

Trade

Econ Pol. - Subsidies
Part 2

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MT

PRIME MINISTER

EXPORT CREDIT SUBSIDIES AND RISKS

In my minute of 19 October ^{P+1} I proposed that we should seek to control export credit subsidies and to limit the risks of ECGD credit insurance. You agreed and asked that my officials, together with those of other departments concerned, should work these proposals up into operational guidelines. This work is proceeding and we shall be sending the results to you when they are ready.

2. Patrick Jenkin, Arthur Cockfield, and I agreed that there should be, in parallel with the exercise on operational guidelines, a critical examination of the economic implications of export subsidies and guaranteed credit. A group of economists in the Treasury, the Department of Industry and Trade, and the ODA have prepared the attached report on the general subject of supporting capital goods exports. You might like to look at the summary and conclusions which are in paragraphs 30 and 31.

3. The report considers both the explicit support through the provision of subsidised export credit and ATP and the potential costs of default. We had a wide-ranging discussion of these costs at your seminar on the international banking situation on 1 September and there is no sign that the risks of default have diminished since then.

4. The report shows that expenditure on fixed rate credit, ECGD insurance and tied ATP expenditure has been concentrated on a fairly small percentage of total exports. Fixed interest support varies.



It has involved substantial public expenditure in the past and could do so again. On individual contracts, especially those involving ATP, subsidies have been very large.

5. Such support involves direct costs of two kinds. There is a transfer of UK resources abroad when subsidies effectively reduce the price of exports to foreign purchasers, as they often do. And taxation and/or Government borrowing are higher, thus adversely affecting the profitability and prospects for other companies, because the subsidies have to be financed.

6. At a more strategic level, the UK gains from the preservation of an open multilateral trading system. Competitive export subsidisation is liable to be self-defeating, leading to losses all round. Hence we have an interest in the maintenance of the Consensus and its use in restraining export subsidies internationally on both fixed rate and mixed credits.

7. I agree with the broad thrust of the report. It provides a useful background to the work on the operational guidelines, and to the parallel work on criteria for support of overseas projects on which I understand officials will shortly be reporting back to E Committee. It will help us decide in cases of specific export projects whether the circumstances are sufficiently exceptional to justify support on the scale that ~~has~~ has been provided in the past. If anything, it suggests that we should be even more sceptical of export credit subsidies than I was in my minute of 19 October.

8. I am sending copies of this minute to Patrick Jenkin and Arthur Cockfield.

G.H.

13 December 1982

7 JUL 1982

GRAND
COURT
MICHIGAN



COMMISSIONER

MI

FROM: I C R BYATT
3 December 1982

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SUPPORT FOR CAPITAL GOODS EXPORTS

I was asked to convene a working group of economists in the Treasury and the Departments of Industry and Trade to assess the economic implications of support for exports of capital goods. I attach our report. The summary and conclusions are in paragraphs 30 to 31.

2. The report shows that expenditure on fixed rate credit, ECGD insurance and tied ATP expenditure has been concentrated on a fairly small percentage of total exports. Fixed interest support varies. It has involved substantial public expenditure in the past and could do so again. On individual contracts, especially those involving ATP, subsidies have been large.

3. Such support involves direct costs of two kinds. Subsidies which effectively reduce the price of exports to foreign purchasers involve a transfer of UK resources abroad. Subsidies have to be financed by taxation, so adversely affecting the profitability and prospects for other companies.

4. Despite these general arguments, subsidies can be advantageous in specific cases. We have examined the arguments advanced for such subsidies in the UK context. There is something in them. We argue, however, that they point to an approach that seeks to confine subsidies to cases in which they can have beneficial industrial results or where they - or the possibility of their use - could deter other countries from using subsidies. One implication of such an approach to subsidies is that the UK should not automatically "match" the subsidies offered by competitors.

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5. At a more strategic level, the UK gains from the preservation of an open multilateral trading system. Competitive export subsidisation is liable to be self-defeating, leading to losses all round. Hence we have an interest in the maintenance of the Consensus and its use in restraining export subsidies internationally on both fixed rate and mixed credits. Lower interest rates have reduced the scale of subsidy through fixed rate credit. It would not be in our interest to have it replaced by other subsidies. Furthermore, the creditworthiness of borrowers has declined - and may decline further. Premium income of export credit insurance should rise sufficiently to cover these risks, and to avoid the development of a new form of subsidy.

6. We conclude therefore that export subsidies are generally not cost-effective and that there is an economic case for limiting ATP and restraining fixed rate credits. We have indicated some ways in which this might be done.

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THE COSTS AND RISKS OF SUPPORT FOR CAPITAL GOODS EXPORTS

1. In contrast to practice with most other forms of exports, there has in recent years been direct encouragement of capital goods exports through measures such as the provision of fixed rate export credits and funds from the Aid and Trade Provision (ATP) of the Aid programme. This note provides a brief assessment of the economic implications of this support, the principal beneficiaries from it, and the extent to which the costs can be justified on economic grounds.

The cost of subsidies

2. The subsidies and guarantees provided on officially supported fixed rate export credits and ATP are a somewhat disguised form of support compared with the provision of straight export or production subsidies, but their costs are no less real. The costs to public expenditure can arise in three main ways:

(a) the cost of the interest subsidy is the difference between the fixed rate of interest on export credits and market rates;

(b) the costs of default by credit receiving countries where this has not been adequately provided for by insurance premia; and

(c) the cost of ATP, which is normally grant aid provided to an overseas country and expressly tied to a particular contract.

3. The cost of the interest subsidies (a) varies from year to year mainly as a result of movements of market interest rates on outstanding credits, but also due to changes in the fixed rate charged on new business. Minimum levels for these fixed rates have been agreed under the "Consensus" agreement, which operates under OECD auspices, in an attempt to limit competition between some credit-giving countries. The Consensus minima for fixed rates change infrequently, but as a result of growing levels of subsidy due to higher world interest rates, a substantial increase was eventually agreed in November 1981. A further increase for some markets was

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subsequently agreed in July 1982. Table 1 shows market and fixed rates of interest and the size of the resulting interest support costs in recent years.

4. The bulk of current expenditure reflects subsidies on credits provided at the low fixed rates that prevailed prior to the recent changes to the Consensus. Thus unless market interest rates fall quite a bit further there will be a continuing call on public expenditure. The terms of past credits are by definition fixed and it is hence possible to affect the total subsidy bill only through the terms granted on new credits. Market interest rates have come down substantially in 1982, but new fixed rate export credits to developing countries still involve a subsidy of the order of 8 per cent of the value of the UK exports supported, even if there are no special terms (see annex 1 for more details of these calculations). Furthermore, we cannot be sure that over the 10-20 year life of a credit, market interest rates will not rise again. The future course of American interest rates is, for instance, not within the UK's control and just below a half of outstanding credits are denominated in dollars. The problem of interest subsidies cannot therefore be regarded as having "disappeared".

5. ECGD is under instruction, taking one year with another, to run its insurance business at no net cost to public funds. It does this by rejecting unduly hazardous risks and by charging premia at a level judged sufficient to fund net losses on claims paid and operating costs. In recent years, however, the flow of new premium income has not been sufficient to cover losses and these have had to be met from cumulated reserves (see diagram 1) although not all these losses are attributable to business on fixed rate credits. In relation to premium income of around £235 million in 1981-82 the negative net cash flow figures averaging about £50 million a year over the past three years and a prospective negative net cash flow of the order of £280 million in 1982-83 are clearly large and cannot be sustained for long without substantially reducing if not eliminating cumulated cash reserves (which stood at about £480 million at the end of 1981-82). At the moment the perceived risk of default at some stage in the life of a medium or long-term credit is probably rather higher than it was in the case of a large

TABLE 1: AMOUNTS AND COSTS OF FIXED RATE EXPORT CREDITS IN THE UK

	Cost of interest subsidies	ATP Expenditure	Average consensus minimum interest rates on new credit over 5 years		Average market interest rates		Fixed rate credit outstanding at end year (current prices)		
	£m (current prices)	£m (current prices)	(a) To developing countries (category III)	(b) To rich countries (category I)	(i) 3 month £ interbank ¹	(ii) 6 month Eurodollar ¹	£	Foreign currency (£ equivalent)	Total
1977-78	116	0	7.5	8.0	8.1	7.9	4280	30	4310
1978-79	220	12	7.5	8.0	11.9	10.9	4670	240	4910
1979-80	357	30	7.5	8.0	16.0	14.7	4630	850	5480
1980-81	461	29	7.7 ²	8.5 ³	16.5	15.8	4320	1770	6090
1981-82	587	53	8.5 ⁴	9.5 ⁵	15.2	17.3	4430	(2840) ⁶	(7270) ⁶
November 1982	na	na	10.0 ⁷	12.4 ⁷	10.3	11.0	na	na	na

- Notes: 1. includes margin received by banks.
2. fixed rate raised from 7 $\frac{1}{2}$ % in 7 $\frac{3}{4}$ % in July 1980.
3. fixed rate raised from 8% to 8 $\frac{3}{4}$ % in July 1980.
4. fixed rate raised from 7 $\frac{3}{4}$ % to 10% in November 1981.
5. fixed rate raised from 8 $\frac{3}{4}$ % to 11 $\frac{1}{4}$ % in November 1981.
6. figure for 31 December 1981 in case of foreign currency loans.
7. consensus rates since July 1982.

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DIAGRAM 1

ECCD RECEIPTS AND PAYMENTS ON
ITS TRADING AND INSURANCE ACTIVITIES

£million

NET CLAIMS
PAID + OPERATIONS
COSTS

PREMIUM
INCOME

NET CASH
FLOW

200

100

73-74

74-75

75-76

76-77

77-78

78-79

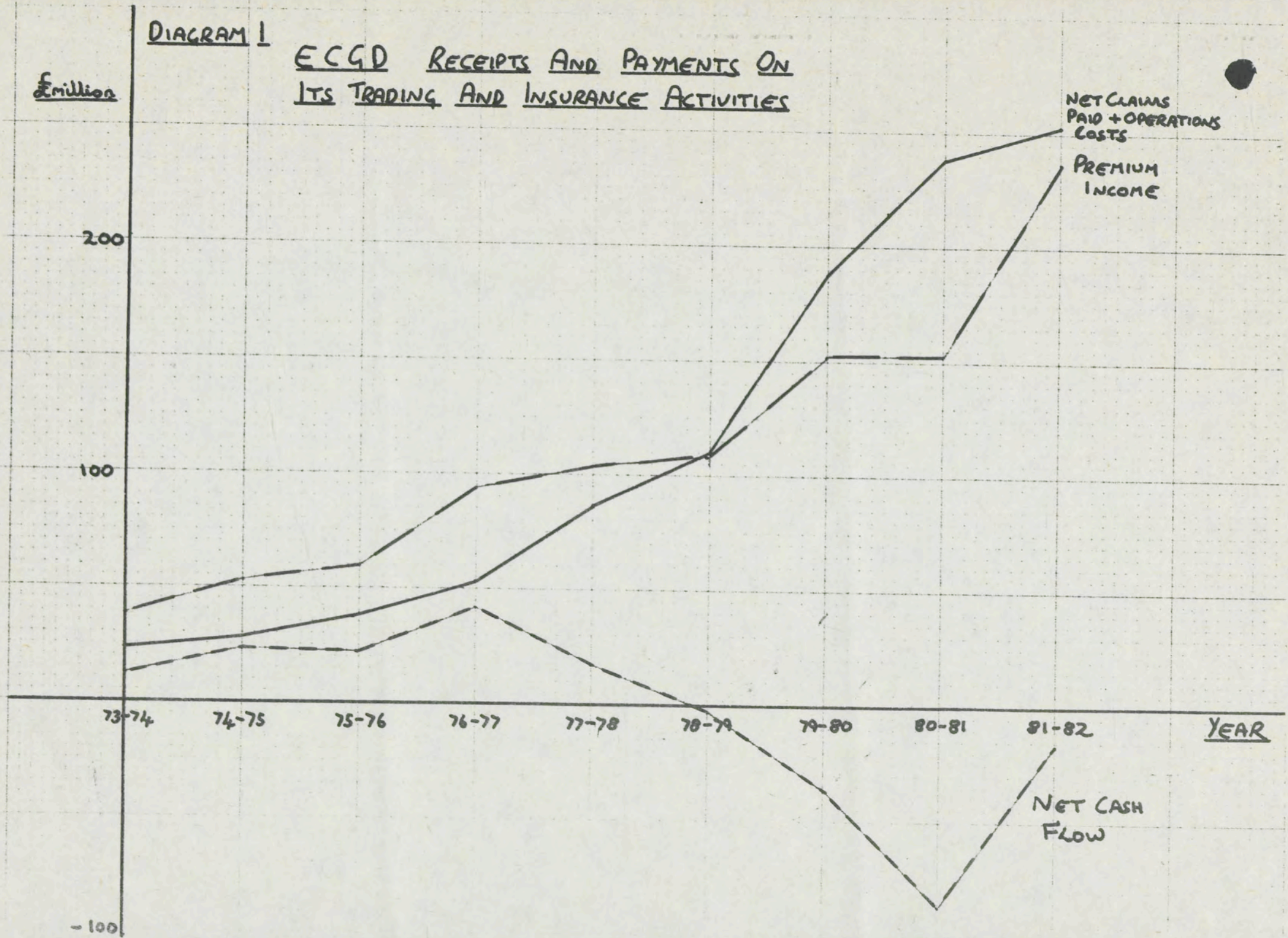
79-80

80-81

81-82

YEAR

-100



number of developing countries. Losses on insurance may thus become a relatively larger part of the budgetary costs of supporting capital goods exports.

6. Funds from the ATP are mixed with fixed rate export credits to provide a higher rate of subsidy to the foreign importer in order to win certain contracts for UK firms. "Mixed" credits thus involve two types of public expenditure costs : interest subsidies and a charge on the Aid Programme. It is sometimes argued that ATP does not involve additional public expenditure as it simply represents a change in the distribution of a given programme. This can be true only in the very short run as the size of the total aid budget is a matter for ministerial decision and there is little reason for thinking that there is less discretion for adjusting the size of this than other programmes. Even in the short run, where the size of the Aid Programme is fixed, increased expenditure on ATP has a cost in terms of the reduced political and developmental benefits that can generally be expected to be derived from using aid funds in this way rather than in the regular bilateral aid programme, though the extent of these lost benefits is difficult to quantify.

Who benefits from the subsidies

7. Under present arrangements, fixed rate export credits are extended by UK banks, who are reimbursed by the Exchequer for the difference between the fixed rate of interest they receive from the overseas customer and the agreed market rate which they have been promised (which for sterling credits is taken to be 3 month interbank rate plus a margin of $7/8$ to 1 per cent according to the life of the credit). Although this subsidy goes to the banks that undertake the lending, they obviously have to pay a market rate of interest on the deposits they raise to carry out this lending and the subsidy is only compensating them for this. It is not necessary to compensate the banks directly for the risk premium that they would normally charge on much of this lending as they have the ECGD guarantee.

8. The benefit of the subsidy is divided between the overseas purchaser (who gets cheap credit) and the UK exporter (who is able to make a larger profit than would otherwise have been the case). The precise division depends on particular market conditions, but it is reasonable to assume that in most cases a good part of the benefit goes to the foreign importer. Thus although interest subsidies on export credits do not take the form of a straight export subsidy, they have substantially similar effects. Indeed, it is possible to express the interest subsidy which is spread over the whole life of a credit in the same terms as a straight subsidy by use of a discounted cash flow approach to calculate its present value. As a proportion of the value of exports the present value of the subsidy has been estimated at more than 50 per cent in some ATP cases when market interest rates were of the order of 15 per cent - see the table in annex I. As noted in paragraph 4, the fall in market interest rates has reduced the rate of subsidy, although it is still of the order of 30-40 per cent in ATP cases.

The characteristics of export credit subsidies and ATP as policy instruments

9. The exports supported by fixed rate export credits and ATP have accounted for about 5 per cent of total UK exports and about 8 per cent of manufactured exports (ie about $1\frac{1}{2}$ per cent of GDP, or just over 1 per cent when account is taken of their import content). The support thus helps only a small proportion of exports. The main qualifying condition for this support, however, is simply that the exports in question customarily attract credit terms of 2 years or more and that they go to non-EEC countries. Fixed rate export credits are generally available automatically if this condition is met and ECGD cover is available in the market concerned. There is, however, some scope for discretion in that a higher subsidy rate can be achieved in some cases by adjusting the terms of the fixed rate credit or by mixing it with funds from the ATP.

10. Some limits are placed on this discretion by the "Consensus" agreement on minimum interest rates on fixed rate credits. The same minimum interest rates, however, apply whatever the currency of denomination of the credit (apart from special arrangements for currencies where market interest rates are below the minimum of the matrix, eg the yen). This means that the Consensus does not in

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practice set a uniform maximum subsidy rate, since market interest rates on different currencies vary widely, as do expectations of changes in their exchange rates. The OECD and EC also operate various notification procedures to regulate the use of mixed credits, but like the rules governing fixed rate export credits they do not actually place any maximum limits on the subsidy rates. The Consensus and the levels of market interest rates in relation to the minimum fixed rates thus impose some constraints on the use of subsidies for capital goods exports, but do not preclude their use as instruments of industrial and commercial policy if countries so wish.

Responding to the subsidies of other countries

11. It is often argued that the provision of subsidies on UK capital goods exports is justified because other countries do so. This does not, however, in itself establish an economic case for the UK adopting a similar policy even though the UK goods may be held to be basically competitive. There is obviously a cost involved in copying the practices of others because subsidies paid on capital goods exports have to be paid for by higher taxes on the rest of the economy. Indeed, as a large part of the subsidy provided by fixed rate export credits and ATP is likely to go to the foreign importer, they tend to reduce the real incomes of UK residents as a whole. Automatically matching the subsidies of others can thus be a very costly policy.

12. The scale of these costs will depend on whether the subsidies of others are likely to be a permanent feature of international trade. Where subsidised foreign competition is the rule rather than the exception, it will probably be necessary to support not just current exports but future ones as well. The costs to the British economy of doing this would be substantial and in these circumstances may well be in the UK's interests to treat the subsidies of others as a datum and specialise in the production of goods that do not need such support.

13. The position is, however, complicated by the fact that the level of subsidies provided by others varies over time, particularly in the case of fixed rate credits, as market interest rates fluctuate, but fixed rates are adjusted only infrequently. There may, in particular, be a respectable case for an intermittent subsidy to

British capital goods exports where there are large fluctuations in market interest rates - and therefore the subsidy implied by the availability of fixed rate export credit - in all countries. These fluctuations could cause excessive swings in UK competitiveness if the UK did not allow the differential between its fixed and market rates to move broadly in line with the corresponding differential in other countries. In such circumstances, though, all credit giving countries should see their common interest in securing early changes to the Consensus minimum rates.

14. The objections to responding to the subsidies of others therefore apply with less force where there is a reasonable expectation that the need for subsidies is only temporary. This might be the case if retaliation by the UK can influence competitors' behaviour and induce them to eliminate or at least to restrict provision of subsidies. Correspondingly retaliation will be counter-productive if it serves only to escalate the level of subsidy. In economic terms therefore matching is not justified for its own sake, but only because of any contribution it can make to the eventual elimination of subsidies. In the absence of such a contribution the case for subsidy has to be made out on specific industrial or other domestic policy grounds and on the usual economic criterion that the benefits outweigh the costs.

Arguments for supporting capital goods industries

15. The thrust of the government's economic policy has been to rely on the operation of market forces to secure the most efficient use of resources. This is not to say that markets are always perfect or that there is never a case for government intervention. The question is how strong are the arguments in the case of capital goods exports. The capital goods industries do not all have distinct characteristics differentiating them from other industries in such a way as to justify public support through export subsidies. Capital goods exports, though, and particularly large project business, frequently, but not invariably, tend to be characterised by large and intermittent orders, a substantial degree of sub-contracting, significant bidding costs, the importance of reputation and goodwill in

winning orders and having a significant part of their total business in developing countries. These characteristics, however, are not unique to capital goods exports.

16. It is perhaps worth distinguishing between government intervention in the form of the provision of insurance services and in the form of subsidies. Many of the arguments about the scale and riskiness of capital goods exports point to a need for insurance facilities rather than subsidies. Through its greater ability to pool risks and the fact that it is ultimately underwritten by the Exchequer, an agency like ECGD may be able to insure risks (particularly in the case of medium and long term business) at lower net costs to the customers than a private enterprise. There are thus strong arguments for government intervention in the form of self-financing insurance facilities for exports and in this paper therefore we focus on the arguments for subsidies. In particular the paper examines the arguments that they support industrial policy and that they create employment.

(a) Industrial arguments

17. A case can be made on various grounds for public subsidies to help industry. There may, for instance, be certain types of risks that are not covered by ECGD insurance, but which it is difficult for individual firms to cope with by themselves. Winning orders for capital goods exports often involves heavy bidding costs in relation to contract size. Projects may also be risky because they involve new technology or because they are extremely large in relation to the size of the firm undertaking them. In these circumstances British companies which take the "lead" in bidding may tend to be cautious, especially in their pricing. There could be a case for some public subsidy here. The government should, though, in general look for an appropriate market response in the form either of risk finance or diversification of the firm concerned.

18. The development of new technologies often involves a "learning curve" with costs per unit falling as experience of production is built up. Orders won through export subsidies may help this experience to be acquired, though if the benefits from doing this accrue only to the firm winning the order the provision of a public subsidy is not necessarily justified. Not all capital

goods exports, however, have this characteristic (the technology of ships, for instance, is fairly well established) and where they do, the appropriate level of subsidy will vary from case to case. This argument does not, therefore, provide a satisfactory justification for general support such as the basic interest subsidy on fixed rate credits, and the subsidy rate on more selective devices like ATP is probably rather more than can be justified on these grounds alone.

19. Where costs and benefits occur which are not reflected in the price mechanism some public subsidy may be justified. When a lead company wins a contract it generates orders for other sub-contracting firms and may stimulate "follow-on" business for other firms. The benefit to sub-contractors should be reflected in the allowance the lead firm makes for the costs of their work in formulating its bid, so no subsidy is justified on this account. Prospective "follow on" orders may, however, justify some support. Although there have been clear cases of such follow on orders, there is little or no systematic evidence that substantial unsupported follow-on orders do result from contracts won with the use of aid or large export credit subsidies or that they are greater than for non-capital goods exports. There may in fact be a danger that subsidising capital goods exports may make it more difficult to sell follow on orders on commercial terms, as competitors may retaliate and importers may be encouraged to expect subsidies. The arguments about gaining a marketing advantage and securing follow on orders do not therefore provide a satisfactory justification for export credit subsidies and only limited justification for ATP.

20. Industrial policy also has to respond to the changing pattern of international comparative advantage (due to such factors as the development of the newly industrialising countries, the rise in oil prices, the development of North Sea oil production and so on). Such changes are likely sooner or later to compel changes in the structure of British industry. It is extremely difficult, however, to say which British industries should be encouraged to grow and which should contract. It is correspondingly difficult to decide how to use export credit subsidies and ATP to encourage such structural adjustment. Export credit subsidies help increase demand

for capital goods and may thus facilitate investment, technological innovation etc in the industries that supply them. The subsidies may therefore indirectly promote structural adjustment. They may, however, also delay adjustment by supporting industries in which the UK no longer has a comparative advantage (eg shipbuilding).

21. In some cases moderating the pace of decline in industries which may be uncompetitive in the long run, could ease the process of redeploying resources which may be painful and costly. Similarly support which alleviates the effects of economic changes (eg in exchange rates or interest rates) may be justified if it does not distort or delay adjustment toward the industrial structure consistent with trend changes in market forces. It is often difficult in practice, though, to distinguish fluctuations and trends and there is a danger that in seeking to alleviate the effects of the former, policy may end up resisting necessary adjustment to trend changes in competitiveness etc. at a considerable net cost in terms of a higher tax burden on the rest of the economy which has to bear the cost of financing these subsidies.

22. At best ATP and fixed rate export credits are thus somewhat crude instruments for intervention in support of industrial policy objectives. They do not cover sectors to which the industrial arguments for subsidy apply with equal force and they do not allow much freedom to select cases by reference to the relevance of these arguments. Insofar as they can be used to support the "right" industries they do so indirectly by subsidising their exports and are not conditional on any investment or restructuring being undertaken by the firms in question. They do not act directly on many of the problems which make the development of new industries so difficult (eg the costs and risks of new technology, the development of a skilled labour force etc) or which make the decline of old industries so painful (eg poor labour mobility).

(b) Employment arguments

23. Pressures for protectionist measures (such as ATP and subsidised export credit) and other measures to help industry naturally tend to increase in periods of recession, when many industries are facing contraction rather than growth in an expanding

economy. It is thus sometimes argued that support for capital goods exports can be justified on employment grounds. It is desirable, however, to distinguish (a) whether to assist industry and employment by policy measures that have implications for public finances, and if so by how much, and (b) whether official support for capital goods exports is an efficient way to use a given total of fiscal aid to industry. Of course (a) and (b) are not wholly independent, but it is not the purpose of this note to answer (a). The overall stance of macroeconomic policy is thus taken as given. Although we estimate the effects of policy measures as if they are providing a stimulus to aggregate demand, this is simply because it helps the presentation of comparisons.

24. An attempt has been made to estimate the costs per job-year of export credit subsidies and ATP and the results are set out in table 2. The results depend on how quickly the resources that would be unemployed in the absence of these measures are reabsorbed into employment through the normal operation of market forces. The estimates set out below illustrate the implications of three assumptions; namely that resources are fully re-employed after 3, 5 and 10 years. The other key assumptions for these cost per job calculations are the rate of subsidy and the extent to which the employment produced by these fiscal measures is additional or would have occurred in any case. Supported employment is assumed to last the life of the project and after this the level of employment is lower than if the project had not been undertaken until all those who had been employed on it are again re-employed.

25. In the case of ATP we assume that all exports are additional, although this will not necessarily be the case where the UK initiates a mixed credit offer or where the exports the ATP supports crowd out other exports that could have been covered within ECGD's credit limit for the market in question. To the extent that all the exports are not additional the cost per job figures for ATP will be underestimates. In the case of export credit subsidies UK exports of capital goods have been assumed to be substantially more responsive to the provision of subsidies than any available statistical studies of UK exports suggest is the case. To the extent that UK exports are less responsive to the provision of subsidies, the estimates of cost per job year shown below will be underestimates. Finally, it is worth emphasising that the margin of error around these estimates are inevitably wide.

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TABLE 2 DIRECT COSTS PER JOB YEAR OF EXPORT CREDIT SUBSIDIES AND ATP

	Export credit subsidies	1982 prices Mixed credit: ATP plus fixed rate credit
1. Re-employment over 10 years	£50,000	£33,000
2. Re-employment over 5 years	£130,000	£87,000
3. Re-employment over 3 years	£200,000	£132,000

26. Cost per person off the unemployment register is likely to be higher than cost per job since some jobs will go to people who were not previously registered as unemployed. If unemployment is reduced there are likely to be some offsetting savings in benefit payments and additional personal tax receipts, but the figures in the table are many times larger than any feasible figure for the annual gains to the Exchequer on this account.

27. There can be no doubt, on the evidence of this table, that export credit subsidies are an extremely expensive way of reducing unemployment. A comparison may be made with the cost of special employment measures (SEMs). Estimates of the gross cost per person off the register of the current set of SEMs using DE/MSD estimates of their effectiveness range from about £3000 in the case of YOP to about £7000 in the case of the Young Workers Scheme. However, some of these measures are concerned more with redistributing the burden of unemployment than with an attempt to generate an increase in the level of employment. The SEMs which can most appropriately be compared with the above figures seem to be either the Community Enterprise Programme (CEP), or measures like the previous government's Temporary Employment Subsidy (TES) or Professor Layard's proposed incremental employment subsidy. The CEP currently has a gross cost per person off the register of about £5000 a year.

28. Any assessment of the cost of employment subsidies depends on what are inevitably uncertain estimates of their effectiveness in generating net additions to national employment. Academic estimates of the effects of the TES suggest that it had a gross cost of approaching £4000 per person off the unemployment register (at 1982 prices). Professor Layard suggests that the subsidy he has proposed would have a gross cost of some £7000 per person off the unemployment register. With more pessimistic assumptions it would be possible to double that figure, but even so the cost is well below the lowest figure in table 2. Moreover, the government have, of course, decided not to introduce a scheme on the lines of that proposed by Professor Layard.

29. The fact that the public expenditure cost of interest subsidies on export credits is comparatively low in the early part of the life of an export credit may, however, mean that the short run effects of a change in the rate of subsidy relative to other countries may be comparatively strong. Treasury analysis suggests that the demand stimulus provided by most fiscal measures is completely crowded out after about three to four years under a regime of monetary targets - see for instance the Treasury model simulations prepared for the NEDC meeting in April. (This is the case for increases in ATP which add to public expenditure, as well as for measures such as increased nationalised industry investment or a reduction in the National Insurance Surcharge). As the public expenditure costs of increased export credit subsidies fall mostly after the actual exports are delivered, the crowding out process is likely to take longer, but it will not be postponed indefinitely. Indeed future real incomes are likely to be reduced as higher taxes have to be paid to finance the continuing payments of interest subsidies. The comparatively favourable short run effects of export credit subsidies are thus likely to be more than balanced by their longer run costs.

SUMMARY OF CONCLUSIONS AND POLICY IMPLICATIONS

30. The balance of the arguments discussed in this assessment of the economic effects of support for capital goods exports suggests the following conclusions.

(a) There are no a priori reasons for discriminating in favour of the capital goods sector by providing a general subsidy on its exports. Nevertheless, the scale of the support provided through the interest subsidy on fixed rate export credits has been very large in recent years. The fall in market interest rates and the rise in the Consensus minimum fixed rates have now reduced the level of subsidy, but they have not eliminated it, and circumstances could change at some time in the future to raise the level of subsidy once more.

(b) The fact that other countries may support their capital goods exports through subsidised export credits and mixed credits is not an economic argument for automatically doing likewise, even if UK firms would be competitive in the absence of the foreigners' subsidies. Subsidising UK exports always has a cost, especially as part of the subsidy is likely to benefit the foreign importer, and the rest of industry will directly or indirectly bear this cost through higher taxation. The justification for "matching" the subsidies of others thus depends on whether the industrial and commercial benefits outweigh these costs or whether "matching" - or the threat of it - gives the UK any negotiating advantage.

(c) There is little systematic evidence that capital goods export business won with the help of subsidies generates significant follow on orders or other marketing advantages. Such benefits may occur in some cases, but are not obviously greater than for many other types of unsupported UK export business.

(d) The government's economic policy is to rely principally on the operation of market forces to secure the most efficient use of resources. Markets do not, however, always work perfectly and there can be a case for supporting particular industries or firms. Industrial arguments do not, though, provide a satisfactory justification for general support of the capital goods industries such as that provided by fixed rate export credit subsidies. There are arguments for supporting particular industries to help them develop new technology or to assist them over a period of "convalescence" while they improve their international competitiveness. There may also be instances in which export orders convey benefits to other UK firms and industries. It is, however, difficult to determine to which industries and firms these arguments genuinely apply and to target export subsidies to help them. Insofar as export credits and ATP can be used to support the "right" industries they do so indirectly by helping them to win export orders and are not conditional on any investment or restructuring being undertaken by the firms in question. Because this support is not specifically designed to meet particular industrial objectives this greatly reduces its cost effectiveness.

(e) Estimates in this paper suggest that export credit subsidies and ATP are likely to be an extremely expensive way to reduce unemployment. Export credit subsidies can appear attractive because the production of exports occurs fairly quickly but the interest subsidy is spread over a period of years - the "benefit now pay later" argument. The continuing burden of paying interest subsidies long after the exports concerned have been delivered means, however, that over a credit's whole life there is likely to be a net reduction in the UK's real national disposable income.

(Not for publication) ↓

31. This analysis suggests the UK should seek to control and target the scale of support given to the capital goods industries in order to improve its industrial and commercial cost-effectiveness. In particular we offer the following policy conclusions.

(1) There should be no subsidy as a result of the operation of ECGD's insurance services. ECGD should continue therefore to pursue the objective of running its trading and insurance business taking one year with another at no net cost to public funds. In view of the deterioration in the creditworthiness of many customers and the fact that in many cases this is likely to be more than a temporary phenomenon, this could well mean charging higher premia for business in some markets, commensurate with the increased risks. It will in addition mean a stricter policy to refuse unacceptable risks. The UK does not gain by the production of exports for which the customer does not pay.

(2) The Consensus is an important instrument to restrain self-defeating competition through the use of export subsidies. In the present climate of world recession the Agreement could be subject to considerable pressure in spite of the beneficial effect of lower market interest rates. It is therefore important to maintain the Consensus in order to deter an outbreak of "beggar my neighbour" export subsidies. The UK, however, should do more than this and it should support a closer alignment of Consensus rates with market rates of interest. This could imply a closer alliance of UK policies with those of the Americans and Germans, and some opposition to French views.

(3) The UK should scrupulously avoid actions, especially in the field of ATP, which undermine its credibility as an upholder of the Consensus. Thus to the extent that an ATP is retained it should as far as possible be confined to "matching" the terms of

others. There should be no presumption, however, that the UK should automatically "match" - only when the likely economic benefits warrant it. The rates of subsidy provided through mixed credits which use ATP funds are, however, high and probably rather higher than the economic benefits usually warrant. It is therefore necessary to set limits on both the rate of subsidy provided on specific contracts which use ATP funds and the total amount of funds available in the ATP budget. We note that the Working Group on Criteria for the Selection of Overseas Projects is developing the idea of "thresholds" for rates of subsidy. For any projects with rates of subsidy above the "threshold" it would be necessary to show exceptional benefits.

(4) The fall in interest rates during 1982 has virtually eliminated the subsidies on many new sterling credits, though there is still a subsidy on new sterling export credits to developing countries. It would not be in the UK's economic interest to offset this development by making up the subsidy through other means (eg ATP, longer repayment terms, or insurance premia which are below what the market would require).

(5) The UK should consider also how to restrict interest subsidies should market interest rates rise again. The best way to achieve this aim would be through changes in the Consensus minima for fixed rates to prevent them getting too far out of line with market rates. In the absence of such multilateral agreement there are a number of ways the UK could take action on its own; of which the following are some possibilities:

- The establishment of a maximum differential between the rate of interest paid by the importer on export credits and the market rate of interest : this would require the adjustment

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of the rate paid by the importer in order to keep within this maximum differential if market interest rates rise by more than a certain amount. A related idea would be to have a fixed differential (which would never be above the agreed maximum) between the market interest rate and that paid by the importer through the provision of floating rate credits. Another way to achieve a maximum differential between the importer's and the market rate of interest in circumstances in which the importer attaches considerable weight to the interest costs being known and fixed would be to finance exports through guaranteed fixed interest rate bonds. If long term market interest rates rose the existence of a maximum differential between market rates and those paid by the importer would inevitably imply the payment of higher interest on new bonds by importers;

- the avoidance of all special terms on fixed rate credits (eg cover for local costs, capitalisation of pre-commissioning interest etc);
- a rise in the minimum level of fixed interest rates on export credit for particular markets or particular types of exports where demand is less sensitive to credit terms or the industrial case for support is weak;
- the encouragement of financing in low interest rate currencies when sterling market interest rates have risen relative to the Consensus minima for fixed rate lending, but when market rates for other currencies have not done so.

CALCULATION OF SUBSIDY RATES AND SOME EXAMPLES 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 of about 1 per cent 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. Market long term interest rates are used as a proxy or indication of the "agreed" rate over the period of the export credit in order to calculate the size of the subsidy and as the discount rate in order to convert it into a present value sum.

3. The level of subsidy rises substantially if there are modifications to the basic fixed rate export credit facility. To take a specific example, assuming a fixed rate loan of 10 per cent and a market rate of 12 per cent, an export credit with a 15 per cent downpayment, a four year draw down and an eight year repayment period results in a subsidy level of $8\frac{1}{2}$ per cent. This subsidy level increases:-

- (a) to 10 per cent if credit is provided for local costs equal to 15 per cent of UK content;
- (b) to 12 per cent if in addition the repayment period is extended to fifteen years and
- (c) to 14 per cent 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 railways contract (43 per cent). The Indonesian hydro-electric power project (52 per cent) and the Zimbabwe railway contract (56 per cent) show the effects of combining ECGD and ATP subsidies. In the bid for the Mexican Sicartsa I contract, which the UK won, ECGD and ATP subsidies were combined with a subsidy under the Science and Technology Act, giving a total subsidy level of nearly 65 per cent.

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 7½% 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) 7½% for balance of UK content over 10 years	-	£65m plus £75m ITA	-	73%	40,000 man years	ING 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 7½% 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: 7½% 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 S3 assistance 44½% 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	11% 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.	7½% 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