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CABINET

MINISTERIAL STEERING COMMITTEE ON ECONOMIC STRATEGY

SUB-COMMITTEE ON ECONOMIC AFFAIRS

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# REVIEW OF REGIONAL ECONOMIC POLICY

Memorandum by the Secretary of State for Trade and Industry

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1 Regional economic policy has been the subject of much criticism, including some from our own side of the House. All of us are concerned about its cost-effectiveness. On the industrial component of this policy, my Department alone spent some £750m in 1982/83 which included some very large exceptional items. In the current financial year the Government as a whole is likely to spend about £460m on regional development grants (RDGs) and £106m on regional selective assistance (RSA).

2 Some critics question whether regional policy is justified at all when current levels of unemployment are so high across the whole country. Others point to the persistence of higher levels of unemployment in the Assisted Areas in spite of regional policy. Yet others criticise the Assisted Area map when so many non-Assisted Areas have rates of unemployment above the average for the present Development Areas: 9 per cent of the working population are in such areas, most of them in the West Midlands.

3 The RDG scheme in particular has been criticised for not being job-related and for its over-concentration on manufacturing industry. That criticism carries most force where it appears that a large amount of grant is paid to highly capital-intensive projects that create few jobs on projects which would probably have gone ahead anyway in the same location without that assistance, thus incurring deadweight expenditure. Sullom Voe is perhaps the most notable example.

4 The RDG scheme also fails to meet EC requirements. By aiding replacement investment, it is in breach of the competition rules: aid to replacement investment must be ended by 31 December 1984. Moreover, because RDGs are not calculated on

a project basis and do not have a job link, they can seldom be used to claim European Regional Development Fund (ERDF) money. At present we are unable to take up all our ERDF quota: unless the present scheme is changed, the shortfall in our take-up is likely to grow as the ERDF increases in size.

5 In the past regional policy has been justified principally on economic grounds - the need to avoid over-heating in one part of the country while another part has underused resources. This economic case is now much weaker, and the case for a regional policy must rest largely on social and political grounds (as we agreed in MISC 14 before the Election on the basis of the first report from officials).

6 A regional policy is also needed to enable us to compete effectively with other countries in attracting internationally mobile projects: at present, foreign owned enterprises account for 20% of capital investment in Development Areas. Also if we had no regional policy, we would not be able to claim any money from the ERDF, which is one of the main financial benefits we obtain from the Community.

7 If therefore we are to have a regional policy - as I conclude we must - we need to ensure that it is properly structured to meet EC requirements, that it concentrates more on jobs and less on capital-intensive manufacturing industry than the present RDG scheme, that it encourages self-sustaining growth in the disadvantaged areas, and that it is as cost-effective as we can make it.

Regional Investment Incentives

8 It is with this in mind that we should assess the recommendations set out in the second report by officials (Anson), the most important clearly being those relating to a revised RDG scheme. In essence, these proposals are:

(a) to extend the scheme to cover some service activities as well as manufacturing;

(b) to reduce grant payable to capital intensive projects by introducing a cost-per-job limit;

(c) to pay grants only for projects which create jobs and thereby exclude grants for replacement investment;

(d) to pay a grant based specifically on the number of jobs created for particularly labour-intensive projects.

9 As a corollary of these proposals, desirable modernisation investment which safeguards rather than creates employment would have to rely solely on selective assistance and higher payments under the national support for innovation scheme as recommended in Anson (para 2.12-2.14).

10 I also propose that, in future, only net jobs created within a company or group measured on a national basis should be used in the calculation of selective assistance. Monitoring this will involve some extra work, but I believe that it is important to prevent selective grants being used to assist projects that merely relocate jobs.

11 I believe that this package of proposals meets many of our criticisms of the present scheme and that it would be cost-effective. The new RDG scheme would greatly reduce deadweight expenditure, while retaining the automaticity and predictability which are essential if it is to continue to influence firms' actual decisions to invest. A more discriminatory scheme requiring more monitoring will necessarily be more costly to administer. We will of course need to ensure that the extra staff required are kept to a minimum and the extra administrative costs should be relatively small when offset against the public expenditure savings.

12 The proposals permit a wide range of grant levels. If we pitch the level of grant too low, there is a real risk that we will damage the cost-effectiveness of the scheme, but we do not need to decide upon levels of grant now. Anson briefly described five options on grant levels (paras 2.26 - 1.28).

13 The Chief Secretary has proposed a further option, a simple job grant. I believe that we should firmly reject this. A job grant not linked to investment would go beyond neutrality and would actively subsidise labour-intensive production methods. It might induce uncompetitive investment, particularly in manufacturing: it would certainly do nothing to change the long-run competitive position of companies. As a result, many of the jobs induced by it would probably not last.

14 We also need to preserve our ability to attract mobile inward investment. Most other West European countries offer automatic grants on a project basis, and predictability is particularly important for overseas companies unfamiliar with British arrangements. This clearly necessitates a capital-related element of grant and it is simply not open to us to deal with this by operating a different scheme of assistance for inward investors.

15 I believe that to go further than the Anson proposals in linking grants to job creation - and still more to introduce a simple job grant - would be misguided. A job grant of the size permitted by EC ceilings is likely to represent less than 5% of capitalised labour costs, and therefore to be ineffective - especially as labour, once taken on, cannot easily be shed. Furthermore, unions may seize upon job grant payments as a bargaining counter for higher wages.

16 The scheme suggested by Anson would not greatly reduce predictability, but a job grant would, and this is another major disadvantage. All grant would be calculated solely on the basis of jobs created. We know from experience with selective assistance that initial expectations of job creation are frequently revised downwards, often by large amounts; and if grants are unpredictable, companies are less likely to take them into account in investment appraisal. Job grant would then be treated largely as windfall, and much of our expenditure on it would be deadweight. Indeed I believe that a job grant might well have an effectively higher cost-per-job created than a capital-related grant.

17 Finally, a job grant would require even more Civil Service manpower to administer than the Anson scheme, because jobs created would have to be monitored in every case.

Timetable and Procedure

18 Whatever changes we decide upon, if we are to achieve public expenditure savings as quickly as possible and meet our EC commitments, we need to introduce legislation in the present Parliamentary session. Failure to do so will delay implementation of the revised regional policy package and the realisation of the public expenditure savings until mid-1986. The timetable is tight. I consider that the best way forward would be to introduce a short Bill which would enable RDGs to be payable on a project basis subject to a cost-per-job limit and with a supplementary job grant for labour-intensive cases as recommended by Anson. Time has been allocated to the Co-operative Development Agency Bill in November. It would be possible to combine the legislation, which should be no more than 3-6 clauses, with this. I recommend that we proceed in this way.

19 Given the fundamental nature of the review and the scale of changes that we propose, I believe we should publish a White Paper with "green" edges. This would inter alia:

(i) include an assessment of the effectiveness of past regional policies;

(ii) set out our objectives and general approach to regional policy in the future in the light of developments in the economy and the EC since the present structure of regional investment incentives was introduced in 1972;

(iii) announce our proposals for revising the framework of the regional development grant scheme and for introducing legislation for this purpose;

(iv) invite views on grant level(s); map coverage; and the encouragement of innovation and new firm formation in areas where these are weak;

(v) cover the contribution of other Departments' policies to regional economic policy, including the interaction between the Urban Programme and regional industrial policy.

Much background work has been done already. We should ask officials to start drafting immediately, so that we can publish the White Paper when we introduce the legislation, probably in November. By clearly stating our general approach and outlining the framework of the proposed new scheme, we would minimise the uncertainty that potential investors now feel.

20 Introducing the joint job and capital grant framework recommended in Anson enables us to keep open our options on rates of grant, coverage and other key variables. It does not, for example, preclude the option proposed by the CPRS. But before we can proceed with legislation I think that we must decide in principle between joint job and capital grants as proposed by Anson and relying on job grants alone - the further option proposed by the Chief Secretary. We should have great difficulty in justifying to Parliament legislation which leaves Ministers free to choose between two radically different approaches.

Costs and Savings

21 In 1979 we reviewed regional policy and cut expenditure on it by about a third after the transitional period. Without any changes in the average rate of RDG or of map coverage, my proposals above would alone produce new net savings of some £100 million a year. Further savings may well be possible, depending on our decisions on the rate (or rates) of automatic grant, on map coverage, and on any other proposals to encourage innovation and new firm formation in the Assisted Areas, eg increased promotion of schemes.

Assisted Areas Map

22 The map is of critical importance. Although MISC 14 decided in March that no work should be done at that stage on it, we should now ask officials to start work immediately on revising it. They should take account of changes to the Travel-to-Work-Areas boundaries and to unemployment statistics when the data from the 1981 censuses become available. I think we should give officials clear guidance on the basis we want for designating Assisted Areas. My preference is for an index constructed from data on unemployment, including long-term unemployment; industrial structure; occupational structure; and peripherality - with the last two being given least weight. This would leave for our later consideration the sensitive judgements on changes in the map: and there will need to be some major changes as the distribution of unemployment has changed a good deal since the map was last revised.

23 At present the coverage of the Assisted Area map is 27% of the working population: 22% in the two inner tiers eligible for RDGs, and a further 5% in the outermost tier. To reduce the total coverage would reduce our ability to reclaim monies from the European Regional Development Fund for infra-structure, as well as industrial, projects. So I believe we should keep the total coverage about the same as at present. But I also believe there should be some reduction in the percentage eligible for automatic assistance. My own clear preference is for a single inner tier.

Other Issues

(i) Central Government Co-ordination

24 We all wish to see improved co-ordination of our regional policies. This applies to the interaction of regional industrial policy with rural policy, but in particular to its interaction with urban policy. The need for policies in these distinct, but related, areas to be well aligned and for there to be effective co-ordination in the administration of assistance under these policies is recognised by the DTI and the Department of the Environment. The two Departments have been co-operating to this end and I look forward to this co-operation and co-ordination being further strengthened to better enable us to form a joint view of local economic problems and how to deal with them. Also, DTI and the Department of the Environment have sizeable staffs located in the regions and we need to continue to explore ways in which we can increase their efficiency through the closest possible co-operation and co-ordination.

(ii) Innovation and New Firm Formation

25 The economies of the Assisted Areas appear weak in respect of innovation and new firm formation, and we said in our manifesto that we would "diversify regional economies by encouraging the fullest use of our schemes for innovation". We should aim to encourage indigenous self-generating growth. There is a case for increasing promotion of DTI's Support for Innovation and its Small Firms Service. The Anson Report also suggested a possible differential rate of grant in national support schemes. I am myself opposed to going as far as that; but all these ideas could be put forward for discussion in our White Paper.

Conclusions

26 If we are to achieve public expenditure savings as quickly as possible - and limit the period of industrial uncertainty before the changes finally take effect - we must have legislation in the present session. Therefore I invite colleagues to agree to the broad framework of a system of regional development grants under which grant is paid against approved capital expenditure subject to a cost-per-job ceiling with an alternative job grant for the most labour-intensive projects.

27 I agree with the Chief Secretary that we should instruct officials to start work on revising the regional assistance map; I propose that we should give officials specific instructions as indicated in paragraphs 22 and 23

28 I agree that we should arrange for the preparation of a White Paper for publication later in the year. This should be along the lines indicated in paragraph 19.

29 I also agree with those other recommendations in the Anson Report which the Chief Secretary proposes we should endorse.

30 By making the system more cost-effective, we can achieve major savings. I believe that we should aim for savings of at least £150 million. We should also seek closer co-ordination of policy objective between the DTI and the Department of the Environment, to improve overall efficiency and effectiveness.

31 I attach importance to the DTI and the Department of the Environment continuing to develop through the closest possible co-operation and co-ordination in the areas of regional industrial policy and urban policy a joint approval to local economic problems.

C P

Department of Trade and Industry
30 September 1983