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Secretary of State for Trade and Industry

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2 June 1986

The Rt Hon John MacGregor OBE MP
Chief Secretary
HM Treasury
Parliament Street
LONDON
SW1P 3AG

Prime Minister?
DGR 2/6

Dear John,

PES

The only bids which I am submitting for a net increase in provision are for my R&D budget. Before I set out the detailed case I would like to draw your attention to the table in Part I of the last Public Expenditure White Paper (copy attached) which shows my Department's provision declining in cash terms by 48 per cent between 1985/86 and 1988/9. This is a larger reduction than any other Department is experiencing. Even if one excludes the Nationalised Industries and ECGD, the decline is 14 per cent which is still more than any other Department. This comes at a time when the Government is acknowledging the need for more industrially relevant R&D expenditure - a point you yourself emphasized in the debate on Public Expenditure on 20 February.

Indeed the work that has been undertaken in MISC 119, and on which I have embarked in E(RD) has shown British industry is doing less R&D than its competitors and that the gap is widening. In my view it should be a major objective of this year's Survey to decide how we can stimulate longer term wealth creation. I believe that the successful application of technology is the key. Other Governments are increasing their financial support and we also need to do more. As it is, the attached graph shows that the Government is planning to spend steadily less on R&D over the next three years. If we were convinced that industry's R&D effort was adequate - and I do not dispute that the major funding responsibility will continue to lie with industry - the decline in Government support would not be of concern. But the evidence is

JF4AAE

1786 1986 BOARD OF TRADE BICENTENARY

999-1

not reassuring. Industry and the City still take a very short term view of returns.

Two major new international R&D programmes will begin to build up expenditure in the PES period - EUREKA and the new Community R&D programme. I want to submit bids to cover the cost of these programmes. This will represent a net increase in my Departmental provision. I do not have savings to offer up against the bids from other programmes. If I am unable to persuade you of the case for additional resources, the consequences would be that I would have to impose a substantial cut on my present R&D programme and cut back on our proposed support for EUREKA. In my judgement industry would see this as a damaging reversal of our policies, particularly since it is only a year since a new tougher policy on R&D was announced by Norman Tebbit.

My bids fall into three categories:

(a) the Community framework programme;

(b) EUREKA;

(c) the proposals put forward by Sir Robin Nicholson and approved in principle by E(RD) for a SERC/DTI programme to "pull-through" new advances in technology into industry.

The additional bid for the Community framework is for EUROPES provision to cover increases in Community expenditure on industrial R&D programmes of 300 mecu, 350 mecu and 450 mecu above the DTI's EUROPES baseline. This would not affect the overall public expenditure planning totals. The other two bids are for an increase in PES provision. They are as follows:

	1987/8	1988/9	1989/90
£m			
EUREKA	+15	+30	+40
pull-through	+6	+12	+19
Total:	+21	+42	+59

I will deal with each of these in turn.

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COMMUNITY FRAMEWORK PROGRAMME

The eventual size and composition of this programme is still uncertain. But my EUROPES baseline is inadequate both in relation to the growth in the Community's R&D expenditure to which HMG has increasingly become committed and because existing EUROPES baselines do not reflect the Community's policy, which the UK supports, of giving more priority to industriall relevant research. Whilst a re-allocation of the EUROPES baselines of other Departments, would help with the latter point, an overall increase in EUROPES cover also seems essential. For the reasons set out below I do not believe it is feasible for me to reduce my provision for domestic R&D to accommodate the costs of the Community programme. Although my Department fully endorses the need to contain the size of the new framework programme you will appreciate that any bid has to be in relation to what I judge to be the most likely outcome. I believe that the eventual outcome could well be in the region of 6 becu, even if we can secure initial French and German support for a lower objective. My EUROPES bids are therefore on the following assumptions:

- a 6 becu framework programme of which 60 per cent will be aimed at benefitting industry sponsored by DTI

- a 1.2 becu ESPRIT programme which continues to be treated outside EUROPES.

Should the course of negotiations suggest a different outcome, my bids would need to be revised. If a smaller programme were to emerge, for example, I would be very ready to reduce my bid.

EUREKA

Although I have agreed to fund the first ten projects from my existing provision, additional funding is needed if we are to continue to play our full part in this important initiative. We shall endeavour to convince UK firms in our dealings with them that participation in a EUREKA project confers benefits through improved market opening and thereby seek to head off applications for financial support. But our firms know that their competitors in Europe are getting help from their Governments. If we are not prepared to support our firms, albeit not up to the levels they allege their European competitors are supported, then they will simply not enter into EUREKA projects. We estimate that some 20 new EUREKA projects are likely to arise each year in which UK firms will not go ahead without Government support. The estimated costs to the Department are of the £15m, £30 and £40m quoted above.

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PULL-THROUGH

At E(RD) on 17 April the pull-through programme was approved on the assumption that other Departments would match the financial contributions to be made by Kenneth Baker and myself. My technical bid is therefore for a transfer to match my contribution. No net increase in public funds is involved. The amounts quoted in the E(RD) paper are £6.25m, £12.5m and £18.75m.

I have of course examined very carefully the scope for making a contribution to the costs of the Community framework programme and the additional EUREKA projects from within my domestic provision. I have concluded this is not feasible. You will recall that there was a major review of the Department's R&D expenditure last year in which your officials were fully involved. This looked at the priorities for expenditure within a reducing budget. Expenditure on project support was substantially cut back, both by reducing the support to large companies and targeting support on projects which achieved substantial external benefits. A scheme of around £80m is still regarded as a minimum for a general scheme of this kind, particularly if we are to have the resources to encourage companies to undertake their own R&D projects to apply the results of Alvey and other collaborative programmes. I do not therefore believe there is scope for reducing general project expenditure. For collaborative support we have earmarked a provision of £60m a year. There are substantial commitments to Alvey and other on-going collaborative programmes throughout the PES period. The remaining uncommitted headroom is needed by our contribution to pull-through and to the first ten EUREKA projects. The final category within my domestic R&D provision is non-project support. This is concerned with spreading awareness of existing and new technology to companies whose prospects of competitiveness depend heavily on the successful application of technology. Our forward allocation is about £100m a year. I believe it would be very short-sighted to reduce this expenditure. The enlarged Community programme, the EUREKA initiative and the pull-through programme, need to be backed up by awareness programmes if the UK is to get full benefit. I will cope with this additional pressure to expand awareness but I certainly could not contemplate a cut.

Following a further analysis of our R&D expenditure at Sunningdale this last January and the respective value for money of support for domestic as against international programmes, we have engaged in a detailed survey of British companies views on this issue over the last few months. The results of this exercise have just come to light. Although there are inevitably shades of opinion which in part reflect the particular technologies and industry sectors in

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question, the overwhelming conclusion is that UK firms will only benefit from international programmes if they have strong domestically-based scientific and technological capabilities. If firms, large and small, do not have such indigenous capabilities they are not regarded as credible partners in the first place and are also unable to exploit the results of international programmes effectively. Adequate domestic programmes of support must therefore have priority over international programmes. This is not to say that UK firms will not welcome a shift in Community R&D in those sectors where there is a clear Community dimension. That is certainly a policy we should encourage. But if that were to lead to a diversion of resources away from support for domestic activity, UK industry's view is that this would represent worse value for money. This should certainly influence the negotiating stance we adopt on the size of the new Community R&D programme but it will not be the only factor determining the final outcome and, in any case, decisions are unlikely to have been taken before the PES round is over. What I need to establish with you in the bilaterals is that the provision for domestic expenditure on which last year's review was based will be maintained at present levels and that additional resources will be provided for the new international programmes that have begun to take shape since the review and since last year's Survey baselines were agreed.

Against this background I regard the bids for the pull-through transfers, EUREKA and EUROPES as the minimum with which I can manage. They are also consistent with the discussions we have had in E(A) and E(RD) about the overall shape of the Government's support for civil and military R&D and the overriding priority of our support for R&D going in areas where it can increase industrial competitiveness and hence wealth creation.

As I made clear at the beginning of this letter, I am limiting my additional bids to the R&D area. As you can imagine, a number of other proposals which would have involved a net increase in my Department's provision were presented to me. I have decided not to proceed with these nor with increases in manpower or running costs, apart from the funding needed to cover the responsibilities transferred to my Department from the PSA, as set out below. As you know, I am due to consider a Corporate Plan before the bilateral season dealing with the future size and structure of the Companies Registration Offices. I will be writing to you later about the manpower and running costs implications of this plan.

There is one other point I should draw to your attention. I have been searching for a way to avoid having to introduce a moratorium on new regional development grants in March 1987. As you may remember Leon Brittan agreed this with you, George Younger and

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Nicholas Edwards, in the last Survey as a way of meeting higher expected costs on other demand led programmes. In my view it would be most unfortunate in political terms to impose a moratorium on regional spending in 1987/88 and I have managed to find a way of covering the additional costs in England. Savings are now forecast in the demand led programmes which were expected to increase last year and I propose to transfer the resultant savings back to my regional provision for 1987/88. My officials will be writing with the details. Malcolm Rifkind and Nicholas Edwards know of this proposal. It will need to be taken into account in their proposals to you on public expenditure.

There is also a technical bid for new provision following from changes in financial responsibility for Property Repayment Service (PRS) funding. The main element is major works for office accommodation. As you know these costs are to be attributed to Departments as from 1987/88. The costs associated with terminations of lease agreements are ones that would have to have been met under the previous funding arrangements. The bid is therefore a technical one arising from the transfer of responsibility.

The amounts for my Department are:

		£m
1987/8	1988/9	1989/90
+2	+4	+1

On a similar basis, as regards the transfer of responsibility from the PSA in relation to minor new works and internal decorations, I need an extra £1m in each of the PES years to cover the costs of necessary work.

I understand Leon Brittan pointed out in last year's bilateral that there was no provision in the Department's budget for further expenditure on the Columbus project. That remains the position and collective decisions will be required on the British National Space Centre's Plan, to be submitted in the Summer, which will include the results of the Columbus project definition phase. The same is true of launch aid. We have indicated clearly to British Aerospace (and to Rolls Royce) how difficult it will be for the Department to provide any launch aid for Airbus developments, and we have urged the companies to exploit private sector means of

1786
1986
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financing such developments. No provision exists in our present budget for support of this kind.

I am sending a copy of this letter to the Prime Minister.

Yours

PAUL CHANNON

Paul

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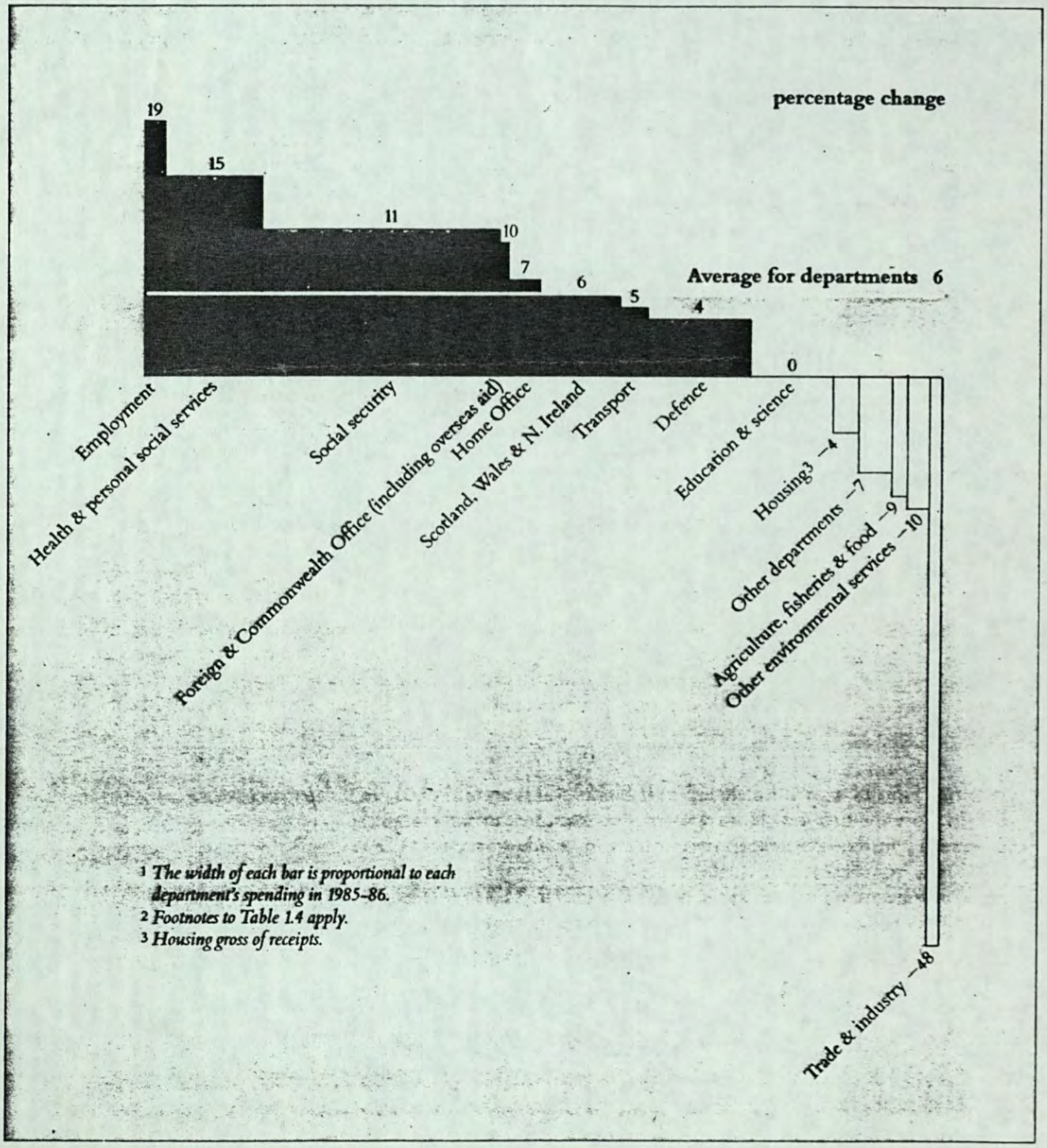
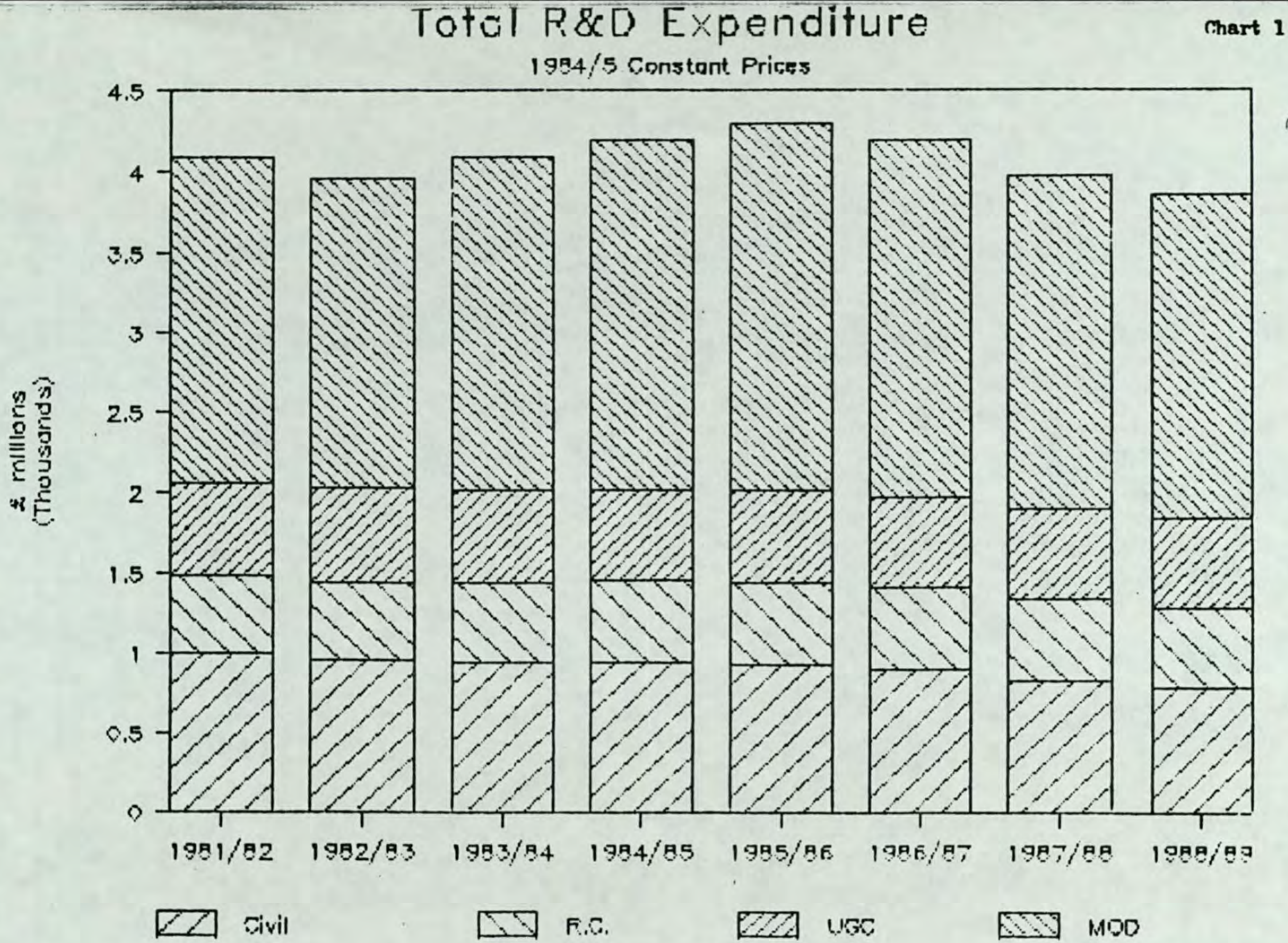
Chart 1.7 Percentage changes in departments' cash spending between 1985-86 and 1988-89[1,2]



1 *The width of each bar is proportional to each department's spending in 1985–86.*
2 *Footnotes to Table 1.4 apply.*
3 *Housing gross of receipts.*

Chart 1


Total R&D Expenditure
1984/5 Constant Prices
£ millions
(Thousands)
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
1981/82
1982/83
1983/84
1984/85
1985/86
1986/87
1987/88
1988/89
Civil
R.C.
UGC
MOD

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