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for meeting

PRIME MINISTER

## PUBLIC EXPENDITURE AND THE EUROPEAN REGIONAL DEVELOPMENT FUND

We are to discuss the treatment of ERDF receipts for privatised industries at E(A) on Thursday on the basis of the Chief Secretary's minute to you of 13 November. ~~ATTACHED~~

My purpose in this note is to inform colleagues of the widespread damage which the present public expenditure treatment of ERDF receipts could do if applied inflexibly to privatised industries; to report briefly on how the policy generally is affecting local authorities; and to offer some suggestions. I am sure that we need to solve the whole question of the handling of ERDF as it applies to both privatised industries and local authorities, before it causes us unnecessary risk of embarrassment and damage to our policies. The main facts are that:

- i. Industries which have been or are to be privatised now account for almost one-third of the UK's share of the ERDF;
- ii. In England at least local authority applications for ERDF grants are falling rapidly as the capital control system bites harder. This is because they do not give sufficient priority to them in the use of the scarce capital allocation. The number of applications was almost halved between last year and this and fell by 40% in value. The importance of bids from privatised industries therefore increases;
- iii. If the UK does not put enough bids in to take up its share of the ERDF, other member states will step in. The UK's deficit on the European Community budget (even after the Fontainebleau rebate) will increase.



More generally, the credibility of our water privatisation policy would be undermined if it were perceived that as a direct result ERDF assistance were cut off (or, alternatively, arbitrary and damaging cuts were sought from the remainder of my Department's expenditure programme).

In particular, my predecessors have initiated a massive programme for cleaning up the Mersey. The North-West Water Authority will contribute a substantial amount. Over the life of the project, ERDF grant of some £500m will be attracted to it. Without the grant, the time-scale will be extended or water charges will have to be substantially raised. We will be open to most damaging criticism from local as well as European interests if we were to withdraw support now. The attractiveness of the Water Privatisation Bill could also be seriously impaired.

The floatation price we could obtain for the water service PLCs would be reduced if ERDF grant is not going to be available. Or, in other words, the more we can honestly look forward to in a prospectus for sale by way of ERDF grant, the more we can expect the sale proceeds to contribute to the Exchequer.

The paper which is covered by the Chief Secretary's note, suggests (paragraph 20) that the investment which the ERDF grants support may bring in extra tax revenue and contributions from the industries and individuals concerned and reduce unemployment benefit. Against this background it would be unreasonable to expect Departments to have an arbitrary cut in their programmes on account of any ERDF grants received by industries they used to sponsor.

We need to find a more satisfactory way of channelling ERDF grants to privatised industries without undermining the general policy of non-additionality. Unless some solution is found, we cannot keep up our take from the ERDF. There simply will not be enough applicants to take the place of privatised bodies. The requirement



to make offsetting savings in public expenditure would have the effect of making the net cost of our contributions to the Community go up.

I quite understand the Chief Secretary's concern that ERDF transactions should be properly brought to account in the public expenditure arithmetic. One possible solution would be to make provision for a separate programme within public expenditure generally rather than take account in any individual departmental programme at the estimated level of receipts from the ERDF. This would preserve the principle of non-additionality in much the same way that we do now for ERDF receipts in general.

I should also refer to the impact on ERDF applications of our system of controls on local authority capital spending. It was my intention, had we overhauled the system before the Election to "top slice" the total allocation to local authorities in such a way that those local authorities which subsequently applied for ERDF grant could do so without having to find separate capital cover. Our existing commitments - including the 80% guarantee on capital allocations - make this for the most part impossible in 1987/88. We therefore continue to face considerable difficulty in squaring the need to encourage take up of ERDF grants with the need to control capital expenditure as a whole.

There is one short-term measure that will help with the worst cases which will result from this situation next year. Some £5m was deducted from the total available for local authority capital expenditure in 1987-88 before the allocation total was determined in anticipation of bids for ERDF grant from Local Authority companies. I shall therefore be able to allow payments to Local Authority companies.

The £5m is however only a palliative. The tighter we control local authority capital expenditure the less able are local authorities to submit applications for ERDF grant; and if we do not take up the grant, we increase our deficit with the Community. If we are



not to let this unsatisfactory situation persist, and expose ourselves to potential criticism and difficulty we need to decide now in the context of the future of the capital control system how this dilemma might be resolved. I hope we can discuss all these issues on Thursday.

One final point: the Water Authorities have been sufficiently worried by the Brussels embargo on water schemes, now lifted, to press me to agree that they will continue to be able to receive these grants after privatisation. I must tell them where they stand from the point of view of the United Kingdom Government.

I am copying this minute to other E(A) members and to Sir Robert Armstrong.

NR

17 November 1986

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