management Partners and Hinkley Point C was a good idea, their careers would blossom. I am sure there must have been some sensible civil servants somewhere who said, "Look, this is a disaster. We cannot give this contract in 2008 to this company. It cannot possibly work." Their careers would probably wither. They are probably out doing the gardening now. Is this not true? Why do you not take responsibility for this?

Sir Nicholas Macpherson: It is very important that civil servants tell Ministers how it is.

Paul Flynn: Why did they not?

Sir Nicholas Macpherson: Another lesson of the recent years is that it is very important indeed. I would like to think that, in recent years, I have given Ministers a number of messages that they have not wanted to receive, but this goes with the job.

Q259 Chair: How have you assessed the risk in the Hinkley Point case? If it all goes terribly well, EDF will make a profit, but if it all goes pear-shaped, the taxpayer will have to bail it out with their £10 billion guarantee?

Sir Nicholas Macpherson: This is a very tricky issue.

Chair: How do you assess the risk?

Sir Nicholas Macpherson: You assess it by doing a number of simulations, both in terms of the energy price but also in understanding what comes back to the state, what the state picks up and ultimately what it is paying for. As I said, I would be happy to come back to Mr Flynn on this issue.

Q260 Paul Flynn: Is it not the definition of madness to do things that go wrong and then keep doing them? You have not learned the lesson of 2008, and it is a huge loss to the public. You have committed the same mistake now at Hinkley Point.

Chair: Point made. You will write to us—

Sir Nicholas Macpherson: I will write to you. These are good questions and they deserve a proper answer.

Chair: About both contracts: what risks did you fail to assess in the 2008-09 contract, which has now gone pear-shaped, and what lessons have been learned that we can see have been learned in the assessment of Hinkley Point risks? Thank you.

Paul Flynn: I shall look forward to the letter with great interest.

Chair: I have asked if it can come to me, if that does not matter, but by all means copied to you.

Q261 Mr Evans: We will move on to spending control now, which deals a little bit with Hinkley Point C as well. What sort of management takes place to ensure things like long-term maintenance on roads, for instance, and potholes versus emergency money having to be doled out this winter, in order to make up for the shortfall of maintenance over a much longer period of time?

Sir Nicholas Macpherson: The first point is that the Treasury cannot be an expert on potholes, so it has to rely on the Department for Transport, which I would hope contains people who really do understand potholes, what drives them, how often they occur and the economic damage they do when your car suspension, like mine, has been rather badly affected by them.

This is an area where we have made improvement in recent years. We have developed a methodology where, at least as far as capital projects are concerned, we can line them up in terms of their economic return. We can then advise Ministers, "Here are 100 projects. Project No. 1, in our view, has the highest economic return. Project No. 100 has the lowest." If they then want to prioritise some particular area, that is a matter of political choice, but it is the role of officials to give them the best evidence base possible. The Department for Transport has always been quite good at looking at individual transport projects; the challenge is to compare a transport project with, say, a project building a new science centre or a new defence asset. The Treasury is in a better place to do that.

Within departmental budgets, the Treasury cannot seek to determine where all spending takes place, so we delegate. My guess is on potholes that there is a choice between how much money is given to the Highways Agency to spend on refurbishing the M1 and how much to give to local authorities to deal with local potholes on roads around towns, villages and so on.

Q262 Mr Evans: There are competing demands on short term versus long term. In a period of economic austerity, the temptation must be to forgo repairing the roof or maintaining the roof, waiting until the crisis happens when we have gale force winds and half the roof goes missing.

Sir Nicholas Macpherson: Getting that balance right is a challenge. It reminds me of flood defences, which we also looked at in the context of trying to line up which projects had the biggest return. If you feed the wrong assumptions in about how many floods you are going to have, you may get suboptimal outcomes.

Having said that, I am always quite surprised that Governments can take very long-term decisions. Successive Governments have taken quite big decisions on pensions in this country, and indeed the age of retirement, which have very big long-term financial consequences, but which really have virtually no consequences in the short run. It is tempting to think that there is something about Government that is all terribly short term, but this country, perhaps more than a number of countries in Europe, has addressed some of the demographic challenges.

That is not a party-political point. One of my first jobs in the Treasury was at the time of the Fowler reforms in the mid-1980s. I was quite impressed even then by the interest Ministers had about spending in 2030. We are now 30 years nearer 2030, but those decisions have made the British long-term public finances far more stable than if those decisions had not been taken.

Q263 Mrs Gillan: Can I just ask a supplementary to that? I have a great deal of interest in one very highly expensive project called HS2. It is currently being quoted as costing £50 billion at 2011 prices. Do you feel that the Treasury is always entirely honest about the cost of these projects? To be quoting figures like this on a long-term project at 2011 prices is hardly transparent. Surely on many of these projects, such as HS2, they do not fulfil the cost/benefit provisions that the Treasury itself has set.

Sir Nicholas Macpherson: I can understand why you would raise that issue. I need to be very careful what I say about HS2.

Q264 Mrs Gillan: Why?

Sir Nicholas Macpherson: I am here to explain Government policy.

Mrs Gillan: Your caution is commendable, but it is a very serious question. This is one of the biggest spenders, far bigger than Hinkley.

Sir Nicholas Macpherson: It is a very serious question. It was interesting as a case study. There has been quite a lot of debate about the return.

Mrs Gillan: Which is dubious, obviously.

Sir Nicholas Macpherson: You will recall that the Department for Transport has returned to this several times, and it has raised interesting issues around whether people work on trains.

Mrs Gillan: That has already been discounted as rubbish, because people do work on trains.

Sir Nicholas Macpherson: Speaking for myself, I prefer one-and-a-half-hour journeys to 40-minute journeys. It does raise important issues, which is why it is very important to have an agreed framework for measuring costs and benefits. It has been put to me that the

Treasury would be against every single big project in Britain. I keep trying to find out whether the Treasury was against the M25 or not, but it has been put to me that the Treasury was against the M25. Occasionally, politicians can be more visionary than desiccated Treasury officials, who know the price of everything and the value of nothing.

Q265 Mrs Gillan: Can I just ask you—I am obviously bearing this project in mind—at what point the Treasury turns around and says, "We have looked at this. The original assumptions that were made are incorrect, and we have now studied this project in more depth"? You have made a point of saying that assumptions change and that assumptions can be incorrect. At what point does the Treasury make that clear and try to influence?

Sir Nicholas Macpherson: That is a really good question. The Treasury does not just sign-off something like HS2 and say, "Here is £70 billion. See you in 50 years' time." This is a big component of the nation's capital budget and it is something that we really ought to come back to fairly regularly in the context of spending reviews. Even within a project like HS2, there are quite a lot of variables for which you do not have to take decisions absolutely immediately. It is Government policy that HS2 goes ahead, so it will go ahead, and when it goes ahead, the Treasury will continue to be all over it. We have a huge interest in this money being spent wisely and on its own terms having a successful project. Again, we work with the Major Projects Authority in the Cabinet Office to ensure that that happens.

Q266 Mrs Gillan: The Major Projects Authority reports have been suppressed, so we are not able to see, even parliamentarians and the Committee working on the Bill at the moment, the risks. Is it not basically true that the architecture at the moment means that you, in effect, do not have any spending controls on a project such as this?

Sir Nicholas Macpherson: I think we do, but these are still very early days.

Q267 Mrs Gillan: It is a very tenuous and very fragile control that you have on this project.

Sir Nicholas Macpherson: I would not say "tenuous and fragile".

Q268 Mrs Gillan: What words would you use to describe it? "Commanding and totally in control"?

Sir Nicholas Macpherson: We have the right controls in place. If there is any question of this going over budget, we will be very firmly involved in determining what happens next.

Q269 Mrs Gillan: Could you let the Committee know what your critical path is and what your controls are, and also what the up-to-date pricing—the latest pricing—on this project is? As I say, all of this is quoted in 2011 prices. It would be most useful to have a current statement before the election period and before Parliament prorogues.

Sir Nicholas Macpherson: I will see what I can do, and there will be an opportunity to return to this issue in the next spending review.

Q270 Chair: Presumably the Treasury does publish its advice on benefit/cost analysis of projects like HS2 and other public sector projects.

Sir Nicholas Macpherson: Certainly cost/benefit assessments are published as part of these projects.

Q271 Chair: Is there any reason why, for example, the Treasury has not already published the cost/benefit analysis on the various airport options, for example?

Sir Nicholas Macpherson: We have tasked Howard Davies to review airport options, and he will be reporting in due course.

Q272 Chair: You do not need to comment on the conjecture I am making, but historically the Treasury has always been in favour of another runway at Heathrow. What does the Treasury do to assess the political risks to the deliverability of the various different options and factor that into the equation about such a decision?

Sir Nicholas Macpherson: The Treasury is just officials. We are here to serve Ministers.

Q273 Chair: You are there to provide advice. I am asking how you provide advice about the various risks attached to the deliverability of various options. Some of us would argue that there is no point in favouring Heathrow because the political risks are so high. They have defeated it twice; what is the evidence that it is not going to be defeated again?

Sir Nicholas Macpherson: You have to be realistic. I am a Treasury official. There are certain things that you tend to feel strongly about when it comes to controlling expenditure, but you have to be realistic. There is no point in me fantasising about abolishing the retirement pension or something, because I have to overlay what is politically deliverable.

Chair: Some would say that people are fantasising about another runway at Heathrow.

Sir Nicholas Macpherson: I am not fantasising on anything to do with that.

Chair: You get the gist of what I am saying. It is about how you give advice to Ministers.

Sir Nicholas Macpherson: I do get the gist. That is why you need iteration. There are some things that are just fundamental constraints. If it is Government policy, say, to protect the aid budget, there is no point in me going back and saying, "You should not have made that commitment," because that is politics. You are elected on the basis of commitment.

Q274 Chair: I understand exactly that point, and you are not there to publicly make an alternative case. What I am asking about is whether you do analysis in order to challenge what you might be presented as fait accompli, so that Ministers are confronted with the consequences of what they have decided to do?

Sir Nicholas Macpherson: Yes.

Chair: I will come back to the aid point, and on HS2 you will publish the benefit/cost ratios?

Sir Nicholas Macpherson: I will come back to you on HS2.

Mrs Gillan: I would be very grateful. Thank you very much.

Q275 Kelvin Hopkins: Could I just follow this line of questioning a little? We understand that, clearly, Ministers make decisions in their vanity, and land them on you to deal with. You then have to say, "Minister, this is going to cost an enormous amount of money. The cost/benefit analysis is complete nonsense but, nevertheless, if that is what you want to do, we will have to do it." I understand that, but I would hope that, behind the scenes, you would remonstrate with Ministers very strongly if they were doing something that is nonsensical in economic terms, because of the cost/benefit analysis.

Sir Nicholas Macpherson: We have lively discussions. If something is on the Treasury's budget and it is manifestly poor value for money, I would seek a direction and that would be published in the usual way. My job as an official is to support, occasionally challenge and seek to deliver the democratically elected Government's programme. Along the way, I would hope under any Administration there would be lively exchanges of views and that Ministers would welcome those lively exchanges of view, because they are delivered in a heartfelt and sincere way.

Q276 Kelvin Hopkins: I do not want to go into all the *inaudible* [11:02:11] but there is one area where the Treasury could have advised Ministers not to go ahead in the way they did, and that was PFI. Building Schools for the Future was a very expensive programme. This was done based on a PFI approach. I have an example. My local sixth-form college was rebuilt on public borrowing and saved an enormous amount of public money because of that. We now are landed with a gigantic long-term burden of payments on PFI schemes. Did the Treasury not say to Ministers, "This is nonsense; we should do it by public borrowing, because it will cost the Treasury a lot less."?

Sir Nicholas Macpherson: There has been a continual debate about PFI in the Treasury pretty much ever since I can remember. I worked with Ken Clarke very closely in the 1990s. He was a Chancellor who really embraced PFI, and for a good reason. You quite rightly focus on the bad aspects of PFI. I do think its effect has really been to improve public sector procurement. Going back to the early 1990s, there were some pretty disastrous public sector projects that were not delivered at cost and on time. I know there are some bad PFI examples, but there are plenty of good ones where projects were delivered to budget and on time and everybody has lived happily ever after.

Where I totally agree with you is this is something that you have to continually come back to; you have to learn the lessons from it. There have been some really ropey PFI contracts, but there is nothing intrinsic. You are raising an age-old question about, when you are procuring something for the public, the point at which the private sector's role ends and the public sector's begins. I can contract in a whole lot of different ways. As a Treasury official, what I would really like is continually to look, compare and contrast the costs and benefits of different modes of procurement, and not to let short-term concerns about the effect on the balance sheet inform activity. That way disaster lies. With the benefit of hindsight, the Treasury should have been more neutral on this balance sheet issue. There were various points when we probably colluded with a desire to get projects off the Government's balance sheet.

Q277 Chair: That was a very honest answer. I want to wrap this up as quickly as possible. I just want to make one or two further points, and ask one or two further questions. I do not think anybody now defends the quality of the Strategic Defence and Security Review. Certainly the Institute for Government concurs with the view that it was rushed and it was a cost control exercise. It lost its strategic oversight. We have gaps in maritime reconnaissance and cybersecurity, and one other area that I am told I am not allowed to talk about. Looking back, what lessons have you learned about SDSR and what we failed to risk assess as we made these cost reductions? How is it going to be different next time?

Sir Nicholas Macpherson: The political class and indeed the official class need fairly early on in the next Parliament to have a very grown-up conversation about what this country needs to prioritise.

Q278 Chair: Can you explain why that did not happen in 2010?
Sir Nicholas Macpherson: It did. It is axiomatic that it did.

Q279 Chair: It got short-circuited at the end, didn't it?
Sir Nicholas Macpherson: There is a risk that, if you try to do something that is of a scale of a strategic defence review to meet a very early public spending timetable, something is going to give. This is an issue for Parliament, Ministers and officials. There is a prior question about what this country wants to prioritise. If you want to have defence forces that can influence events in certain places successfully, you have to pay for that.

Q280 Chair: In terms of your institutional priorities, is it fair to suggest that you would like to get a public spending round or even a comprehensive spending review done as quickly as possible, within a certain time frame?
Sir Nicholas Macpherson: Last time round we had to—

Chair: The answer is yes.

Sir Nicholas Macpherson: The answer is not yes.

Q281 Chair: One of the things the Institute for Government says in their paper is that there needs to be much longer to allow collaboration between Departments—proper conversations—to balance different risks against each other of cutting or adding to different programmes, and that time has not traditionally been allowed in the annual public spending round. For all the energy that goes into it—it is the thing that obsesses Whitehall every year—it is not that kind of collaborative, co-operative process, is it?
Sir Nicholas Macpherson: We have moved in the last 10 years or so to far less frequent Spending Reviews. We had a spending review in 2010. There was a brief update in 2013, just to get us through 2015-16. We have no spending plans beyond 2015-16 so, one way or another, there is going to have to be a way fairly early in the next Parliament for determining, at the minimum, plans for 2016-17 but, ideally, a public spending review that can set plans for the whole Parliament.

Q282 Chair: Fine, but who holds the responsibility in Whitehall for comprehensive financial planning for Government?
Sir Nicholas Macpherson: The Treasury.

Q283 Chair: Yes, but all the evidence points to the fact that you are much better at controlling totals—budgeting for Departments—than active financial planning. Can I give you another example? I will give you two examples briefly. In the 2009-10 review, the Treasury squeezed £150 million out of the Ministry of Defence, which came out of the carrier programme by delaying it by 18 months. That added £1.6 billion to the programme. That is not very good financial planning, is it?
Sir Nicholas Macpherson: I do not think that is necessarily our finest hour. I have read the transcripts and you have made this point before.

Chair: It is seared on my imagination as an absolutely appalling episode.

Sir Nicholas Macpherson: It is something we should learn from.

Q284 Chair: How do you learn from that? What do you learn from it?

Sir Nicholas Macpherson: I learn from that that, if you are going to delay things, you have to be very clear on what impact that delay will have. It may be that something had to be delayed, and delaying that was the least expensive option.

Q285 Chair: Let's have another example. The Environment Agency came before us, and I have a very clear example in my constituency of a deteriorating seawall. It would have been much cheaper to maintain that seawall than to do a capital programme to repair it, in cash terms, but because you now favour capital expenditure over a revenue expenditure, it is more difficult for the Environment Agency to spend revenue mitigating the deterioration of an asset than to capitalise in a new asset. They have complained to us about it. That is not very good financial planning.

Sir Nicholas Macpherson: Inevitably people complain about things that have gone less well. I was singing the praises of separating out the capital budget but, from time to time, there are times when you want to be able to move money across into current spending and, assuming this case study is true, that is a good example.

Q286 Chair: When we did the 2010 review and the politicians decided to protect certain budgets and not other budgets, did it surprise you—it surprised me when I discovered it—that we have cut the intelligence and security budget?

Sir Nicholas Macpherson: The big challenge for the next Parliament, the big question, is what programmes the main political parties, in their manifestos, promise to protect.

Q287 Chair: The question is about not what political directions you are going to be given, but what advice and analysis you present to Ministers about the risks of, say, squeezing the security budget.

Sir Nicholas Macpherson: The Treasury is not comfortable with input targets. Any input target will inevitably constrain the Treasury's room for manoeuvre. I totally understand why politicians feel it necessary to make commitments on inputs, and the 0.7% commitment on overseas aid is a classic of its kind. As far as I can make out, all the main political parties are completely committed to this, but it is an input target and it therefore constrains the choice you have.

Q288 Chair: Do we not need three new ingredients to public spending management? We need time when we are doing public spending rounds. We need different incentives, so it is not about stopping Departments ganging up on the Treasury; it is about getting them to collaborate to decide rational priorities. For example, what co-operation is there between FCO, which is being cut, and DFID, which is being expanded? I am not talking about what FCO delivers; it is about their back office, their objectives and their integration. What co-ordination has there been between the two Departments to ensure they maximise the synchronicity of their goals, objectives and plans, and what they are delivering to maximise value for money? Where is it?

Sir Nicholas Macpherson: Funnily enough, by necessity, there is much more co-operation between DFID and the Foreign Office. I recognise all the points you are making and they are very fair points; your point about incentives is really important. The Treasury continually reviews the sets of incentives. The one caveat I would make is that sometimes, you do not have time. In an ideal world, we would all be philosopher kings. We would all co-operate and we would have a really good in-depth review. After two years, we come up with the answer. Sometimes, you have to address the public spending issue before it is too late.

Q289 Chair: The result is, as you have pointed out, that we have cut local government by 40%. Adult social care is not a mandated programme, so our A&Es are filling up with patients who should be looked after at home and the beds are all being blocked by people who should be looked after at home. My local CCG is now working out how to give money to Essex County Council, so the health service is going to pay for the adult social care that is being cut as part of our great public spending control programme. It does not seem very rational. It is the left hand not knowing what the right hand is doing, and the Treasury oversees this.

Sir Nicholas Macpherson: I am confident we can make progress on these issues.

Q290 Chair: You talked about, for example, ensuring decisions are taken to promote growth and productivity, rather than to prevent it, earlier. Sir James Dyson says that we are going to need 200,000 engineers in this country to re-industrialise our economy and to deal with all the demands. Why are we cutting 16-to-19 education? Every sixth-former in the country is suffering a squeeze because other programmes have squeezed that programme. Where is the management of the flow of A-level students into engineering?

Sir Nicholas Macpherson: There were many years when spending on 16-to-19-year-olds was being expanded and it did not necessarily seem to give Mr Dyson—

Chair: The Secretary of State said that 16-to-19 education had been cut "by accident and not design".

Sir Nicholas Macpherson: Can I give you a counter-example of a positive development?

Chair: I am sure there are some.

Sir Nicholas Macpherson: I wanted to come here with good news today. The Treasury recently published its latest National Infrastructure Plan. Through that plan, and you have been talking about the long term today, we have homed in on a critical constraint to infrastructure in London, which was tunnelling skills. There is a lot of tunnelling going on. There is Crossrail; there is the water tunnel; there are interesting projects for north-south tunnels. On the back of the Infrastructure Plan, the Treasury convened meetings with the industry specifically to address this point. I just use that as an example of where sensible Government planning, in terms of an indicative view of the future, is rather similar to Mr Hopkins's view of the Department for Economic Affairs. I just want to give you that positive insight.

Q291 Chair: I absolutely applaud this, but we need more of it. The question is how we are going to get more of it. We promoted Mr Kelly, who was in charge of budgeting, and he now does budgeting as a DG as opposed to being a D, a Director. He has a relationship with the new Chief Executive of the Civil Service, who is very ambitious in this field and certainly does not recognise what we currently do in Whitehall as financial planning, in terms of what the private sector does in a large business. What is your vision for replicating what we are doing on tunnelling skills across all the major programmes of Whitehall in order that we manage our public expenditure much better?

Sir Nicholas Macpherson: It is going to start very soon, and I should have brought Mr Kelly with me to explain what he is doing, because there are quite a lot of exciting things going on to promote better financial management. John Manzoni is a critical part of the solution. Again, I do not want to read, not least because I have not brought it with me, our financial management strategy, but we get the point that this is important, and we are going to prioritise it far more. We are going to have fewer economists and a few more strategic financial managers who work in the Treasury.

Q292 Chair: We have Mr Manzoni in front of the Committee tomorrow, if you want to have a conversation with him before he appears before us. You have an opportunity.

Sir Nicholas Macpherson: I will advise him accordingly.

Q293 Chair: I put it to you that the Treasury has historically done budget setting and is not geared to doing financial planning. In other systems—Canada, Belgium, Germany—financial planning in Government is a separate role and held in a separate Department. This is completely different from having a Department for economic affairs. I do not agree with that. Why should we not consider this kind of separation of tasks? You are responsible for financial planning but you are not delivering it at the moment.

Sir Nicholas Macpherson: You could do. Look, we are committed to getting better at this. I would argue that, if we fail, maybe your solution is the answer. I just would not move straight to an office for management of the budget. I am not certain that that works any more effectively than our set-up, but I am willing to be persuaded that the Germans do it better than we do.

Q294 Chair: Where does the Cabinet Office fit into your vision?

Sir Nicholas Macpherson: The Cabinet Office is very important. You can change the boundary between the Cabinet Office and the Treasury, but the most important thing is how the Cabinet Office and the Treasury work together. When we work together effectively, we can make quite a big difference. Too often in the past, various institutional issues have obstructed progress.

Q295 Chair: How important is it that the Treasury, as the economic affairs Department, has ultimate say over the absolute total of public spending and borrowing?

Sir Nicholas Macpherson: That is important. That finance Ministry role of determining what the country can afford is of critical importance. You do want a bit of institutional tension, certainly between No. 10 and the Treasury in that regard. If this was all subsumed in some monster Cabinet Office Department, I would worry where it would all lead.

Q296 Chair: Economists do not do very good financial planning, do they? They do game theory.

Sir Nicholas Macpherson: Some are clearly better than others. I am less pessimistic than you are.

Chair: Thank you very much. You have been very frank with us, and it has been a very helpful session. We have kept you over time and I apologise to you for that, because I know you had another appointment. I do apologise, but thank you very much indeed.

Sir Nicholas Macpherson: Thank you for inviting me. It is always a privilege to appear before this Committee.