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Qz.05464

MR NORGROVE (10 Downing Street)

MINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY
SUB-COMMITTEE ON ECONOMIC AFFAIRS (E(A)),
11.45 am, 20 NOVEMBER 1986

I attach briefs for the Prime Minister on the two items on the agenda of tomorrow's E(A) meeting:

1. Public expenditure treatment of Regional Fund receipts by privatised industries

2. European Community research and development Framework Programme.

I am sending copies of this minute to Mr Woolley and Mr Unwin.

D F Williamson

D F WILLIAMSON

19 November 1986

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MINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY
SUB-COMMITTEE ON ECONOMIC AFFAIRS (E(A)), 11.45 am, 20 NOVEMBER

Item 2: European Community Research and Development Framework Programme, 1987-1991

References: E(A)(86)54. Note by the Secretaries covering a note by the Chairman of the Steering Committee on European Questions
Secretary of State for Trade and Industry's minute of 18 November
Secretary of State for Energy's minute of 19 November

CONCLUSIONS

1. You may be able to conclude that:

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i. to reach agreement during our Presidency on the European Community's 1987-1991 Framework Programme for research and development (R and D) is a desirable but not an essential aim. The United Kingdom should stand by the objective of a 5 becu programme on the basis endorsed by E(RD);

ii. the Fontainebleau abatement should not be taken into account in calculating the expenditure implications for departments of the R and D programme, since this would increase public expenditure;

iii. the distribution of the current EuroPes provision for R and D should be changed to reflect the changed emphasis in the new programme, following the method outlined in Annex B of E(A)(86)54; but, if so;

iv. the Secretary of State for Energy, the Chief Secretary and the Chief Scientific Adviser should discuss ways of reducing the adverse consequences for the Department of Energy's R and D programme, especially in the early years of the new Community Programmme;

v. officials should biennially review the new EuroPes allocations to see that they match the pattern of expenditure as particular projects get under way.

5 becu

7.7

BACKGROUND

2. The background to the current negotiations is summarised briefly in paragraphs 2-7 of E(A)(86)54. Essentially, the Single European Act (SEA) will for the first time provide a formal basis for the strategic ("framework") decisions within which Community-sponsored research is carried out. The current framework programme expires at the end of 1986 (though many of its individual elements will continue thereafter); about half of this is devoted to research in the field of energy. In line with the SEA - and with the United Kingdom's own priorities - the emphasis under the new programme will switch to research designed to promote Europe's industrial competitiveness, especially in areas such as telecommunications and information technology.

3. As E(A)(86)54 says, the European Council is committed to increasing the proportion of the Community budget devoted to R and D. In the United Kingdom's view simply to hold Community R and D at its present level would require a 4.3 becu Framework Programme for 1987-1991 (the formally-agreed view within the Community is however that 4.89 becu would constitute level funding). The Commission originally proposed a grossly inflated programme of 10.35 becu which received virtually no support. The formal proposal, at 7.735 becu, is also much too high in the view of the three countries (the United Kingdom, France and Germany) who will have to foot most of the bill. It contains a high proportion of non-essential elements and research which is better supported at national level.

4. The sub-Committee on Research and Development of the Ministerial Steering Committee on Economic Strategy (E(RD)), took the view that the ideal outcome for the United Kingdom in relation to our research priorities and political commitments would be a programme of 5 becu with the emphasis on industrial competitiveness. E(RD) endorsed as a United Kingdom aim in the

negotiations an outcome at the bottom of the range 5-6 becu. In the negotiations so far, the United Kingdom has argued for an outcome below 5 becu, as have France and Germany. All other member states favour at least 6 becu and half support the Commission's figure. This suggests that we shall be doing well if we reach agreement on 5 becu: very slightly above this looks a more likely outcome.

5. <u>Public expenditure implications</u>. The United Kingdom's line in the negotiation needs also to take into account the implications for public expenditure of possible outcomes. Under the EuroPes arrangements agreed at E(A) in February 1984, Departments were allocated a notional level of provision corresponding to their share of Community expenditure on the first R and D Framework Programme. The provision has since been uprated each year in line with the planned increase in domestic public expenditure. Departments are expected to find offsetting savings to meet the United Kingdom's contribution to Community expenditure in excess of the baseline.

6. Hitherto, this has not caused significant difficulties, because the baseline has generally covered prospective Community expenditure. But the new R and D Framework programme will cause strains for three reasons:

i. the baseline will accommodate Community expenditure on R and D of 3.5 becu (around £2.5 billion) between 1987 and 1991, significantly less than the feasible minimum of the new Programme. Departments will have to make offsetting savings, involving reductions in their other programmes, in order to cover the shortfall;

[illegible]

ii. the Treasury and the spending Departments disagree over whether the Fontainebleau abatement mechanism should be taken into account in calculating the offsetting savings which Departments will have to make. E(A) agreed in February 1984 that the EuroPes arrangements would need to be reviewed when a corrective budgetary mechanism was adopted. Ministers have not collectively discussed the matter since then; but there was agreement between Treasury and other departmental officials in 1985 on a method of calculating the net public expenditure cost of additional Community spending which would take the Fontainebleau abatement into account. Treasury Ministers believe that this agreement was misconceived. Considerable sums are at stake. For a Framework Programme of 5 becu, the application of the Fontainebleau abatement would reduce the cost to Departments by around £90 million between 1987 and 1991 (from £190 million to £100 million); public expenditure would be correspondingly higher;

iii. there is a mis-match between the shares of the EuroPes baseline held by individual Departments and the expected pattern of Departmental responsibility for the new Programme (Annex A of E(A)(86)54). The main problem concerns the Departments of Trade and Industry (DTI) and Energy. The DTI has less than 20 per cent of the baseline but is likely to be responsible for over half of the expenditure under the new Programme; the Department of Energy has almost 40 per cent of the baseline compared with less than a quarter of expected expenditure. If the baseline were reallocated to remove these disparities, the DTI would still have to pick up the largest part of the bill for the new Programme, but its share would fall by some £120m. The cost to the Department of Energy, on the other hand, would rise by some £55 million (more if the Joint Research Centre is included) even though the absolute level of expenditure on energy-related research is unlikely to be any lower in a new Programme of 5 becu than it is in the current Programme.

MAIN ISSUES

7. The public expenditure implications are significant for tactics during the rest of the negotiations and in particular whether we should table a presidency compromise before the 9 December Research Council. During the presidency we have more direct influence than we shall have in the future on the content of the Programme, and this is valuable from the research and industrial point of view. The two succeeding presidencies (Belgium and Denmark) both support a high level of expenditure. On balance it would be better to settle, if possible, during our Presidency but we should not be too concerned if the negotiations do go on longer.

8. There is likely to be little dispute in E(A) that a settlement below 5 becu is virtually unattainable, not least because it would be hard to argue that a lower figure was consistent with the objective of increasing the Community's R and D effort. We should, however, continue, in conjunction with France and Germany, to argue for a maximum figure at that level. We shall have done well in negotiation if, whenever the Programme is adopted, its total cost is significantly under 5.5 becu. In short, 5 becu should be our objective, with only the smallest margin of negotiating manoeuvre for Mr Pattie.

9. Applicability of the Fontainebleau mechanism. The spending Departments will argue that rules agreed by officials for operating EuroPes provide for the Fontainebleau abatement mechanism to be taken into account when calculating the net public expenditure cost of additional community expenditure; and that if no allowance were made for the abatement, the new Programme would lead to a reduction in public expenditure because of large enforced cuts in domestic research programmes. The Chancellor of the Exchequer will say that Ministers have not agreed any firm rules for the operation of the EuroPes system; and that he was not consulted about what he regards as the erroneous calculations set out by his officials in, eg,

PESC(EC)(85)8. He will argue, rightly, that the Fontainebleau mechanism was designed to reduce the impact on public expenditure of our contribution to the Community budget and that its effect would be dissipated if part of the abatement were used to subsidise the cost to Departments of Community R and D.

10. The distribution of the EuroPes baseline. Positions on this issue are entrenched. The Secretary of State for Trade and Industry is unlikely to agree to a new Programme which exceeds existing EuroPes provision unless the provision is reallocated; the Secretary of State for Energy is unlikely to support such a Programme if the provision is reallocated. The Chancellor of the Exchequer and the Secretary of State for Foreign and Commonwealth Affairs may support the Secretary of State for Trade and Industry's argument that it would be inequitable to determine the offsetting savings which Departments will have to find on the basis of a distribution of provisions which bears little relation to the pattern of expenditure under the new Programme. The Secretary of State for Energy may point out that any aggregate overspend on current EuroPes provision arising from the new Programme would be the result of additional expenditure for which other Departments, notably the DTI, are responsible; and that - however worthy such expenditure may be - it should not be financed at his Department's expense. It may not therefore be easy to reach agreement on a redistribution of the baseline - for which there is, in logical terms, a strong case -unless the Department of Energy were to be relieved of at least part of the consequential burden, particularly in the early years of the new Programme. The Chief Secretary to the Treasury will wish to comment; and may suggest that a partial solution may lie in the permitted carry-over to 1987 of savings totalling some £8 million in the Department of Energy's EuroPes baseline. Other Departments (with the exception of the DTI) would no doubt bid for a share of any extra provision; but their difficulties are small compared with those of the Department of Energy.

11. The underlying problem is the effect of the operation of EuroPes. Clearly it is sensible to have an internal system designed to ensure where possible that Community expenditure in the United Kingdom displaces expenditure which would otherwise have been undertaken by the United Kingdom public authorities. The difficulties arise when it becomes necessary to consider a change in the shape and scale of some Community expenditure programme. By definition the EuroPes provision available will be inadequate, and the only way to prevent domestic difficulties would be to ensure that the additional Community expenditure does not happen. If this result cannot be achieved, then either there has to be a charge on the Reserve, or Departments have to make offsetting savings. In the present context an increase in Community expenditure relevant to industries sponsored by the DTI is in prospect; as the Secretary of State's minute of 18 November accepts, some at least of this expenditure can reasonably replace DTI funding which would otherwise have been provided. So far as the Department of Energy is concerned, however, there seems to be no prospect of cutting back on Community expenditure to which the Department attaches lower priority (and for which it has hitherto had EuroPes provision), so that the effect of applying the current rules would be to cut back on domestic R and D to which the Department do attach importance. (Energy have no flexibility to find offsetting savings elsewhere, since their total programme contains only domestic housekeeping, R and D, and payments to redundant mineworkers.) So far E(RD) has not been able to establish a rational basis for cutting back one Department's R and D programme for the benefit of another's, although the possibility of such reallocation will remain a theme in that Committee's work. But the effect of EuroPes in the context of the Community R and D Framework will be seen by the Department of Energy as imposing an arbitrary reduction in their domestic programme for the benefit of other Departments, for reasons which have nothing to do with them.

HANDLING

12. You might invite the Chairman of the Steering Committee on European Questions (Mr Williamson) to introduce E(A)(86)54 very briefly, before inviting the Secretary of State for Trade and Industry to speak. He may ask the Minister of State, Department of Trade and Industry (Mr Pattie) to describe the prospects for the negotiations in more detail. You might then try to reach conclusion on the two significant points of disagreement on public expenditure (paragraphs 9 and 10 above). The Foreign and Commonwealth Secretary, Ministers of spending Departments and the Chief Secretary will want to comment.

Cabinet Office

19 November 1986

MINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY
SUB-COMMITTEE ON ECONOMIC AFFAIRS (E(A)), 11.45 am, 20 NOVEMBER 1986

Item 1: Public Expenditure treatment of Regional Fund receipts by privatised industries

Chairman's brief

References: Chief Secretary's minute of 13 November to the Prime Minister
Secretary of State for the Environment's minute dated November 1986 to the Prime Minister
Secretary of State for Energy's minute of 19 November

CONCLUSIONS

1. You may be able to conclude that:

i. The Government's existing policy on the public expenditure treatment of European Regional Fund receipts by privatised industries remains valid; and there is no case for a general waiver of the rule that Departments should find offsetting savings.

ii. The Government's commitment to some programmes (such as the Mersey Basin clean-up programme) may be such as to cause difficulties if the programme were to be checked solely because of privatisation: in such cases the public expenditure treatment of European Regional Fund receipts will need to be decided by Ministers ad hoc.

iii. Consideration should be given at official level to ways in which we might seek to ensure that sufficient, high quality, public sector projects are found to enable the United Kingdom to continue to fill its Regional Fund quota as the privatisation programme gathers further momentum.

BACKGROUND

2. The European Regional Fund. This Fund was set up largely as a result of United Kingdom pressure at the time of accession, in order that there should be a Community instrument which would bring financial benefits to the United Kingdom and help to offset our large net contribution to the Common Agricultural Policy (CAP). In 1985 Regional Fund commitments to the United Kingdom were £345 m (24% of total commitments).

3. Each member state is allocated a quota range for commitments. A member state is guaranteed commitments of at least the minimum of its quota range provided that it submits enough applications which satisfy the criteria laid down in the regulation. (Other things being equal, it will get more than its minimum share if it submits more good quality applications than other member states.) In 1985 the United Kingdom's quota range was 21.42 - 28.56%. From 1986, following the accession of Spain and Portugal, it is 14.5 - 19.31%.

4. Public expenditure treatment. Existing policy on receipts for the European Community is to:

i. maximise the United Kingdom's share of receipts without compromising budget discipline;

ii. use the receipts, as far as possible, to finance existing public expenditure programmes (thereby reducing public expenditure, after taking account of the Fontainebleau abatement system, by 34% of the receipts) and not additional programmes (which could, of course, be useful investments but would increase public expenditure, after taking Fontainebleau into account, by 66% of the receipts). A consequence of this policy is that a Department which wants to use Regional Fund receipts to finance an additional public sector programme or to pass the receipts to a private sector body is normally expected to find offsetting savings.

5. British Telecom. When British Telecom (BT) was privatised it was agreed that the normal rules should apply: ie the Department would need to find offsetting savings for any Regional Fund money passed to BT. It was, however, agreed that offsetting savings would not be required for payments made to BT from grants agreed before privatisation.

ISSUES

6. The Secretaries of State for Energy, the Environment and Transport believe that the policy should be changed to allow newly privatised industries to receive Regional Fund money without a requirement that the sponsoring Department find offsetting savings - which they will not be able to afford. The Treasury see no case for change. The arguments are set out in paragraphs 16-28 of the Note by Officials attached to the Chief Secretary's minute of 13 November. The main arguments advanced are as follows:

i. Take-up of Regional Fund. Receipts by industries which have been or are about to be privatised account for around 30% of total United Kingdom receipts, amounting to about £67 m in 1985/86. Spending Departments think it will be very difficult to find enough good quality public sector projects to make up the shortfall after privatisation - all the more so, the Secretary of State for the Environment argues, because of the present system of controls on local authority capital spending. Unless some mechanism exists to allow the rules on finding offsetting savings to be waived, receipts will fall and we shall fail to reach our quota range. The amount of receipts at risk would rise if, as has been suggested, the Commission declines to make grants to local authority airports and bus companies unless the BAA and the NBC continue to receive grants after privatisation.

The Treasury considers that Departments must do their best to find good projects and that they can put in a bid for additional PES funds if they feel that exceptional treatment would be justified. The Treasury does not believe that the argument about local authority spending control is relevant.

ii. If we cannot fill our quota, we should be giving up a real income transfer to the United Kingdom paid by the taxpayer of other member states equivalent to about 34% of the Regional Fund grants forgone. Departments - but not the Treasury - argue that the benefit to the economy from this may be greater than the loss associated with the corresponding increase in public expenditure equivalent to 66% of the Regional Fund grant.

iii. Account needs to be taken of the benefits to the Exchequer of Regional Fund receipts, in the form of flowbacks such as increased corporation tax receipts and lower unemployment benefits; and of the greater sales proceeds resulting from the inclusion in privatisation prospectuses of Regional Fund commitments.

The Treasury argue that taking account of flowbacks will be tantamount to extra reflation.

iv. Special problems arise over water privatisation, in particular over expected receipts from the Regional Fund of about £500 m for the North West Water Authorities' £1.7 billion project to clean up the Mersey Basin. The Department of the Environment say they will not be able to find this money by offsetting savings and if the Regional Fund money is as a result not accepted, the project will be delayed and/or water charges put up. They do not believe that this would be an acceptable consequence of the Government's privatisation programme.

7. The public expenditure decisions announced in the autumn statement may encourage Departments to see further ways of evading the planning totals. It is important, therefore, not to make any change in the public expenditure rules that might open the way to this. The Committee may, however, consider that the Government's public commitment to some programmes - such as the Mersey Basin clean-up programme - is such that difficulties would arise if the programmes were checked solely because of privatisation; and that it should be possible to consider such cases on merits on an ad hoc basis, and not necessarily only as part of the annual public expenditure survey process. The Committee may also consider that further work should be carried out at official level to seek good quality, eligible projects which might wholly or partly replace grants for privatised industries.

HANDLING

8. The Chief Secretary to introduce his letter and the accompanying notes by officials. He will argue for no change in the existing arrangements. The Secretaries of State for the Environment, Energy and Transport will want to argue for a change, concentrating respectively on the problems the existing policy may cause for water, gas, and BAA privatisation. The Secretary of State for Wales and the Secretary of State for Employment (who is concerned about the impact on tourism of any check in the programme for cleaning up British beaches) may want to support the Secretary of State for the Environment over water.

Cabinet Office
19 November 1986