CONFIDENTIAL

Prime Minister

CC JV
AW

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

EXPORT CREDIT SUBSIDIES

I would like to consult you about the position on export credit subsidies which is described in the attached paper.

2. Although I am as conscious as anyone of the need to increase exports and to help British firms to face international competition, the fact that the cost of ECGD's interest support programme has risen from £220 million in 1978-79 to an estimated £700 million in 1982-83 must raise some fundamental questions both about the total subsidy bill for capital exports and about the scale of subsidy in some individual cases. It is not clear to me that this is necessarily the most cost-effective way of preserving or creating jobs, or that it is wise to make particular sectors of industry so heavily dependent on subsidy, without in this case any particular plan to phase the subsidy out.

3. The proposals in the paper are essentially gradualist. They do not envisage any abrupt change of policy. They propose some limits, and some more selectivity and restraint. They would allow for flexibility while putting a firmer question-mark over the more extensive subsidy cases.

4. The paper is in a form in which it could be circulated to colleagues in an appropriate Committee but I would like if I may to discuss it with you before going any further.

(G.H.)

2 August 1982

CONFIDENTIAL

EXPORT CREDIT SUBSIDIES

I am concerned about the scale of our export subsidies for capital goods. Government support for some recent export contracts has reached (in present value terms) a rate of 50% or more of the value of the UK element of the contract - before taking account of the increasingly real possibility of payments delays or losses through rescheduling or default. The biggest Government subsidy is the interest support available automatically from ECGD to enable exporters to price on the basis of a fixed interest rate below market rates. In 1978-79 ECGD's interest support subsidy cost £220 million; the estimate for 1982-83 is about £700 million, and other subsidies are provided from the Aid Programme and under the Industry Act. Thus in four years this has become a major public expenditure programme. A forward policy on export risks and subsidies is also likely to weaken the finances of ECGD's normal insurance operations, thus either adding to premiums to the generality of exporters or swelling the PSBR.

2. Export subsidies on this scale have other disadvantages. Part of the benefit goes to overseas purchasers. The UK gets no benefit, either in employment or other ways, from that element. The subsidies are not directed so as to have the greatest effect on output or employment and are indeed a very expensive way of preserving or creating jobs. They supported only 5% of exports in 1980/81 and go mainly to certain capital goods industries with a heavy weight towards a small number of firms, which are liable to become rather heavily dependent on them. There is also the general point that the taxation or borrowing to finance these subsidies is likely to put up costs and destroy employment elsewhere. These points are further discussed below. The table attached to Annex 1 shows certain projects in the past few years that have involved very high rates of subsidy. The scale of the problem can be seen from the fact that the 33 per cent subsidy involved in the Polish ships case of 1977 is lower than all the other subsequent cases listed, which show an average rate of subsidy of over 50 per cent.

Annex 2 shows that a relatively small number of UK companies are responsible for contracts that have received a very high proportion of the export subsidies.

Advantages and Disadvantages of Export Credit Subsidies

Balance of Payments Support

3. The balance of payments argument for export credit subsidies is similar to the one used for attributing a "shadow" price to the value of foreign exchange earnings, ie. that such earnings are worth more to us than the present exchange rate implies. But this argument is irrelevant to the present situation of the balance of payments, and inconsistent with our belief in freedom from exchange controls and a market exchange rate.

Industrial and Employment Support

4. It may be said that export credit subsidies are needed to offset the effects on industry of a high exchange rate. But such subsidies have to be paid for by the rest of the community, including the rest of industry, and a significant part of the subsidy (more of it as the scale of subsidy rises) in fact goes to benefit the overseas customer. £700 million of subsidy requires £700 million of extra taxation or borrowing. The generality of industry, which in fact is having more difficulty in fighting imports than in maintaining exports, can be hit by the cost of such subsidies either directly through taxation (eg. NIS); or through the effects of higher personal taxation on wage costs; or through higher interest rates. The extra exports obtained as a result of the subsidy of course create employment, but they require extra finance for use during production and pending payment by overseas customers. This requirement competes with other demands for finance within the monetary target, whether the additional finance is bank credit or part of the PSBR. The competition will crowd out other credit demands and tend to raise interest rates. The conclusion on both the subsidy and the financing must be, as we have said so often in relation to subsidised activity of all kinds, that industrial assistance and the creation of employment by this route inevitably means burdens and a loss of employment elsewhere.

5. Export credit subsidies are therefore vulnerable to the main criticisms to which all attempts to subsidise employment and output are liable. Indeed

some of these criticisms apply to export subsidies with even greater force than they do to other fiscal measures. Treasury estimates suggest that in terms of the cost per job export credit subsidies tend to be five to ten times more expensive than other forms of direct employment assistance, and in certain circumstances the comparison can be even more unfavourable for export subsidies. Annex 3 summarises the most recent estimates of cost per job of export subsidies and certain other forms of public expenditure to assist employment. The table attached to Annex 1 includes estimates of jobs created or preserved by particular projects, but these are estimates made by the companies and do not represent a reliable estimate of the effects of particular projects on employment.

6. The benefit of export credit subsidies is confined to a small, random group of UK manufacturers and their overseas customers. If our concern is with industrial costs it may be better to concentrate on measures to reduce industrial costs generally through tax relief rather than heavy subsidy to the few.

7. Another possible case for export subsidies is the one sometimes advanced on industrial grounds. It is said that the heavy capital goods industries which derive most of the benefit from export credit subsidies have a strategic value to the future of British industrial performance which is greater than their contribution to output or exports might suggest. Moreover some of the industries concerned are located in areas of high unemployment.

8. But the level of subsidy in medium and long term official export credit is extremely costly and is well above the levels judged acceptable for direct support of industrial restructuring eg. under the Industry Act. Moreover export credit subsidies are unselective. They do not differentiate between the potential or profitability of the companies which receive them; they support the current operations rather than the capital development of these companies. Unlike domestic industrial subsidies they are not conditional on restructuring or improvements in productivity. If export credit subsidies support strategic sectors it is more by accident than design.

Subsidies as a form of protection

9. While we have been prepared to contemplate selective and ad hoc restrictions on certain categories of imports, we have not wished to encourage protection or the retaliation or emulation that it is likely to cause. Export credit subsidies are, of course, a form of protection for domestic output and employment in the capital goods industries, but in addition they are a form of subsidy which involves both direct and indirect losses to the UK economy. Part of the subsidy is captured by the foreign importer. Having acquired their capital goods at subsidised prices the importing countries can then use the equipment to compete with the UK on terms which UK industry may find difficulty in matching (as for example in the case of the Polish ships contract a few years ago).

Matching Overseas Competition

10. In the eyes of the capital goods industries the case for export subsidies is simple and compelling: the need to match terms offered by their overseas customers. But from the national point of view it is by no means clear that it is right to pursue a policy of matching if that produces substantial losses financed out of the public purse. There must be an upper limit to what it is worth subsidising. And we are not well placed nationally to engage in competitive subsidising any more than in competitive protectionism. We are more exposed and less able to afford such a race than many of our competitors. It is already clear that a competition in subsidies has entered into several major capital projects recently (eg. in Morocco and Mexico).

11. It is sometimes suggested that interest support from ECGD is needed to enable industry to compete on terms of equality with competitor countries which subsidise their export credit rates and with Japan and other low interest rate currency competitors. But most purchasers can take the prospects of currency change into account as well as the interest rate. A sterling interest rate may still look more attractive than a lower yen interest rate if the yen is expected to appreciate substantially over the life of the contract.

Maintaining UK export markets

12. A variant of the argument about matching is that some heavily subsidised contracts are needed to maintain a UK presence in overseas markets. In other words, the cost of export subsidies should be seen not in relation to the 5 per cent of UK exports which they support directly, but as an inescapable overhead of total UK export effort. But the notion that heavily subsidised capital goods

exports are an essential "loss leader" for the rest of British exports cannot be substantiated from the evidence any more than the contrary view that each increase in the level of subsidy which HMG is prepared to offer to gain a big export contract reduces the future prospects of non-subsidised export business in the markets concerned.

The current case for subsidies: A possible presentation

13. It is perhaps possible to present a case for these subsidies on an amalgam of arguments. The first is based on confidence that - as a result of the success of government economic policies - interest rates will fall and the cost of subsidies will turn out to be significantly less than is currently expected on the basis of long-term yields. Coupled with this, there is the argument referred to in paragraph 4 above that the subsidies are needed to give temporary protection to British industry during a period of high real exchange rates which may be regarded as transitional. Thirdly, to the extent that the subsidy takes the form of a charge on the Aid Programme, that may be regarded as substituting for ordinary bilateral aid within a fixed total programme, and in this sense as costless in public expenditure terms.

14. While it is certainly our aim to achieve lower interest rates and we are now making progress in doing so, we cannot count on this to remove the subsidy burden. The future course of interest rates, over the whole life of projects now coming into subsidy, is not wholly within the UK's own control. And if inflation is not to rise again, there may have to be a real return to savers and thus significant real interest rates world-wide. As to the case for subsidies as temporary assistance to industry, their particular incidence is less satisfactory than a more general reduction of industrial costs, and indeed reduces the pressure on the firms concerned to squeeze their own costs. Finally, the argument about adjusting priorities within the Aid Programme takes no account of the substantial costs of ECGD subsidies involved in mixed credit packages, which represent a straight addition to public expenditure.

Conclusions

15. The attractions of matching some of our competitor-subsidised export credit offers and winning some of the export contracts available are more apparent than real. In many cases the size of subsidy required is such that the contracts are not worth winning. And we are creating a situation in which part of the capital goods industry is depending on subsidy (and on <u>lobbying</u> for subsidy) for its continued existence.

16. In short this area of subsidy betrays all the features which the Government has set its face against in its supply side policies: a growing public expenditure bill in an open-ended expenditure programme, a large subsidy with unclear objectives which is not cost-effective and a part of industry becoming a pensioner of the state at the cost of substantial (employment-detroying) taxation levied on the rest of the economy.

Controlling the Costs

17. Our long-term objective in this field should be to support the multilateral phasing out of export credit subsidies through the OECD Consensus. Most OECD governments are already committed to this policy, the US and the Australians being perhaps its most enthusiastic advocates. But even the latest changes in Consensus rules still leave considerable scope for subsidising.

18. Export credit subsidies are not the only example of an open-ended public spending programme. But they have certain characteristics which make them even less amenable than other programmes to the influence of normal public expenditure control mechanisms. One is the length (and unpredictability) of the time-lag between the time when government support for a contract is committed and the time when the costs of that support emerge in the estimates and public expenditure figures. Another is that unlike other cases where the rules which determine expenditure are fixed (often by Parliament) the rules for export credit subsidies are to a considerable degree ad hoc and flexible, and are not subject to any form of Parliamentary authorisation or control. Nor is there proper accountability for the cost of export credit subsidies. This is especially true of the most heavily subsidised projects where ECGD is apt to have to foot the bill for proposals passed by other Departments.

19. Ideally any control mechanism would be directed to the cost of the subsidy element in export credit commitments, in aggregate and in relation to individual contracts. But the cost of past commitments can be changed uncontrollably by movements of interest rates, making nonsense of cash control. A possible approach would be via a combination of measures on the following lines:-

a. A rolling annual limit on ECGD's total exposure under the fixed rate credit scheme. This need not be an absolute limit but would represent a trigger for consideration of whether aspects of the scheme needed to be adjusted.

b. Fixing a maximum acceptable level of subsidy in net present value terms for any individual case; and a separate limit on the total subsidy level in ATP cases.

c. Selective hardening of export credit terms for particular markets or sectors. It is wrong to give automatically the full extent of the subsidy permitted by Consensus rules on contracts in all markets and industrial sectors.

d. A tougher line on 'country limits' for offers of support under Section 2 of the 1978 Act (the 'national interest' provision) with the aim of directing the available total of export credit support towards countries with more favourable repayment prospects.

20. If this approach is agreed, officials could be invited to work out more precise formulae to give effect to (a)-(d) above.

SUBSIDY LEVEL OF SPECIFIC EXPORT CONTRACTS

The attached table gives details of recent bids by UK companies for major overseas contracts involving very high subsidy levels. It shows the impact of the various forms of government support on the total level of subsidy incorporated in each bid, expressed as a percentage of the value of the UK element of the contract.

2. Subsidies made available under the Industry Act, the Science and Technology Act and the Aid and Trade Provision (ATP) are normally on grant terms. But the largest form of export subsidy - expenditure on interest support by ECGD - involves a stream of payments to the banks over the period of the export credits to meet the difference between the fixed rate of interest paid by the borrower and the agreed return to the banks, which is a margin over short term money rates. These expected future payments can be discounted back to give an estimate of subsidy costs in net present value terms.

3. The level of subsidy can build up substantially if modifications to the basic fixed rate export credit facility are allowed. To take a specific example, assuming a fixed rate loan of 11% and a market rate of 14%, an export credit with a 15% downpayment, a four year draw down and an eight year repayment period results in a subsidy level of 10.0%. This subsidy level increases:-

(a) to 11.8% if credit is provided for local costs equal to 15% of UK content

(b) to 14.9% if in addition the repayment period is extended to fifteen years and

(c) to 17.8% if in addition the interest accruing during the draw down period is capitalised.

4. An example shown in the attached table of the high levels of subsidy which can result solely from use of ECGD's interest support programme is the Hong Kong Island Line railway contract (43%). The effects of combining ECGD and ATP subsidies are seen in the Indonesian hydro-electric power project (52%) and the Zimbabwe railway contract (56%). In the bid for the Mexican Sicartsa I contract, which was awarded to the UK, ECGD and ATP subsidies were combined with a subsidy under the Science and Technology Act, giving a total subsidy level of nearly 65%.

5. All these subsidy figures take no account of possible additional Exchequer costs, through payment of claims by ECGD, which could result from defaults on credits.

CASES INVOLVING EXCEPTIONALLY HIGH SUBSIDY ELEMENTS

Date	Country	Project	Value of Exports	ECGD Terms	Local Costs	ATP	Other Assistance	Subsidy	Companies' estimates of jobs created or preserved	Comments
1977	Poland	24 Ships	$142.3m	7½% over 7 years for 70% ($100m) of loan.	£9.55m	-	B.S. guarantee for Eurobond borrowing of $65m. Intervention Fund Subsidy of £28m.	33.6%	-	
1981	India	Coastal Steel Plant	£780m	85% of UK goods at 7¾% over 10 years with 5 years' grace.	£50m (RTA)	-	£125m ODA grant and special Industry Act support of up to £20m. agreed.	54.3%	50,000 man years	Proposed offer of buy back agreement. Contract lost.
1981	India	1) Thermal Power station and 2) Associated coal mine	1) over £368m 2) £134m.	1) 7¾% for balance of UK content over 10 years	-	£65m plus £75m RTA	-	73%	40,000 man years	HMG side agreement to increase bilateral aid and Ministerial decision to waive pro rata provisions in IDA agreement. Terms of 2) still under discussion.
1981	Kenya	System X	£13.7m	85% of UK content at 10% over 8 years	-	£6.85m	-	ATP 44.5% ECGD 9.9% 54.4%		
1981-2	Mexico	Sicartsa I	£232.5m	85% of UK content plus 15% locals and EC element at 7¼% over 15 years.		£34.9m.	£5m grant under Science and Technology Act	ATP 22.1% ECGD 40.3% PPDS 2.2% 64.6%	25,000 man years	Contract Won.
1981-2	Mexico	Sicartsa II	£68m	85% of UK content and eligible EC (German) costs and local costs: 7¾% over 3 years' grace	£41m. (financed in DM up to 15% of UK and eligible £ (element)	-	Authority given to use ECGD S.3 matching facility.	39.8% excluding S 3 assistance 44¼% with 7% interest on UK element.	-	Contract lost.
1981	Hong Kong	Rail cars for Island line and for Kowloon-canton railway	£55m) £60m) £17.5m	8½% over 8½ years with capitalisation of interest. Cash contract: no ECGD cover	none	-	- - PPDS £3,507m	) 43%) -	N/A	The PPDS assistance for the cash contract enabled Metro Cammell to quote a lower price

Date	Country	Project	Value of UK Exports	ECGD Terms	Local Costs	ATP	Other Assistance	Subsidy	Companies' estimates of jobs created or preserved	Comments
1981	Hong Kong	Castle Peak 'B' Power Station	£755m	8½% interest over 12 years from date of commissioning of Units 1+2 and then Units 3 and 4.	HK$ 1.4bn	-	CEC at half (ie. 1%) premium rate at cost of £0.8m. S.7 assistance for consultancy services - £20m.	42%	34,000 man years.	-
1981	Zimbabwe	Railway Electrification Phase 1.	£27.46m	11½% of UK element and local costs (15% of UK/third country costs) over 10 years at 7½%.		£8.239m	-	56% ECGD 23% ATP 33%	1,000 man years	Possible follow-on contract but again on ATP supported terms
1981	Indonesia	Hydro Electric power projects at Mrica and Maung	c.£50 m.	7¼% over 10 years plus local costs of up to 15% of UK content		£12.075m	-	52% ATP 25% ECGD 27%	N/A	Still under negotiation

Annex 2

£ Millions

SOME FIGURES TO SHOW THE DISTRIBUTION OF EXPORT SUBSIDIES BY COMPANY

NAME OF COMPANY/GROUP listed in order of export performance with the figures in brackets giving the companies' positions in 1980 in relation to the top 100 UK exporters	BUYER CREDIT CASES with loan value over £20 million for years 1977-81		TENDER TO CONTRACT COVER current firm agreements at 28.5.82		COST ESCALATION SCHEME issued agreements to date (13.7.82)		ATP CASES APPROVED IN 1981		INDUSTRY ACT AND SCIENCE TECHNOLOGY ACT. Current approved offers at 13.7.82	
	No of cases	total loan value	No of cases	ECGD's maximum payment liability	No of cases	net cost to ECGD	Offers approved	Amount of ATP involved where offers accepted	No of cases	Amount of assistance involved where offers accepted
GEC (5)	7	1,339.11	14	77.74	8	24.74	4*			
British Aerospace (6)	3	724.30			2	3.58				
Rolls Royce (10)	3	843.01			1	(0.13)				
British Shipbuilders (19)	5	289.69	2	3.14						
BICC (20)	2	234.28	4	7.71	1	1.25	4	2.87		
Davy Group (24)	4	445.72	6	75.82	5	6.72	4	34.94	2	5.00
GKN (30)	1	39.65			1	0.07	1			
Babcock (40)	1	44.40	2	7.86					1	
Simon Group (51)	1	62.37	2	4.64	4	0.27	1			
John Brown (54)	1	43.06	1	2.80			2			
STC (62)	1	159.08					2		1	
Westlands (70)	1	36.67	3	9.20						
Cementation (Trafalgar House)	2	66.92					2			
Metro Cammell (Laird Group)	1	68.25	3	24.55	3	7.49			1	
Klockner	2	65.51	2	36.78			1			
Total	35	4462.02	39	250.26	25	43.99	21	37.81	5	5.00
Total of other companies	23	1105.13	7	47.41	–		14	–	3	12.66
Grand total	58	5,567.15	46	297.67	25	43.99	35	37.81	8	17.66

* including one case with Balfour Beatty (BICC) and Westinghouse.

ANNEX 3

ESTIMATES OF COST PER JOB

All estimates of costs per job are subject to substantial margins of error. In most cases it is likely that some, and possibly a large proportion, of the employment "created" by a measure would have occurred anyway, or merely displaces employment elsewhere. It is difficult to estimate the precise size of this "displacement" effect. Assumptions also have to be made about how long a job will last and how one should compare the cost of a stream of subsidy payments with a lump sum subsidy (ie through the use of a discount rate). The following figures must therefore be regarded as broad orders of magnitude. Moreover, they are not strictly comparable in that the estimates for regional policy incentives and export credit subsidies are for extra employment, but those for selective employment measures are for the gross cost per person off the unemployment register. Changes in employment tend to be associated with smaller changes in the number unemployed.

DIRECT COSTS PER JOB OF MEASURES TO REDUCE UNEMPLOYMENT

	Scheme	Source of estimate	Estimate of cost per job year in 1982
1.	Regional policy* incentives in the 1960's and 1970's	Published DOI material with adjustments for displacement effects	£16,000
2.	Short-time working compensation scheme	Treasury estimate	£7,000
3.	Job replacement scheme	Treasury estimate	£4,000
4.	Youth Opportunities Programme	Treasury estimate	£3,700
5.	Job splitting scheme+	Treasury estimate	£600-1100
6.	Export credit* subsidies (effects of a 15% subsidy)	A range of Treasury estimates based on alternative assumptions about employment in the absence of a subsidy and the extent to which the subsidised exports are additional	£50-200,000

Notes * Effect on employment

+ There is no evidence yet on which to base the estimates of the cost of the job splitting scheme. These figures assume that the subsidy will be £500 or £1000 and that the deadweight loss is only 10%. It remains to be seen what the take up will be.

Trade

10 DOWNING STREET

Prime Minister

The Chancellor would welcome your views on where the attached paper might be discussed by colleagues. He is inclined to think that E(X) is too heavily weighted in favour of Trade ministers, and would prefer an ad-hoc group or E.

Would you be content for it to be circulated to E? Not E

After speaking to the Prime Minister I have told the Chancellor's office she would support a decision to circulate this to E. WR

WR 2/8