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PART A

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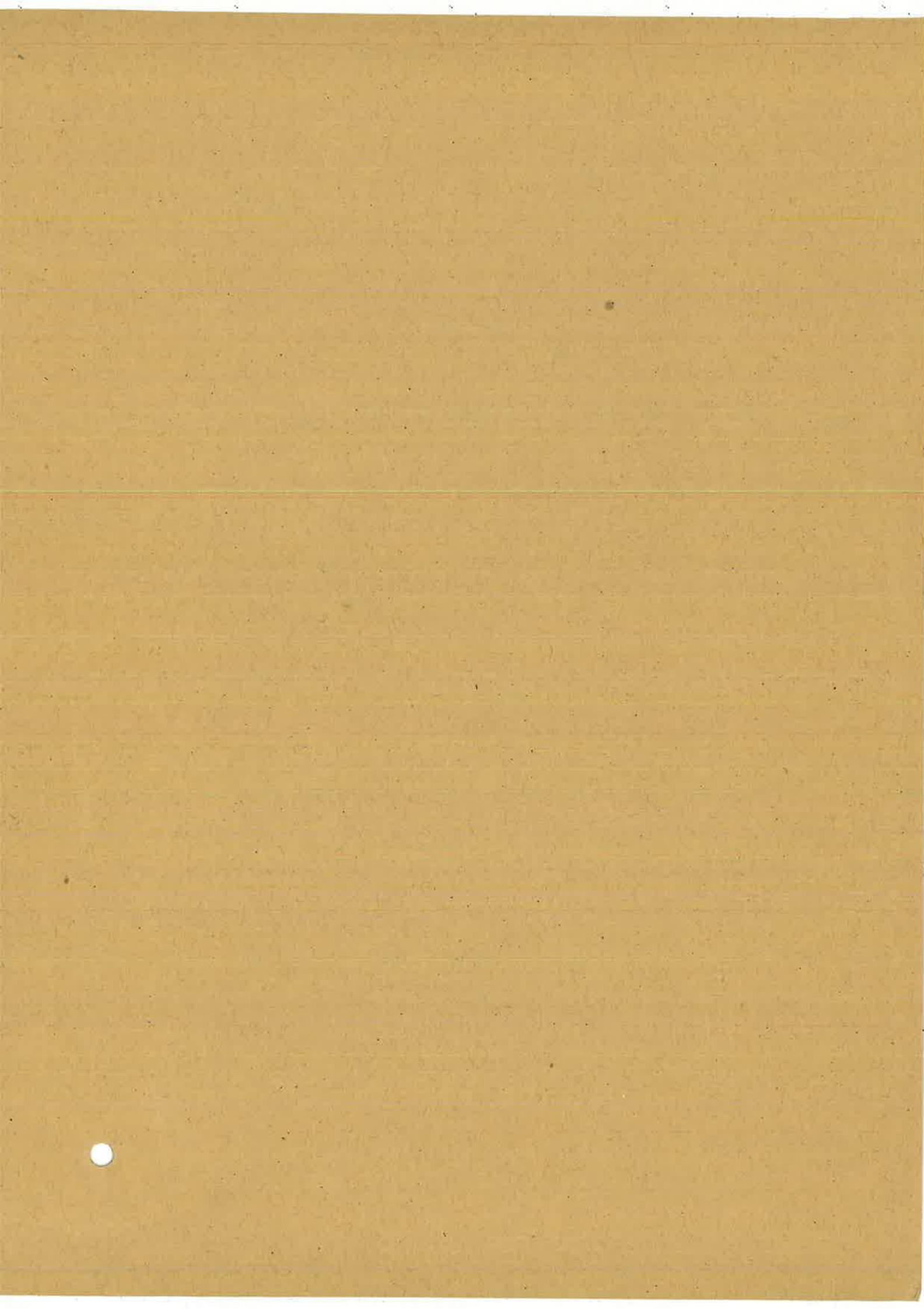
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CHANCELLOR'S PAPERS ON
THE 1983 PUBLIC
EXPENDITURE SURVEY
(PES) : DEFENCE ESTIMATES

PART A



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From: P J KITCATT
Date: 20 July 1983

CHANCELLOR

cc Chief Secretary
Financial Secretary
Mr Middleton
Mr Bailey
Mr Mountfield
Mr Battishill
Mr Lord

PES 1983 : DEFENCE

Your private secretary asked for briefing for tomorrow's Cabinet in case discussion spread to individual programmes, and specifically to defence. Our advice would be to avoid discussion of defence if possible, in case Mr Heseltine obtained the pre-emptive support of the Prime Minister; but briefing on your selected defence issues is below.

Carry through of 1983-84 cut

2. There are strong grounds for pressing for cuts to carry through the 1983-84 cash limit reduction (£240m) announced on 7 July. This means that the 1983-84 baseline from which 3% real growth should be calculated is lower. Ironically therefore MOD are hoist by their own simplistic year-on-year 3% logic. The implications of the £240m cut on the Falklands - exclusive element of the defence budget would be as follows:

	<u>£m cash</u>	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
(a) Survey baseline		15,958	17,270	18,310	18,290
(b) of which Falklands		- 624	- 684	- 552	
(c)		15,334	16,586	17,758	18,290
(d) cash limit cut		- 240			
		15,094			
(e) 3% growth (except for 1986-87)			16,324	17,486	18,010
(g) f + b			17,008	18,038	18,010
(h) savings on baseline (g-a)			- 262	- 272	- 280

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3. Savings of the order of £260m per annum would be invaluable - if only to offset other defence bids. These savings would bring further, indirect benefits. The lower the defence baseline, the lower the bids for 1984-87 real growth and for inflation compensation.

Falklands and 3% Growth

4. Hitherto the path of defence provision has been determined by two public commitments: to aim to increase the defence budget in real terms by 3% each year up to 1985-86, and to provide for Falklands costs from monies additional to this growth path. Both commitments were reaffirmed in the 1983 PEWP (copy attached).

5. Treasury Ministers attempted to argue last summer that the defence budget should be asked to absorb some or all of its Falklands costs on the grounds that much "Falklands" expenditure benefits our overall defence capability (for example the 4 new frigates or the Tri-star tankers - but not, most notably, the airfield) and that NATO does not generally distinguish between its members' NATO and other (eg Belize, Northern Ireland, Hong Kong) expenditure. In the wake of victory, however, Mr Nott secured the commitment to full compensation; Cmnd 8789 provision accordingly reflected the "normal" defence budget plus extra Falklands costs:

	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>
a. defence provision	15,987	17,290	18,330
of which			
b. 3% growth	15,363	16,606	17,778
c. Falklands	624	684	552

The baseline is now somewhat lower owing to Budget changes and the 1983-84 cut. But the principle remains.

6. It would not benefit the Treasury now to argue that 3% growth should be calculated from a Falklands - inclusive baseline. The higher the baseline, the more 3% growth costs; the calculations based on line a above will always be larger than those taken from line b. Moreover, Falklands costs will decline (after the replacement of equipment lost, and the capital cost of the garrison), but the baseline is perpetuated.

*On reflection,
I agree.
Sp*

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7. To secure further reductions in defence provision, it would be preferable to abandon the policy of 3% annual real growth (for example by a percentage cut across all the PES years) than to attempt to circumvent it by manipulating Falklands figures. It is also arguable that the public perception of the Falklands commitment is more concrete than the abstract arithmetic of the NATO growth calculation. It would be easier to present a defence budget without full 3% growth than one without Falklands extras.

Implications of no growth after 1985-86

8. Mr Heseltine may try to paint a horrendous picture of 1985-86 defence capability if real growth is not continued. The MOD PES contribution alleges that less than 3% growth "would mean cutting back our conventional capability"; this is nonsense - military effectiveness will always increase with an annual spend of £18 billion or so. For example, the real increase in procurement expenditure since 1978-79 (about 40%) has far outstripped budgetary growth over the same period (about 20%).

9. DM find it very difficult to speculate on what should or should not be cut out if the defence budget does not continue to grow after 1985-86. I strongly advise Treasury Ministers not to attempt this game, on which Mr Heseltine will inevitably have any access to more plentiful, more expert and more up-to-date information. Instead, Treasury Ministers should retain the high ground, pointing out:

- a) It is primarily for MOD to order their priorities within the provision agreed.
- b) Defence Ministers should consider very carefully before crying wolf. Before 1982-83 Mr Nott instituted over £1000m of cuts and still reported to his colleagues an excess over agreed provision of £200m. In the event, MOD's problem in 1982-83 was a £1 billion plus underspend - alleviated by addback measures and advancement of bill-paying. With proper financial management, MOD ought to be able to cope with 1985-86.
- c) MOD's internal forward planning is undertaken on their annual long term costing (LTC). Last year's LTC - endorsed by Mr Nott assumed precisely no growth in the defence budget

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after 1985-86. This year's LTC may have made more ambitious assumptions. But if Mr Heseltine is worried, he should revert to the plans and capabilities envisaged by his predecessor.

d) Any MOD complaints about budgetary problems sit oddly with their reluctance to pursue value-for-money in their equipment procurement. The inevitable penalty of paying over the odds for weapons like ALARM, Sea Eagle, Stingray and Spearfish is less cash for other projects. (In all these cases, MOD preferred to develop an expensive British weapon rather than buy cheaper American off-the-peg).

10. The main HMT argument against further growth will be the simple macro-economic one that increasing defence expenditure is incompatible with the Government's wider objectives of reducing public expenditure in order to lower the PSBR and taxes and promote economic growth. By 1985-86 defence spending will have increased by 25-30% in cost terms over 1978-79; it must henceforth take greater account of economic considerations.

11. Other Treasury lines might include the following:

(a) The NATO aim is only an aim (like the UN aim that 0.7% GDP be devoted to overseas aid), not a binding commitment; whether it can continue to be achieved must depend on economic circumstances.

(b) Of the major Allies, the UK contribution to NATO is already second only to the US in absolute terms, per capita, and as a proportion of GDP. We should not increase the unfairness of our defence burden.

(c) The 3% aim is crude and meaningless. All defence expenditure counts; simplistic year-on-year arithmetic applies; it concerns only inputs, not output or defence capability.

(d) MOD must exploit their substantial scope for increasing defence output by greater efficiency and optimising value-for-money. In this way, proper "real growth" can be achieved (as for the health programme) without increasing input costs. There must be scope for switching from "tail" to "teeth".

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12. One final point. For 1986-87 onwards we should aim - in LTPE and PES - to hold defence to the broad 1985-86 level. But this should not mean specifically maintaining the defence budget level "in real terms". That would simply be to exchange one volume commitment (admittedly a growth one) for another. Any volume commitment incurs insidious, costly and difficult claims - for pay awards, relative price effect, and cash factor squeezes; it also acts as a ratchet so that the baseline can only be increased, not cut. Our aim therefore should be the double one - not only to avoid increases after 1985-86 but to secure this by a formula ("generally consistent with", "broadly constant", "basically in line with"?) that as far as possible eschews a volume or real terms commitment.

A handwritten signature in black ink, appearing to be 'PJK' or similar, written in a cursive style.

P J KITCATT

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2.1 Defence

Table 2.1

£ million cash

	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84 ⁽¹⁾	1984-85 ⁽¹⁾	1985-86 ⁽¹⁾
Ministry of Defence									
1.1 Defence budget	6,825	7,506	9,232	11,184	12,610	14,411	15,987		
1.3 Royal Ordnance Factories	-4	-10	-4	-4	-4				
Total programme	6,821	7,496	9,227	11,180	12,606	14,411	15,987	17,290	18,330

⁽¹⁾From 1 April 1983 Departments will repay PSA for accommodation and certain other services, under the new Property Repayment Service (see chapter 2.14). Prior to that date the relevant expenditure is comprised within programme 14.

Analysis by broad economic category

Table 2.1.1

£ million cash

	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84
<i>Pay</i>	3,063	3,330	4,028	4,742	5,272	5,484	5,649
<i>Other current expenditure on goods and services</i>	3,646	4,070	5,086	6,352	7,218	8,756	10,110
<i>Subsidies and current grants</i>	30	28	27	29	31	39	49
Total current expenditure	6,739	7,427	9,141	11,123	15,522	14,279	15,807
<i>Gross domestic fixed capital formation</i>	79	72	82	51	79	105	168
<i>Capital grants, loans, etc</i>	4	-3	4	7	5	27	11
Total capital expenditure	82	69	86	58	84	132	179
Total programme	6,821	7,496	9,227	11,180	12,606	14,411	15,987

1. Over 90 per cent of defence expenditure is subject to cash limits. The programme, broken down by broad economic category, is shown in Table 2.1.1.

Royal Ordnance Factories

5. The defence programme includes net repayment to/borrowing from the National Loans Fund by the Royal Ordnance Factories Trading Fund.

Ministry of Defence

Defence budget

2. The Government's defence policy objectives and programme plans will be described in the 1983 Statement on the Defence Estimates.

3. The Government adheres to its commitment to plan to implement in full the NATO aim of real increases in defence spending of 3 per cent a year. The Government has also agreed that all the equipment lost in the Falklands conflict will be replaced—not necessarily on a like for like basis—and that these costs, together with the costs of the Falklands campaign and of maintaining a substantial garrison in the islands, will be met out of monies in addition to the 3 per cent annual rate of real growth. The provision for the defence budget includes £624 million in 1983-84, £684 million in 1984-85 and £552 million in 1985-86 to meet Falklands costs and, these costs apart, provides in full for real growth of 3 per cent a year.

4. The figure for 1982-83 is the latest provision for defence including Winter Supplementary Estimates, which seek provision to cover the extra cost of operations in the Falkland Islands. The forecast of outturn for 1982-83 is still subject to uncertainty.

From: P J Kitcatt
4 August 1983

MR BAILEY

cc: Mr Wilson o/r
Mr Richardson

PES 1983: DEFENCE

We are to meet the Chancellor on Monday afternoon to discuss tactics and objectives on defence expenditure.

2. The Ministry of Defence has made four categories of bid ^{AT FLAG "C"} (including the Falklands) in the Survey. I attach a note¹ that describes each bid and its relevant considerations in a largely factual way; it is meant primarily for information only. I offer below some thoughts on Treasury aims and objectives, which might provide a useful focus for discussion.

3. Continuation of 3% real growth in 1986-87

3.1 This bid has to be resisted. The more difficult question is what the new policy should be and how it should be presented. An acceptable presentation may be crucial to securing a change of policy; there is of course no Manifesto commitment to meet the NATO aim.

3.2 In theory, a number of "compromises" would be possible - 1% or 2% real growth for example. Treasury Ministers' objective ought to be no real growth at all, on the assumption that Cabinet would not agree to real reductions.

3.3 Almost as important as preventing growth is the avoidance of a specific "volume" commitment - such as the maintenance of a constant spending level "in real terms". Any sort of volume commitment would provide the basis for further claims in future Surveys - for inflation compensation or pay award costs. It would also act as a ratchet to prevent cuts.

3.4 The terms in which the 1986-87 expenditure aim is described must therefore be formulated as generally as possible - "generally consistent with", "broadly constant", "basically in line with". These could of course be reinforced by commitments to improve the effectiveness of the fighting forces and to increase our defence capability - neither of which would necessarily imply raising input expenditure.

/ 3.5

3.5 There would be no need to renounce the NATO aim forever (though lasting prevention of defence expenditure growth will no doubt be the Treasury objective); the decision might simply be not to implement the aim in 1986-87, with provision thereafter to be settled in the light of economic circumstances.

3.6 Criticism could be further muted by presenting the no-growth decision as provisional; but this would be to risk further battles about 1986-87 in the 1984 and 1985 Surveys.

3.7 One MOD fall-back might be to accept that it is premature to commit the UK now to 3% growth in 1986-87, but to argue that it would be equally premature (and counter-productive for the Alliance etc) to decide to renounce it. MOD might suggest that 3% growth might be written in for 1986-87 on a provisional basis - to satisfy NATO - but subject to review nearer the time. This Trojan horse should be rejected; it would presumably be extremely difficult politically to reduce defence provision once announced.

4. 3% Growth up to 1985-86

4.1 The Government is committed to increase defence spending in real terms by 3% a year each year up to and including 1985-86. Treasury Ministers have never challenged this commitment, and we assume they do not intend to now.

4.2 On this assumption, the possibilities for reducing defence provision over the next two years are limited to carry-through of the 1983-84 cash limit cut (about £270m pa), and to any clawback for public service pay (each 1% yields £50m).

4.3 If Treasury Ministers were inclined to challenge the 3% commitment, some sort of straight percentage cut would be the most practicable aim. MOD would then have to order their priorities accordingly. It would not be feasible or desirable, for example, for HMT to attempt to suggest what parts of the defence programme might be pruned (MOD have more plentiful, more expert, and more up-to-date information). Nor is there much scope for reductions in non-NATO commitments - Cyprus, Gibraltar, Belize, Brunei, Hong Kong; Falklands apart these cost only some £150m a year.

/ 5. Falklands

5. Falklands

5.1 The Government announced last year that all defence Falklands costs - for the operation and for the garrison - would be met by monies in addition to the path of 3% growth. It is a matter of political judgement whether this commitment can be challenged; we have assumed not.

5.2 The Falklands provision made so far is

	1982-83	1983-84	1984-85	1985-86
£m (cash)	730	624	684	552

It would not be advantageous to include Falklands expenditure in NATO growth calculations unless all this provision could be removed from the defence budget. The lower the baseline from which growth is calculated, the better; so a NATO baseline Falklands-exclusive is preferable to one that includes £500-600m of South Atlantic provision.

5.3 On the assumption that Falklands costs remain additional in 1986-87, the bid is in principle irresistible. What provision is made, however, will depend on how "Falklands" costs are calculated - a number of definitions and interpretations are possible. We understand that MOD will bid for £620m; we at present see no hope of reducing 1986-87 provision below £460m (but it ought to be less in 1987-88 and 1988-89).

5.4 If an acceptable settlement proved difficult one line would be that it is premature to determine 1986-87 Falklands provision now; current estimates cannot be reliable, and the garrison strength could change over the next couple of years. So no provision should be made for the time being. The hope here would be that the Falklands climate at a later date would be less defence-favourable than it is today (so that the budgetary commitment could be discarded); but the success of this tack would be far from certain.

General

6. Paragraphs 7-10 of the attached note describe the bid for the 1983 armed forces pay awards. This must clearly be resisted, but the outcome is, to say the least, uncertain. Paragraphs 11-14 describe the bid for price compensation to avoid a cash squeeze. Part of this bid (for 1984-85 inflation) might be regarded as

/ irresistible;

irresistible; but could be offset by pay clawback and carry-through of the 1983-84 cash limit cut.

7. The table below offers a quick summary of where we stand at present, and where we might hope at best to end up:

£m cash	1983-84	1984-85	1985-86	1986-87
a. baseline	15720	17268	18310	18291
of which:				
Falklands	624	684	552	-
non-Falklands	15096	16584	17758	18291
b. MOD bids	-	178	364	1841
of which				
c. irresistible ⁽¹⁾	-	+ 83	+ 86	+ 550
d. reductions ⁽²⁾		- 260	- 270	- 280
e. final provision (a+c+d)		17091	18126	18561

(1) Compensation for 1984-85 inflation above the cash factor, plus austere Falklands costs for 1986-87

(2) Carry through of 1983-84 cash limit cut; no allowance for pay clawback.

On past experience, it will be a very difficult task to achieve the provision at (e) above.

Points for consideration

8. I suggest that the Chancellor's meeting might focus on the issues discussed in paragraphs 3 to 5 above. The points on which DM would particularly welcome guidance are as follows:-

- (a) are the objectives for 1986-87 nil growth and avoidance of any "volume" commitment (paras 3.2 and 3.3 above)?
- (b) is there no intention to challenge the commitment to 3% growth up to 1985-86 (para 4.1 above)?
- (c) is there no intention to challenge the commitment to compensate the defence budget for extra Falklands costs (para 5.1 above)?
- (d) is it an objective to carry through this year's £240m cash limit cut (para 4.2 above)?

/ (e)

(nominal + real)
govt 2
public - gov.
govt

no volume commitment

out-of-area capital

no commitment

(e) is it an objective to resist the bid for armed forces pay award costs (para 6 above)?

(f) is it an objective to resist the inflation bid as far as possible, while acknowledging a prima facie case for compensation for 1984-85 inflation (para 6 above)?

PJK

P J KITCATT

1983 PES: DEFENCE BIDS

(Note by DM1)

On the basis of the Treasury bids/baseline presentation, the 1983 PES claim would be as follows:

£m cash	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
baseline	17267.8	18309.9	18290.6
a. maintenance of 3% in 1986-87			567.9
b. extra cost of 1983 Armed Forces pay awards	94.9	98.7	101.7
c. inflation compensation to preserve "volume"	82.7	265.5	553.5
d. Falklands			618.0
Total bids	<u>177.6</u>	<u>364.2</u>	<u>1841.1</u>

These figures may change a little over the next few months; but the bids themselves ought not to alter, and are discussed further below.

Maintenance of 3% real growth in 1986-87

2. This is the most important and the most expensive bid. It is important because it is a bid for a "volume" commitment to defence spending; MOD's reluctance to accept cash planning and their ambivalence towards cash limits have been caused and justified by the Government's explicit "volume" commitment up to 1985-86. Extension of a "real terms" commitment (whether for growth or constance) would enable MOD to continue to refrain from full cash management.

3. The bid is expensive directly and indirectly. Directly because of £550-600m price tag shown above. The indirect cost is far higher. The bids at 1(b) and (c) above both stem from the volume commitment. They are bids for price compensation (the extra cost of Armed Forces pay and the extra cost of inflation above the cash factors) to avoid a cash squeeze; the latter is inconsistent with real growth. In this way the 3% real growth bid carries on its coat-tails a host of other bids to underwrite price rises and preserve "volume".

/ 4.

4. In support of this bid, MOD will quote the NATO aim, and its recent extension - with British concurrence - to 1990. MOD will also claim that continued real growth is necessitated by the increasing Warsaw Pact threat, and the desirability of enhancing NATO's conventional capabilities to raise the nuclear threshold. MOD's draft PES contribution alleged that anything less than 3% growth " would mean cutting back our conventional capability"; this is nonsense - military strength would always increase with an annual spend of £18 billion or so (if not quite as rapidly as MOD wish).

5. The main HMT argument will be the simple macro-economic one that increasing defence expenditure is incompatible with the Government's wider objectives of reducing public expenditure in order to lower the PSBR and taxes to promote economic growth. By 1985-86 defence spending will have increased by some 25% in cost terms over 1978-79; it must henceforth take greater account of economic considerations.

6. Other Treasury lines will include the following:

(a) The NATO aim is only an aim (like the UN aim that 0.7% GDP be devoted to overseas aid), not a binding commitment; whether it can continue to be achieved must depend on economic circumstances.

*RK 14-
fund 10.7* | (b) Of the major Allies, the UK contribution to NATO is already second only to the US in absolute terms, per capita, and as a proportion of GDP. We should not increase the unfairness of our defence burden.

(c) The 3% aim is crude and meaningless. All defence expenditure counts; simplistic year-on-year arithmetic applies; it concerns only inputs, not defence capability or outputs (for which, in the defence field, there seem to be no satisfactory/accepted measurements).

(d) MOD must exploit their substantial scope for increasing defence output by greater efficiency and optimising value-for-money. In this way, "real growth" in military effectiveness can be achieved at no increase in input cost. MOD have already been enjoying the extra fruits of their own efficiency improvements; since 1978-79 the procurement vote has increased 40% in cost terms (17% more than the

/ defence

defence budget as a whole). With the personal intervention of Mr Heseltine and MINIS, many more improvements should be possible as the decade develops.

Extra cost of 1983 Armed Forces pay awards

7. This bid, which MOD make every year, is often loosely referred to as the extra cost of the AFFRB award. In fact it is more than this; MOD also add on the Armed Forces cost (up to £5m) of the TSRB and DDRB awards - the only department, probably, to claim Top Salaries compensation.

8. The Armed Forces pay PES claim has always been difficult to contest. Service pay can be an emotive issue, and Mr Nott exploited this to achieve his PES ends. MOD have been successful in blurring the Government's stance. There is a public commitment to Service pay comparability (which has always been maintained - Servicemen get paid about 90% more than in 1979); but there is no commitment to increase the defence budget commensurately.

9. Until last year, compensation for the follow through costs of the Armed Forces pay awards was always justified by the in-year cash limit increment: because of the "volume" year-on-year commitment, one addition implied the others. In the 1982 Survey, Mr Nott obtained no in-year increment, but secured follow-through costs; this resulted in "extra" real growth (about 0.4%) in 1983-84. According to year-on-year 3% logic, absorption of pay costs in-year dispenses with any need for additions in future years.

10. The Treasury aim therefore must be first to hold the 1983-84 cash limit; on the grounds that the AFFRB award costs are less than 1% of the defence budget and should be absorbed - like other public service pay awards - by improved efficiency and good housekeeping. Then the Treasury must ensure this logic is carried through to later years. The danger is that, whatever happens in 1983-84, future provision will be decided not on logic but by the emotion of "not cutting the soldier's weapons to finance his pay".

Inflation adjustment to restore real growth

11. This bid is another MOD perennial. Real growth should mean no cash squeeze. If the cash factors imply a squeeze, extra provision is required.

12. In principle it is difficult to resist this argument so long as the Government has a real terms commitment. In practice its cost should be far less than the original bid. The bid is based on the FSBR forecasts of inflation for 1984-85 and 1985-86 (5.5% and 5% respectively) and on an MOD make-weight "forecast" for 1986-87 of 4.5%. MOD have calculated the difference between the current (cash factor) provision and what these forecasts imply. The bid is therefore a composite of different inflation allowances:

£m cash	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
(a) 1984-85 inflation (5.5%)	82.7	86.0	88.6
(b) 1985-86 inflation (5.0%)	-	179.5	184.9
(c) 1986-87 inflation (4.5%)	-	-	280.0
	<u>82.7</u>	<u>265.5</u>	<u>553.5</u>

13. For practical purposes the elements at serials (b) and (c) can be disregarded. It is too early to forecast 1985-86 etc inflation reliably. MOD have accepted this line before and should be content to bide their time until next year's Survey; these parts of the bid are included only to provide a give-away for a Ministerial "compromise".

14. The 1984-85 inflation bid - assuming that the autumn forecast confirms an excess over the 5% cash factor - will be more difficult. But currently the 5% applies to the whole defence budget - pay and non-pay. If lower provision is to be made for public service pay (about a third of the defence budget), this could either offset excessive non-pay inflation or produce net savings. The modalities of this (eg baseline clawback or ad hoc negotiation) will depend on overall public service pay decisions.

*has the
5% applied
or not yet?*

Falklands

15. The Government is committed to fund all defence Falklands costs by money additional to the path of 3% real growth. Hitherto, the practical implications of this commitment have extended only up to 1985-86, because that was the end of the Survey period. But it will not be possible for Treasury Ministers to resist continuation of the commitment unless they judge the Falklands political climate to have changed considerably from last winter. In principle therefore this bid would be irresistible.

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16. There are broadly two sorts of extra Falkland cost. One is the cost of Operation Corporate - of replacing the stores and equipment consumed or lost last year. The second is the cost of the garrison - the capital and running costs.

... 17. It remains unclear how MOD will compute their 1986-87 Falklands costs or treat last year's PES agreement. The deal struck with Mr Nott was intended to be a firm, once-for-all affair based on MOD's best estimates of equipment replacement costs and on broad-brush garrison figures. The philosophy was that this sort of arrangement would enable MOD to manage the defence programme as a whole, would provide an incentive for them to secure maximum economy and value-for-money on Falklands expenditure, and would eliminate any need to re-examine Falklands costs each year (swings and roundabouts rules).

18. On this basis, the 1986-87 provision for the operation would be about £225m cash. On the assumption that by 1986-87 only running costs are defrayed for the garrison, and that these equate to the £200m at 1982-83 prices quoted to the HCDC, the garrison provision would be about £240m cash. Defence Falklands provision would therefore cost some £460m in 1986-87 - a total of over £3 billion since last year.

19. However, MOD could well bid, we understand, for £618m. We have yet to see a breakdown of this sum. The garrison has proved to be larger than Mr Nott seemed to envisage when he offered his deal; the garrison capital costs have exceeded expectations, and in addition could run on into 1986-87 because progress has been slower than originally foreseen (eg on the works programme). Mr Heseltine has already put down markers to OD(FAF) that he may abandon the 1982 PES deal and seek to increase defence provision to prevent Falklands requirements from squeezing the "normal" defence programme. MOD may therefore have been tempted to bid for estimated actuals in 1986-87. This would have disturbing implications for later years - effectively, MOD would be seeking a Falklands carte blanche.

20. HMT could respond in a variety of ways to such an approach:

(a) We could seek to hold to the agreement in the 1983 PES: a deal is a deal.

/ (b)

(b) We could demand that the ever-increasing burden necessitated a radical reconsideration of the agreement that MOD should be compensated for its Falklands costs; the more HMG's Falklands policy is seen to cost, the more unpopular it will be.

(c) We could argue that in view of MOD's inclination to claim for actuals rather than seek a once-for-all settlement, the issue of 1986-87 Falklands provision should be deferred until nearer the time when more reliable estimates are available (the hope here would be that the Falklands climate in 1985 would be less defence-favourable than it is today).

In any of the above responses, HMT could stress the point Mr Heseltine has made publicly: a great deal of "Falklands" expenditure is not Falklands-specific (the airfield is a notable exception) but will benefit NATO as well (eg the 4 new Type 22 frigates, the strategic Tristar tankers, extra Phantom aircraft etc).

Reductions

21. MOD have offered no reduction in Cmnd 8789 provision. To do so they say, would derogate from existing Ministerial commitments; and indeed, in recent years the Treasury has attempted to restrain increases rather than secure savings on defence provision.

22. There are very strong grounds however for pressing for cuts in this year's Survey. These revolve round the 1983-84 cash limit reduction (£240m) announced on 7 July. This means that the 1983-84 baseline from which 3% real growth should be calculated is lower. Ironically therefore MOD are hoist by their own simplistic year-on-year 3% logic. The implications of the £240m cut on the Falklands-exclusive element of the defence budget would be as follows:

/ £m cash

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	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
(a) Survey baseline	15959.6	17269.9	18309.9	18290.6
(b) of which Falklands	- 624	- 684	- 552	
(c)	<u>15336</u>	<u>16586</u>	<u>17758</u>	<u>18291</u>
(d) cash limit cut	- 240			
(e)	<u>15096</u>			
(f) 3% growth (except for 1986-87)		<u>16326</u>	<u>17488</u>	<u>18013</u>
(g) f + b		<u>17010</u>	<u>18040</u>	<u>18013</u>
(h) savings on baseline (g - a)		- 260	- 270	- 278

23. Such savings would be invaluable - if only to offset irresistible defence bids. The lower the defence baseline, the lower the bid for 1986-87 3% growth (2(a) above) and for inflation compensation (2(c) above).

24. All the above assumes that Treasury Ministers will not challenge the commitment to real growth up to 1985-86. If they do, and are successful, the possibilities for reductions are in theory unlimited.

DM1

4 August 1983

After discussion, the Prime Minister said it was agreed that the costs of the Review Bodies awards from 1983/84 to 1985/86 should be added to the agreed defence budget totals. The Defence Secretary would, however, withdraw his bid for an allowance totalling some £1½ billion over the three years (i.e. line (iii) in paragraph 1 of the annotated agenda) for defence non-pay relative price effect on the understanding that the adequacy of the cash provision was open to review, as last year, in the light of the movement in defence prices. The adjustments set out in paragraph 2 of the annotated agenda should also be made.

There followed discussion of Falklands expenditure. Your Secretary of State recalled that the Government had announced that all the equipment lost in the Falklands conflict would be replaced - not necessarily on a like for like basis - and that these costs, together with the cost of the Falklands campaign and of any future garrison, would be met out of monies in addition to the 3% annual rate of real growth. The best available assessment of the full additional cost of the campaign and of replacing lost equipment in cash terms was £725 million in 1982/83, £223 million in 1983/84, £334 million in 1984/85 and £313 million in 1985/86; a further £365 million (at 1982/83 prices) would be required for the later years. The Chief Secretary proposed that these costs should be re-phased as between the three years 1983/84 to 1985/86 as follows:-

1983/84: £200 million
 1984/85: £345 million
 1985/86: £325 million

Your Secretary of State said that he would prefer that the 1983/84 figure should be £213 million: he would consider whether this could be further reduced. Subsequently you have confirmed that your Secretary of State and the Chief Secretary have agreed that firm additions to the defence budget should be made of £200 million in 1983/84, £350 million in 1984/85 and £320 million in 1985/86.

(On the costs of the Falklands garrison the Secretary of State proposed that the interests of control would be best served by allocating fixed sums and including them in the defence budget. If that was accepted, he would be prepared to argue at OD(FAF) that any additional costs should be met from the defence budget.) After discussion it was agreed that the sums to be added to the defence budget, at 1982/83 prices, should be 1983/84: £400 million; 1984/85: £300 million; and 1985/86: £200 million. This estimate rested on the assumption of an airfield costing around £220 million and of a configuration of forces on the following lines:

- | | |
|-------------------|------------------------|
| 1 SSN | 5 other helicopters |
| 2 Frigates | 8 Rapier fire units - |
| 3 Patrol Craft | with a total onshore |
| 1 Ice Patrol Ship | strength not exceeding |
| 1 Oiler | 2,000 |
| 1 Battalion | |
| 6 Phantoms | |
| 2 Hercules | |
| 3 Chinooks | |

CONFIDENTIAL

FROM: A M BAILEY

DATE: 5 August 1983

CHANCELLOR OF THE EXCHEQUER

Where do we stand on T23 cc Chief Secretary
 Yms AFPRB "compensation!" Mr Kitcatt
 Hlv. the C.R. Central was assumed Mr Mountfield
 we'd hv. to pay? Mr Richardson
 V. diff. not to do so. ~~that~~ Mr Ridley
 to in view of (a) 5 pay Mr Lord
 Squeeze (b) 240 off. ? Best to
 allow for this yr: disallow for future yrs.

PES 1983:DEFENCE

The attached minute by Mr Kitcatt is a brief for your meeting on Monday afternoon. ~~now morning~~.

2. I agree that the points in his paragraph 8 are the main questions for consideration. The brief suggests, in effect, the maximum we can hope to get short of challenging the 3% growth commitment before 1986-87. But I think you will also want to consider how we might seek to "re-interpret" the 3% NATO growth aim earlier than 1986-87.

3. The biggest prize would be to get agreement to aim at something less than 3% even for 1984-85. Given all the other difficulties, it seems to me that we have to look at this possibility very seriously. In particular, you have suggested that we could "re-interpret" by counting in Falklands expenditure. This would clearly not be advantageous taking any base year later than 1981-82, because (naturally enough) since the Falklands conflict the annual rate of "Falkland-related" spending has been and is likely to continue to be on a broadly declining path (paragraph 5.2). But we could say that defence spending, inclusive of the Falklands, has been well above a 3% growth path since 1981-82 (and indeed since 1978-79).

4. As a public defence of a revised path, this would carry some weight. In public (and to NATO) it could be pointed out that a good deal of "Falklands" expenditure is not Falklands-specific but will benefit NATO as well (annex paragraphs 15-20). But our judgment is that the Defence Secretary will not allow Treasury Ministers to make much of this argument in Cabinet. The 3% growth commitment which Ministers have endorsed up to 1985-86 has clearly not been presented in these terms, and to do so would be seen as going back on last year's agreement on Falklands finance.

AT FLAG 'C'

5. So in our judgment there are two options:

a. to challenge the 3% commitment head on (Mr Kitcatt's section 4 - where I agree it would be better to stick to what can be afforded, rather than seek to argue specific defence policy issues); or

- Right. But in what sense is removing the 240/270 a benefit with 30% it isn't

b. to remove the additional bids (annex paragraphs 7-14), and carry forward this year's cash limit squeeze (paragraph 22) - the toughest possible interpretation of 3% real growth.

Could not carry on forward AFRT? wld. be - but needed carry forward all 80

6. The only other point I want to make on the briefing relates to Mr Kitcatt's paragraphs 3.5-3.7: I would much prefer not to settle for any presumption that the 3% is simply suspended for the single year 1986-87, to be reviewed after that. We need to revise the presumption for defence planning and get them starting to think in cash terms. This can only be achieved if Cabinet takes a reasonably firm decision that after 1985-86 public expenditure and tax targets are not to be subordinated to a defence "real growth" commitment.

AMB

A M BAILEY

CONFIDENTIAL

FROM: MISS J M SWIFT *RP*

DATE: 8 AUGUST 1983



PRINCIPAL PRIVATE SECRETARY

cc. Mr Bailey
Mr Kitcatt
Mr Mountfield
Mr Richardson
Mr Ridley
Mr Lord

PES 1983: DEFENCE

The Chief Secretary has seen Mr Bailey's minute of 5 August covering Mr Kitcatt's minute of 4 August, which the Chancellor has discussed with officials this morning.

2. The Chief Secretary had the following comments on these papers:-

- ✓ i. The Chief Secretary does not think that Treasury Ministers could succeed in reversing the three per cent growth commitment before 1986-87, although there should of course be no question of its continuing after that date.
- ✓ ii. MOD should be pressed to absorb the AFPRB award costs. At any rate, MOD should absorb the costs of the TSRB and DDRB awards.
- ✓ iii. Additional Falklands' costs need to be defined very carefully eg. could some of the replacement costs be regarded as partly discharging the NATO commitment.

JMS
MISS J M SWIFT
8 AUGUST 1983

CONFIDENTIAL

Pwp

CONFIDENTIAL

B.12

FROM: ADAM RIDLEY
6 October 1983

CHANCELLOR

1 agree
me

cc CST
Mr Bailey
Mr I P Wilson

? below.

DEFENCE PES: INFLATION GUARANTEE

2 mark so.

It may be entirely unnecessary to do so, but I would like to urge most strongly that we go no further in seeking an understanding with the MOD about cash control than is suggested in paragraph 2 of Mr Bailey's minute to Mr Wilson of October 5.

That suggests that the most we should offer is that the "adequacy of the cash provision is open to review in the light of price movements". To concede any more would be not only bad for cash control and a very dangerous precedent to other Departments, not least DHSS with all their problems in the Health area. The basic logic of the MOD has at its heart the fear that defence relative prices will be moving adversely forever. To accept Mr Heseltine's line is to deliberately build into the planning ^{and} control system a device which negates a fundamental signal from the price mechanism.

That's the formula always used, for every programme, since cash limits began

If the prices of something rise either faster than anticipated or faster than other goods and services, it is surely essential that there should be a bias towards buying less of them.

Right. But the MOD argument is that eg frigates increase in price more rapidly than motor cars, and that they have to

2. It is not only a matter of general principle which is at stake.

It is not difficult to imagine that Mr Heseltine may be seeking to deal with the problem of the extension of the 3% growth target beyond 1985-6 by a two-pronged strategy. He will, first (as he has already indicated in his bilateral) be prepared to offer a slight reduction in the rate of growth for the terminal year of his programme as an apparently realistic reflection of the need to reduce the growth rate in the latter part of the decade. But he will then perhaps seek a series of ad hoc adjustments in subsequent surveys to add to that initially agreed figure so that, in the event, the outcome is a level of spending that is at least as good as he would have obtained if he had secured open agreement in principle to 3% volume growth after '85-6. If there is anything in this suspicion, it must be in our interests to get to the purest possible cash planning for '86-7 and later years.

perhaps. But he couldn't start that for another 2 surveys.

AR

A N RIDLEY

I agree with
17th Bailey. Agree with
misc 99 -
have done the £100m @
on way to misc 99's
with some misc 99's
misc 99's history.

CONFIDENTIAL

FROM: A. M. BAILEY
28th October, 1983.

CHIEF SECRETARY

- c.c. Chancellor ✓
- Mr. Kitcatt
- Mr. Scholar
- Mr. Hart
- Mr. Ridley
- Mr. Lord

MISC 99: DEFENCE 1986-87

Mr. Richardson's minute of today suggests that, if you judge it right tactically in MISC 99 to make a cash offer for 1986-87, "the lowest reasonable sum might be £100m.". I agree with this, but would want to argue that it should also be the highest offer (of course, as Mr. Kitcatt says, on our basis for the earlier years).

2. As the line of figures at the end of Mr. Richardson's minute shows, with the extra £100m. MOD would by no means face a "cliff" in that year. Even Falklands-inclusive, they would get £½ billion more cash in that year, as against £1 billion more in the previous year. With the expected continuing fall in inflation, and the ending of the 3% NATO commitment, that would seem entirely reasonable. To go beyond that and add £2-300m., on the basis of splitting the difference, would hardly look like a cut at all on these figures.

3. Perhaps another £100m. would be worth conceding if it were to be the final concession to reach agreement. But since Mr. Heseltine will presumably insist on taking his case to Cabinet, it does not seem to me that making a further Treasury concession to maintain MISC 99 unity would be worthwhile.

A. M. BAILEY

PRINCIPAL PRIVATE SECRETARY

From: I P Wilson
4 November 1983
cc: (without attachments)
Chief Secretary
Mr Bailey
Mr Scholar
Mr Kitcatt

PES: DEFENCE

I attach a selection of briefing for this afternoon's meeting with the Prime Minister and Defence Secretary.

2. It consists of:
 - a. Main Speaking Note
 - b. 3% or 21% - Annex A
 - c. What presentational problem (including comparisons with NATO allies) - Annex B
 - d. 1986-87 Maintenance of real growth - Annex C

(Below) You will also have received a copy of the slightly revised note by Treasury officials that was sent to the Prime Minister last night, and which she may hand to Mr Heseltine today.

3. ~~Many~~ of these arguments will be familiar to you. The briefing material has been used before, but manuscript deletions have been made where issues are no longer relevant.

4. The attached does not cover the very latest developments and tactical possibilities-eg rephrasing the offer, and presentation of 1986-87 - which might be best discussed orally this afternoon.

below
[- formulae]

(below)
[Rephrasing]



I P WILSON

S E C R E T



From: P J KITCATT
Date: 4 November 1983

CHIEF SECRETARY

cc Chancellor--
Mr Bailey
Mr Scholar
Mr Wilson
Mr Richardson

DEFENCE: MISC 99

Two issues were raised this morning.

2. The first concerns the form of words on inflation, which you have accepted, for 1984-85 and 1985-86.

3. There is an aspect of this which we think must be clarified with Mr Heseltine now. It is whether MOD interpret it as allowing an in-year automatic reopening of the cash limit. We do not think it is what MOD officials want but we are not clear about Mr Heseltine's views. When Mr Heseltine's proposals arrive, we would recommend you to write as in draft attached.

3. The second concerns Mr Heseltine's desire ^{to leave} 1986-87 in limbo. We understand that at the Lord President's meeting the following form of words about 1986-87 was handed round by Mr Heseltine, but not discussed:-

"The Government has not yet determined the provision for defence after 1985-86 which will be considered in the light of international developments and economic circumstances nearer to the time.

The figure for 1986-87 is therefore that for 1985-86 (excluding Falklands provision) increased by the appropriate cash factor, together with £450m to meet the costs of the Falklands commitment in 1986-87."

4. It is totally unsatisfactory to leave this figure unresolved, since it gives us nothing to which we can hold the MOD for the future and it will obviously be used as a base for bidding up (and maybe extending the "real terms" commitment) - and also giving nods and winks to the defence lobby.

5. If in the end we have to settle for something like this, it would be better to use a form of words which would give this figure some status and create at

S E C R E T

least some presumption that it would, in the event, be confirmed. Something on the following lines would go some way towards this:

? | "As is the case with all public expenditure programmes, the figures for the defence programme in 1986-87 is provisional. A final decision will be taken nearer the time in the light of international developments and economic circumstances. The provision for 1986-87 of £ - - - - carries forward the 1985-86 provision increased by the appropriate cash factor of 3%, together with £450m to meet the cost of the Falklands commitment".

But the above would be very much second-best to our preferred decision, which is to have a firm cash figure for 1986-87 settled now.



P J KITCATT

DRAFT LETTER TO MR HESELTINE

Copy to
members of
11/11/85 99

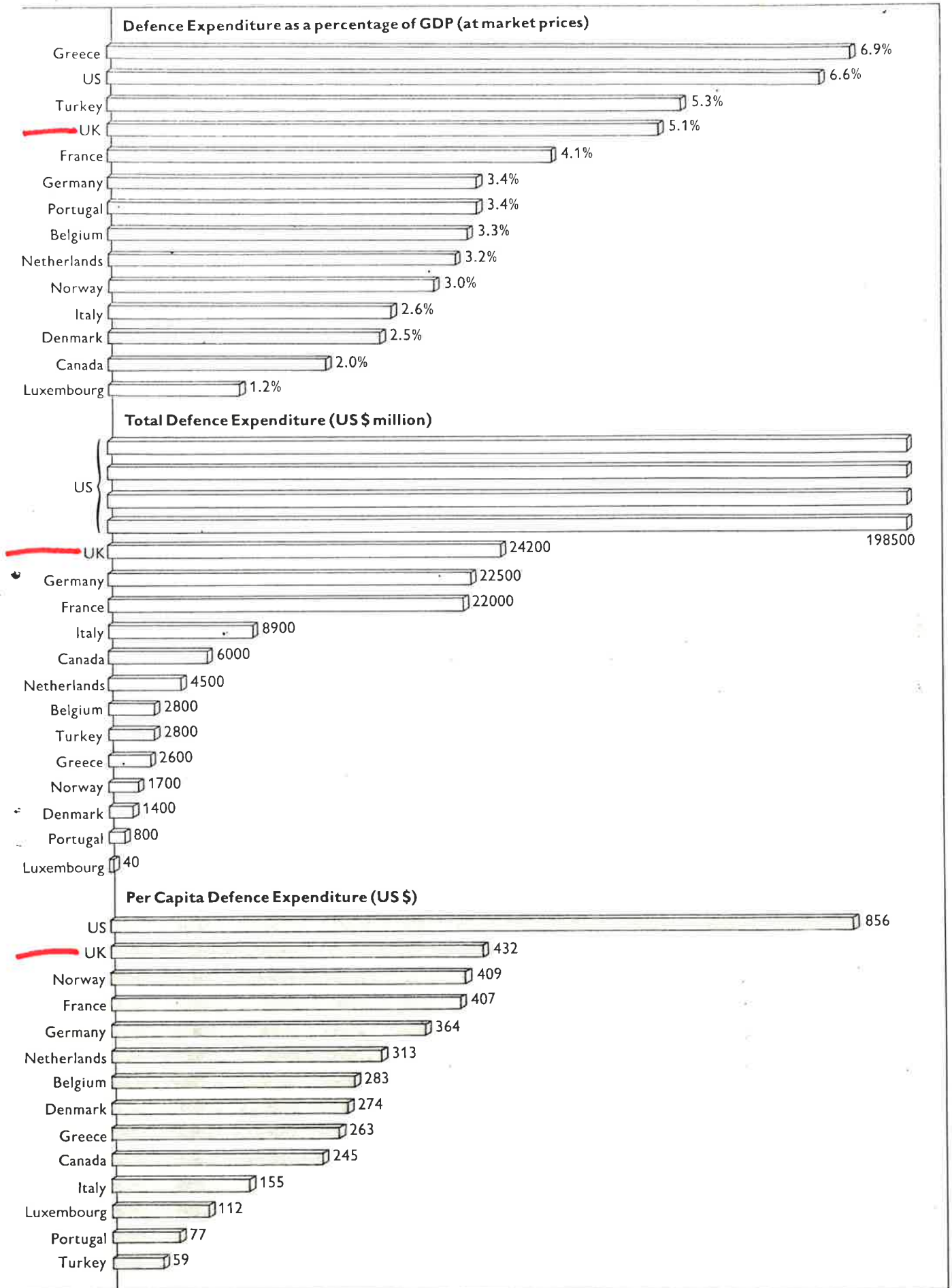
I have seen Michael Heseltine's letter of earlier today.

2. I have accepted his formulation, but to avoid future misunderstanding we must all be clear about what is involved.

3. I fully accept that we are committed to aim for 3% real growth per annum up to and including 1985-86; and that the proposed provision for 1985-86 assumes prices in that year 4% higher than in 1984-85. It follows therefore that if next autumn inflation is forecast to be higher than 4% for 1985-86, then an appropriate cash adjustment will need to be made. This - as I understand it - meets the concern that Michael emphasised this morning: that the achievement of 3% real growth in 1985-86 will not be jeopardised by any foreseeable cash squeeze in that year.

4. My understanding is that Michael's form of words is intended to avoid protracted argument in subsequent Public Expenditure Surveys - an aim I should naturally support. But our agreement should not detract from the importance of in-year cash limits and of in year cash control. My understanding in respect of 1984-85, for example, is that once we have settled a cash figure - in the light, inter alia, of the latest forecast of inflation - the normal cash limit rules will apply: that is, the presumption is that in-year cash provision will not be changed.

Figure 8 Comparisons: NATO Countries 1982



Note
 These figures, which are provisional, have been compiled from NATO sources. Total expenditure and per capita figures are based on 1982 average market exchange rates. They reflect the fact that in 1982 the dollar appreciated less against sterling than against most other NATO currencies. Market exchange rates do not necessarily reflect the relative purchasing powers of individual currencies and so are not a complete guide to comparative resource allocation to defence.

*edited versn of last night's work
(Suitable now for MH eyes)*

DEFENCE

(Note by Treasury Officials)

	£ million cash			
	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
Baseline (of which Falklands agreed)	15,720 624	17,178 684	18,214 552	18,192 450
Mr Heseltine's opening position	15,810	17,330	18,551	19,815
Treasury opening position	15,720	16,910	17,934	18,353
MISC 99 proposal	15,720	17,010	18,040	-

1. MISC 99's proposals - which will be accepted by the Treasury if they are accepted by Mr Heseltine - would mean giving defence £100m in 1984-85 and £106m in 1985-86 above the Treasury's starting position. These figures would leave the defence budget below 1983 Public Expenditure White Paper provision.

2. MISC 99 has made no proposal for 1986-87, on the ground that this is a matter for the Cabinet and not for a small group of Ministers to resolve. The Treasury's preferred position for 1986-87 would be to uplift an agreed non-Falklands 1985-86 figure by the 3 per cent cash factor applicable to all expenditure programmes and to build in no real growth above that; so as to arrive at a cash total (with 1986-87 Falklands costs on top), getting MOD away from their 'real' growth aspirations. On the MISC 99 basis this would give a Falklands-inclusive figure of £18,464m. 3 per cent real growth in 1986-87 would require an additional £530m, giving a total of £18,994m.

3. The Treasury believes that its 1986-87 figure would provide a wholly reasonable profile of defence expenditure over the next three years, with annual increases of £1.3 billion, £1 billion and £½ billion respectively in the successive years. These increases will be difficult enough to accommodate within public expenditure plans, given that the outcome of the bilaterals and of MISC 99 - defence apart - leave us short of our target by £87m in 1984-85, £408m in 1985-86 and £242m in 1986-87.

4. Defence is now the second largest programme - higher than health or education - and consumes 5.5 per cent of GDP. In absolute terms our defence spend is the highest in Europe. We have increased the defence budget every year since coming to office; five successive increases is

/ unprecedented

unprecedented since World War II. Since 1978-79, defence spending has increased in real* terms by over 20 per cent.

5. This has imposed a heavy burden. Over the same period, GDP has increased by only about 1 per cent. The increases in defence expenditure have been paid for not by economic growth, but by higher taxes and interest rates, and by cuts in other programmes. This cannot continue for ever. For the future, defence must take greater account of our wider public expenditure and economic objectives.

6. Further growth in military capability should come from improving efficiency and output, and obtaining better value for money. There is plenty of scope for making defence resources more effective: the civilian manpower proposals alone - now accepted by Mr Heseltine - will free an extra £120m a year.

7. Besides, MOD have had great difficulty in recent years in spending all the money provided. MOD have swallowed without difficulty the 7 July cut of £240m, plus £100m for the 'armed forces' and civil service pay; and still look likely to underspend this year.

8. The NATO 3 per cent aim is only an aim, like the UN aim that 0.7 per cent of GDP be devoted to overseas aid. It is not binding. Mr Heseltine has himself made this clear: he wrote to the Prime Minister in May "But the 3 per cent formula is, of course, a target not a binding commitment".

9. NATO, in any event, is unlikely to cause us difficulty. Other nations will be poorly placed to criticise the UK. The real problem is that other Allies do not follow the UK example. If they did, each European Ally would spend 5.5 per cent of GDP on defence (the current average is 3.8 per cent), and meaningless growth measures could be discarded.

10. We do not believe that, with a 1986-87 budget of over £18 billion, absence of real growth would have dire operational and industrial consequences.

a. MOD's internal plans last year assumed no growth at all after 1985-86. Mr Heseltine ought to revert to the force projections that satisfied his predecessor.

/ b.

* GDP deflator basis

Real growth in military effectiveness can be achieved without an equivalent increase in input cost. MOD must exploit the substantial scope for increasing defence output by greater efficiency and value-for-money.

c. MOD have cried wolf before (notably in the 1981 Survey: even after making over £1000m of cuts in his 1982-83 programme, Mr Nott foresaw a "programme gap" of £200m - but the real problem in 1982-83 was to avoid a massive underspend). MOD costings are notoriously inaccurate. The margin of error for 1986-87 is too great to attach much reliance to claims of gloom and doom at this stage.

d. Substantial scope exists for economies that do not damage the front line: for example over £1200m a year is spent on Service training; over £700m on social and welfare expenditure; and the value of defence stocks at major depots is £7 billion.

FORMULA FOR 1986-87

11. We will need, of course, to agree a figure for 1986-87 in order to complete the expenditure review for the White Paper. But we will need, also, to agree a form of words to describe this figure.

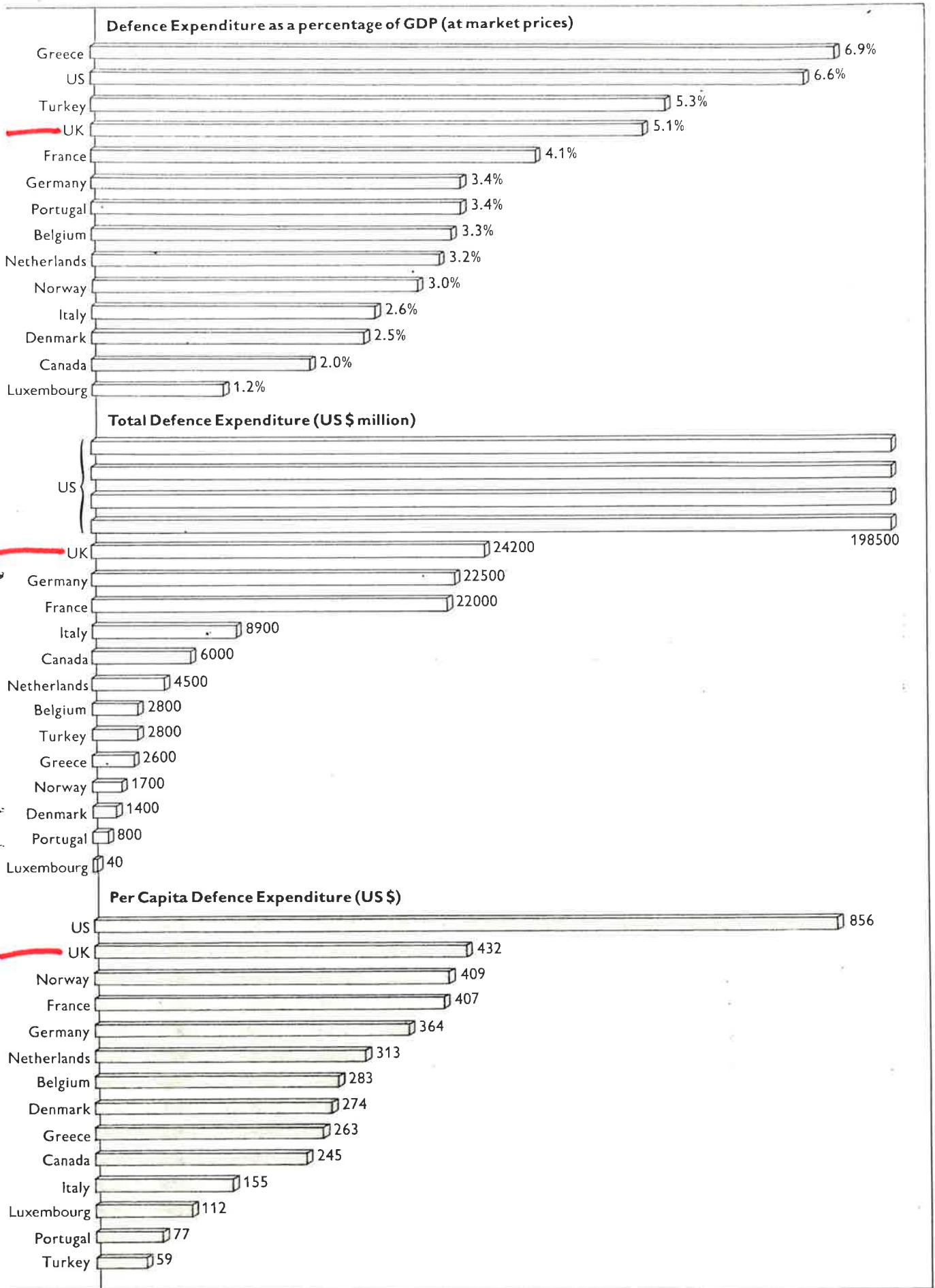
12. The Treasury's aim will be to ensure that the defence planners will work to the agreed figure, so that our commitments do not grow out of step with the available resources, forcing us in future years into highly visible cutbacks or unplanned increases in expenditure at short notice. There will be no Treasury objection to describing in public the figure as provisional and subject to review like other PES figures, provided that firm instructions on the above lines are given to the defence planners.

13. So far as the NATO target is concerned we should point to our achievement since 1978-79, and our further plans up to 1985-86 and emphasise that thereafter real growth will come from increasing efficiency and outputs, not from expenditure input.

HM TREASURY

4 November 1983

Figure 8 Comparisons: NATO Countries 1982



Note
 These figures, which are provisional, have been compiled from NATO sources. Total expenditure and per capita figures are based on 1982 average market exchange rates. They reflect the fact that in 1982 the dollar appreciated less against sterling than against most other NATO currencies. Market exchange rates do not necessarily reflect the relative purchasing powers of individual currencies and so are not a complete guide to comparative resource allocation to defence.

POSSIBLE REPHASING OF MISC 99 OFFER

The MISC 99 offer is:	£m cash		
	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
	17010	18040	<u>18464</u> *
Change on Treasury offer	+100	+106	<u>+111</u> *

* MISC 99 made no recommendation on 1986-87. This figure is a simple revaluation of 1985-86 by the 3% cash factor

2. The total extra across the three years is £317m but we do not believe that the MISC 99 phasing achieves the optimum effect either presentationally or managerially. If Mr Heseltine could be brought to accept that £317m extra is a final offer he might opt for rephasing.

~~The Chancellor would not object to sensible rephasing~~ [not to be revealed before the meeting.]

3. At one extreme the whole £317m could be added to the final year giving:

16910	17934	18670 18650
-------	-------	---------------------------

This phasing would still give 3% real increases in 1984-85 and 1985-86 in fulfilment of the Government's commitment, and a non-Falklands cash increase in 1986-87 of 4.8%, well above the cash factor of 3%. (The Treasury would much prefer to talk solely in cash about 1986-87. My translation into "real terms" would derogate from cash planning and act as a ratchet in future years.)

4. A minimal rephasing would simply round down the earlier years in favour of the final year eg

17000	18000	18514
-------	-------	-------

There is a whole range of intermediate distributions.

5. The Treasury does not believe that Mr Heseltine will argue that pressure on the defence budget requires extra funds in the first two years. There are no signs of such pressure and the recently agreed flexibility arrangements will give further help. Any defence works and procurement underspend in 1983-84 can be carried forward into 1984-85 up to a maximum of £375m. No allowance is made for carry forward in any of the above figures.

6. At the bilaterals with the Chief Secretary, Mr Heseltine argued rather that it would be presentationally difficult for him to accept the Treasury proposals for the first two years, since the figures were below the 1983 White Paper published totals. The Treasury does not see

/ this

this as a major problem since the lower figures still provide for 3% pa real growth. The real issue is whether Mr Heseltine wants more than 3% real growth in 1984-85 coupled with a base 3% cash factor uplift in 1986-87, or whether he would prefer something closer to 3% in 1984-85 coupled with a cash increase in 1986-87 higher than the straight 3% revaluation.

8. Our conclusion is that an offer of some rephrasing of the MISC 99 offer could well prove attractive to Mr Heseltine. But he would first have to accept that it is redistribution not additional cash that is on offer.

PES 1983: DEFENCE

	£ million cash			
	1983-84	1984-85	1985-86	1986-87
Baseline	15719.6	17178.0	18214.4	18192.2
(of which Falklands)	(624.0)	(684.0)	(552.0)	-
Agreed bid: Falklands				+ 450.0
<u>Disagreed proposals for increases/reductions in baseline</u>				
<u>MOD bids:</u>				
inflation compensation	+ 59.3	+ 240.0	+ 308.8	
service pay awards	+ 90.4	+ 93.1	+ 96.8	+ 99.7
1986-87 3% "real" growth				+ 564.1
<u>Total MOD bids</u>	<u>+ 90.4</u>	<u>+ 152.4</u>	<u>+ 336.8</u>	<u>+ 1172.6</u>
<u>Treasury proposals:</u>				
limit growth to 3% in 1984-85 and 1985-86	-	- 267.6	- 280.7	- 289.1
MOD proposed provision	15810.0	17330.4	18551.2	19814.8
Treasury proposed provision	15719.6	16910.4	17933.7	18353.1
MISC 99		17010	18040	[18464]
<u>POSITIVE</u>				

Defence is now the second largest programme - higher than health or education - and consumes 5.5% GDP. In absolute terms our defence spend is the highest in Europe. We have increased the defence budget every year since coming to office; five successive increases is unprecedented since World War II. Since 1978-79, defence spending has increased in cost terms by over 20%.

2. This has imposed a heavy burden. Over the same period, GDP has increased by only about 1%. The increases in defence expenditure have been paid for not by economic growth, but by higher taxes and interest rates, and by cuts in other programmes. This cannot continue. For the future, defence must take greater account of our wider public expenditure and economic objectives. Economic needs must take precedence over military aspirations.

3. We should not therefore plan for any real growth in defence spending after 1985-86, when our current commitment expires. In 1985-86, defence expenditure - depending on method of measurement - will be 20-25% higher than in 1978-79. I have already agreed an addition of £450m for

1986-87 Falklands expenditure. Further growth in military capability can come from improving efficiency and output, and obtaining better value for money. "Real growth" ought to mean increased output, not simply inflating expenditure input. There is plenty of scope for making defence resources more effective: our civilian manpower proposals alone will free an extra £120m a year.

4. There is a strong case for restraining real growth immediately - and not only on public expenditure and economic grounds. In recent years MOD have been unable to spend the provision allotted, and a further under-spend is in prospect this year; if, as seems likely, we provide MOD with more cash than they need in 1984-85, there will be little incentive for them to pursue value for money and increase efficiency - or to restrain inflationary demands from defence contractors. [See Appendix]

5. NATO exhortations are a dubious way of approaching public expenditure planning. The 3% aim is crude and meaningless. All defence expenditure (however wasteful or non-operational) counts. Simplistic year on year arithmetic applies (not, for example, absolute levels of expenditure). The aim concerns only inputs. The aim is only an aim, like the UN aim that 0.7% GDP be devoted to overseas aid; it is not binding.

6. However, we have a commitment to increase the defence budget by 3% per annum up to 1985-86, and if colleagues agree I am prepared to plan on this basis. But we should not provide for annual increases in defence expenditure in excess of the NATO aim of 3%. My proposals allow 3% growth - but no more - up to 1985-86, with Falklands costs on top; this is far more than MOD have been able to spend in the current year.

Manpower

7. A substantial reduction in defence numbers is crucial to our overall manpower strategy. Mr Heseltine has been asked to agree to a target of 170,000 for 1 April 1988. He has not so far indicated that he is prepared to accept that figure or any other level of saving. Ignoring the ROFs, his present bid is for increases above the 1984 level. Yet (at 6.3%, exclusive of the ROFs) he is being asked to contribute little more than the general run of savings and rather less than a number of other large departments have agreed to do (including the Treasury group, at about 8%). In time, with the full development of MINIS in MOD, even larger savings should be possible. But for the moment I believe 170,000 to be a necessary and reasonable contribution to the overall exercise.

DEFENSIVE

8. There were no Manifesto or other election commitments to any level of defence spending. The main presentational difficulty over defence could be in justifying a very high and increasing level of defence expenditure when other programmes are being cut. Mr Heseltine told the Guardian last month, "There are no cuts facing my department. What's facing my department is the rate at which we increase expenditure." The rate should be no more than 3%. [There has never been any public interest in the "21% intention" announced in 1981; but if the question does arise there are various ways of showing that defence expenditure plans for 1985-86 will show an increase of 21% over 1978-79 - for example Falklands-inclusive figures were quoted in the 1983 Statement on the Defence Estimates and could be updated and quoted again - as they were in last week's Lords Debate (attached)].
9. The NATO bogey has been much exaggerated. Other nations will be poorly placed to criticise the UK. The real problem is that other Allies do not follow the UK example. If they did, each European Ally would spend 5.5% of GDP on defence (the current average is 3.8%), and meaningless growth measures could be discarded.

Inflation bid

10. Provision should continue to be based on the cash factors agreed by Cabinet. The existing factor of 5% should be adequate if not generous for 1984-85. It is premature to attempt to forecast public sector costs in 1985-86 and 1986-87. The later years can be looked at again in subsequent Surveys. If inflation is lower than the factor in 1984-85, the non-pay factor will be too generous for the third successive year.

Service pay awards bid

11. There is no commitment to increase provision on account of service pay awards. Excess costs should be absorbed by improved efficiency and good housekeeping, as they are for the civil service. MOD are forecasting an underspend this year; so no in-year cash limit increase is needed. Similarly, 3% growth can be achieved in future years without these additions. At the end of the last Survey John Nott told the Prime Minister "that he recognised that the principle of thus compensating the defence budget for the Review Body awards might need to be given up after the General Election". There is of course no such principle, especially if 3% growth can be achieved without compensation.

DEFENCE UNDERSPENDING

In 1981-82 the then Defence Secretary, Mr Nott, claimed that a £300m overspend against the defence cash limit was inevitable; an in year addition of £300m was made accordingly. In the event, the problem MOD faced was to avoid underspending. The payment of £300m worth of bills was accelerated into FY 1981-82.

In PES 1981, Mr Nott claimed the 1982-83 defence budget to be under severe pressure. He made some £1000m worth of cuts, received a cash addition of £375m, but still reported to OD a "programme gap" (ie an excess over provision) of some £200m.

In the event, the problem MOD faced in 1982-83 on their non-Falklands programme was to avoid underspending. As well as the alleged "programme gap" of £200m, they instituted over £400m worth of addbacks, absorbed the 1982 AFPRB etc costs, and accelerated the payment of some £500m worth of bills. Despite all these measures, the 1982-83 underspend was about £400m. This is in part why MOD have faltered against their 21% real growth target.

In the current year, MOD have accommodated without difficulty the £240m cash limit cut, and another £100m of extra pay costs. Outturn is uncertain at this stage, but the current forecast is of an underspend of £100m.

There is at present no reason to suppose that this underspending trend will disappear by 1984-85. MOD could find difficulty in spending even the provision in the Treasury proposal. The advent of end-year flexibility removes the need for MOD to temper PES bids with realism; any surplus can be carried forward.

DEFENCE EXPENDITURE: IS 3% PA OR 21% CUMULATIVE THE KEY ISSUE?

For 1984-85 and 1985-86, your position is clear. For the present, you are prepared to accept that defence expenditure planning figures should increase by 3% in real terms in each of the next two years to meet the NATO aim, but you are certainly not prepared to concede increases above 3% as a catching up exercise. The Government's economic and public expenditure objectives cannot accommodate such generosity.

2. Until this year, defence PES bids have been based on the commitment to provide for annual real increases of 3%. Mr Heseltine now appears to have been briefed to change tack, and has quoted from the June 1981 White Paper, Cmnd 8288:

"It was announced in March, and has recently been reaffirmed, that the defence budget for the next two years (1982-83 and 1983-84) will reflect further annual growth at 3%, in full implementation of the NATO aim. The Government has now firmly decided to plan to implement the aim in full for a further two years - 1984-85 and 1985-86 - and the programme will be shaped accordingly. This may well mean that defence will absorb a still higher share of our gross domestic product. Defence, like other programmes, will now be managed in cash terms: the intention will be provision for 1985-86 21% higher, in real terms, than actual expenditure in 1978-79."

In short, Mr Heseltine's PES stance is now based on the "intention" in the last clause of this passage.

3. There are a number of answers to this MOD line:

(a) the important growth figures are those for economic growth; GDP has increased by less than 1% since 1978-79;

(b) the NATO aim is an annual growth aim, not a cumulative one.

Most other NATO countries don't even plan for future 3% pa let alone catch up increases in excess of that figure (eg Germany, Netherlands);

(c) we cannot base 1984-85 expenditure decisions on June 1981 intentions. An intention is not a commitment and if the 21% is so important to MOD there are plenty of valid ways of indicating that the intention will be met (eg the Falklands inclusive figures quoted in the 1983 Statement on ^{the} Defence Estimates

(d) Parliament and NATO interest in defence expenditure growth (which is at best a poor measure of defence effort), is concentrated on annual growth. It is the commitment to plan for 3% annual growth that has been reaffirmed in subsequent Defence and Public Expenditure White Papers - not the 21% intention, which predated the Falklands conflict and can legitimately be interpreted as either Falklands inclusive or exclusive;

/ (e)

(e) because the future is more important than the past, there is limited value in pursuing the different ways of measuring past performance. But there should be no difficulty in showing that UK defence expenditure has grown impressively since 1978-79. On the provision to meet 3% annual growth you have offered, real growth over the period will be 27% Falklands inclusive and over 23% Falklands exclusive in cost terms. Even using the MOD's self-wounding methodology for the past, your proposals for future provision will give over 22% Falklands inclusive;

(f) UK press and Parliament have been more interested in cost terms measurements; these are the terms in which "real" growth in all public expenditure programmes can be measured and compared against economic performance. The Government publishes cost terms figures with the Public Expenditure White Paper (1983 PQ attached). If this year's experience is a guide, the presentational problem will be to defend the excessiveness of real growth - especially compared with other programmes and with the past and future performance of the economy;

(g) it is only by MOD's price methodology that the UK's growth performance looks disappointing. MOD's methodology is subject to a great deal of human error and was discredited last year by the Unwin report; it is being replaced by new indices, but even these have run into trouble because of the lack of real knowledge in MOD of what is happening to the prices they pay and their components. Meanwhile, although MOD might now be embarrassed to have given NATO unreliable figures, future expenditure decisions cannot be dictated by the side issue of a discredited set of subjective deflators; and there is no reason why MOD should not come clean to NATO about the Unwin report as part of the educative process.

4. The truth is that there is no commitment to increase defence expenditure by 21%; that there is no current NATO or Parliamentary interest in the 1981 intention; and that it will be mid-1986 before growth up to 1985-86 can be measured anyway - by which time the 1981 intention will be more forgotten; but that on all bases except the self-wounding MOD price methodology excluding Falklands the UK will achieve 21% growth by 1985-86 on the Treasury's proposals. The Defence Secretary must realise all this; only a very weak case would demand such belittlement of the UK defence achievement and there is plenty of evidence that MOD have not always adopted such a posture when it suited their books (Nott to NATO, SDE etc).

WHAT PRESENTATIONAL PROBLEM?

Mr. Heseltine told the Guardian recently, "There are no cuts facing my department. What's facing my department is the rate at which we increase expenditure." For tactical PES purposes, however, the Defence Secretary claims presentational problems with the 3% real growth the Treasury is proposing - the provision would be below the 1983 PEWP figures.

2. HMT sees two real presentational difficulties:

a. defending to colleagues and the country a very high and increasing level of defence expenditure when other programmes are being reduced;

b. explaining the jeopardising of public expenditure and economic objectives by excessive increases in defence spending.

The No 10 letter attached indicated that the Prime Minister's principal concern was over presenting the excessively high levels of defence spending. Domestic criticism, including public opinion polls, has hardened against defence expenditure.

3. There were no Manifesto or other election commitments to any level of defence spending - let alone to NATO aims.

4. The UK's performance on defence continues to be most impressive: the second largest public expenditure programme; 5.5% of GDP; the highest absolute level of defence spending in Europe; maintenance of 3% annual real growth up to 1985-86; £500m a year Falklands costs on top; the defence budget increasing every year for seven successive years (unprecedented since World War II).

5. There should be no difficulty in presenting all this - provided the will exists - as the 1983 Statement on the Defence Estimates (extract attached) demonstrates.

6. The NATO bogey has also been much exaggerated. Other nations will not criticise the UK for its defence expenditure decisions any more than we criticise, say, the Danes or the Germans; they would in any case be poorly placed to do so.

7. It is difficult to believe that a UK decision not to plan for increased defence expenditure beyond 1985-86 will be aped by other Allies. The real problem is that other countries do not follow the UK's example. If they did, each would devote 5.5% of GDP to defence (European NATO average is 3.8% GDP), and relatively meaningless growth aims would be unnecessary.



10 DOWNING STREET

From the Private Secretary:

1 February 1983

LONG-TERM PUBLIC EXPENDITURE: DEFENCE

The Prime Minister had a brief discussion this afternoon about the long-term prospect for defence expenditure. Apart from your Secretary of State, the Home Secretary, the Chancellor of the Exchequer, the Chief Secretary and Sir Robert Armstrong were present.

It was noted that the Government's existing commitment in the public expenditure plans was that the 3% annual rise in defence expenditure in real terms went up only to 1985/86. Thereafter, the expenditure plans showed the programme constant in real terms. The Government had indicated that it subscribed to the NATO guidance up to 1988 but it was noted that the terms of this guidance were vague at crucial points; that it was drafted in terms of aspiration; and that there was a proviso about countries' economic circumstances. It was a weakness in the NATO guidance that it was framed in terms of inputs - expenditure - and not of outputs. There was also some flexibility in what kinds of expenditure could be counted: although some of the Falklands expenditure could, clearly, not be so counted, some could.

Summing up the discussion, the Prime Minister said the Government must now present our defence spending plans in the most positive way, so as to make the most, in the eyes of our allies and the Government's supporters, of the substantial expenditure to which the Government was committed. Falklands apart, defence spending in 1985/6 might well be 20% higher in real terms than it was in 1978/9, taking up nearly 6% of GDP. If this growth rate continued, defence would grow further as a percentage of GDP, crossing over once more with other expenditure programmes, for example, health and education. She feared that such a growth would swing public opinion against defence, and in particular against the Trident programme. It would be important, in interpreting the NATO guidance to take full account of this factor.

I am sending copies of this letter to John Kerr (HM Treasury), John Gieve (Chief Secretary's Office) and Sir Robert Armstrong (Cabinet Office).

M. C. SCHOLAR

Richard Mottram, Esq.,

Chapter Five

Money, Management and Organisation

THE DEFENCE BUDGET

501. The cash limit for 1982/83 was originally set at £13,288 million. This was increased to £13,606 million to allow for additional expenditure incurred as a result of the Falklands campaign, less a reduction in provision as a result of the reduction in the National Insurance Surcharge. We expect the 1982/83 outturn to be within the revised cash provision.

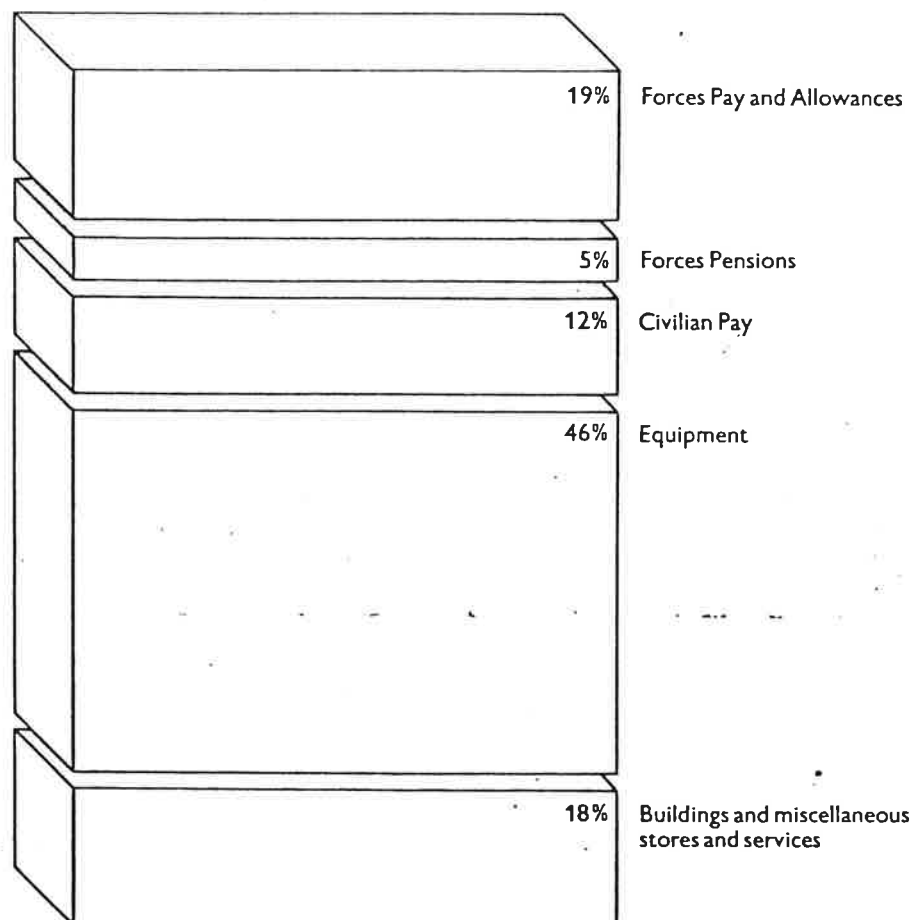
502. The defence budget for 1983/84 totals £15,973 million. This includes £624 million to meet Falklands costs. The defence cash limit is £15,036 million, an increase of some 10% on the final 1982/83 cash limit.

503. Despite economic problems we have increased defence spending every year since taking office. In real terms the provision for 1983/84 shows an increase of about 19% over expenditure in 1978/79. Defence is now the second largest

public expenditure programme. On the basis of average market exchange rates defence spending by the United Kingdom was higher in 1982 in absolute terms than any other major European ally; it was also higher per capita and as a proportion of GDP. NATO comparisons are illustrated in Figure 8. We remain committed to plan to implement in full the NATO target of 3% real growth in defence spending each year until 1985/86. The expenditure plans for defence announced in Cmnd 8789 provide for 3% real growth a year, with Falklands costs in addition.

504. Figure 6 breaks down the 1983/84 defence budget by major categories of expenditure and Figure 7 analyses defence resources by major programmes. Volume 2 of this Statement contains a number of further analyses of the 1983/84 Estimates.

Figure 6 Division of the Defence Budget by Principal Headings 1983/84



1986-87: MAINTENANCE OF 3 PER CENT REAL GROWTH

The Government's commitment to plan to increase defence spending by 3% per annum in real terms expires in 1985-86. The Defence Secretary has bid for a further 3% growth in 1986-87.

2. This bid must be rejected. The eventual cost will be far higher than the £568m claimed in this survey. Any "volume" commitment carries on its coat-tails a host of other bids to underwrite price increases and preserve "volume".

3. MOD will argue that the bid is needed to meet the NATO aim and will stress that this aim was reaffirmed in June by NATO Heads of State and Government, including the UK. But when proposing this, Mr Heseltine:

(i) accepted that "a firm commitment on defence expenditure to the end of the NATO planning period would cause us difficulties (as it would most of our allies)";

(ii) explicitly emphasised that "the 3% formula is, of course, a target, not a binding commitment"; and

(iii) referred to "the UK's good record on 3% and our public commitment to meet it to 1985-86".

A copy of Mr Heseltine's minute to the Prime Minister is attached (Appendix A).

4. The aim is only an aim, like the UN aim that 0.7% GDP be devoted to overseas aid, whether it can be achieved must depend on economic circumstances. (Annex J explains the optimistic economic forecasts behind the 3% aim.)

5. NATO exhortations are a dubious way of approaching public expenditure planning. The 3% aim is crude and meaningless. All defence expenditure (however wasteful or non-operational) counts.* Simplistic year on year arithmetic applies (not, for example, absolute levels of expenditure). It concerns only inputs.

6. MOD may make a play of the diplomatic or transatlantic repercussions, should the UK excuse itself from the 3% target three years hence. We should be sceptical about such claims. As

* This includes all types of Falklands-related expenditure

Mr Heseltine himself has pointed out, the UK has a good record; but economic considerations cannot continue to be ignored and other European NATO allies adopt a much more pragmatic approach to the 3% aim. See, for example, the public comments of the German Chancellor last December (Appendix B). There may be some criticism but the diplomatic consequences abroad are unlikely to be as serious as the political ones at home, if the economic strategy is blown off course. Also, there is increasing evidence that public opinion will not accept that defence expenditure should continue to grow at the expense of pensions, the NHS and other social services.

7. Of the major Allies, the UK contribution to NATO is already second only to the US in absolute terms, per capita, and as a proportion of GDP. For example, the proportion of GDP the UK devotes to defence is half as much again as Germany (5.1% against 3.4%). MOD ought to be striving to reduce the unfairness of the UK defence burden, not to increase it. (Further details of comparative performance in Annex B.)

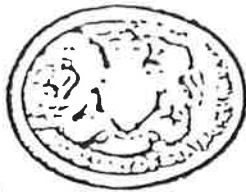
8. MOD's other ploy will be to dramatise the operational (and possibly industrial) consequences of not continuing to increase defence expenditure by 3%. Such forebodings can be discounted:

a. MOD's internal plans last year assumed no growth at all after 1985-86. Mr Heseltine ought to revert to the force projections that satisfied his predecessor.

b. Real growth in military effectiveness can be achieved without an equivalent increase in input cost. MOD must exploit the substantial scope for increasing defence output by greater efficiency and value-for-money.

c. MOD have cried wolf before (notably in the 1981 Survey: even after making over £1000m of cuts in his 1982-83 programme, Mr Nott foresaw a "programme gap" of £200m - but the real problem in 1982-83 was to avoid a massive underspend). MOD costings are notoriously inaccurate. The margin of error for 1986-87 is too great to attach much reliance to cries of gloom and doom at this stage.

d. Substantial scope exists for economies that do not damage the front line. For example, the civilian manpower economies we are proposing are worth £120m per annum; over £1200m a year is spent on Service training; over £700m on social and welfare expenditure; the value of defence stocks at major depots is £7 billion.



APPENDIX A
TO ANNEX D

MO 25/2/28/2

High
deal

PRIME MINISTER

NATO MINISTERIAL GUIDANCE

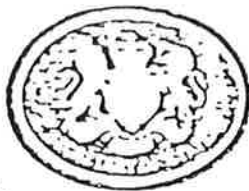
The NATO Defence Planning Committee will be meeting in Ministerial session on 1st/2nd June. On present plans I shall not be present during the plenary discussion of the Ministerial Guidance, when we shall be represented by our Ambassador Sir John Graham - we need to decide the line he is to take.

2. As you know, the Ministerial Guidance is the document produced every other year to set the framework for national and NATO planning for the next five year period - in this case 1985-1990. The draft has been under discussion at working level in Brussels for some weeks and is to be considered by Permanent Representatives on 24th May prior to submission to Ministers. The resource guidance section draft is attached. You will see that, in respect of the 3% target for annual real increases in expenditure, it reads as follows:

"notwithstanding economic and financial constraints, the standing Alliance commitment to the 3% formula guidance is confirmed."

This is a repeat of the 1981 formula which John Nott endorsed on behalf of the Government.

3. A firm commitment on defence expenditure to the end of the NATO planning period would cause us difficulties (as it would most of our allies). But the 3% formula is, of course, a target not a binding



commitment. In view of this, the UK's good record on 3% and our public commitment to meet it to 1985/86. (when the Ministerial Guidance will come up again for review), I believe it would be wrong and unnecessary to mount any opposition to a repeat of the formula to which we subscribed in 1981. Internationally, this would provoke an unhelpful transatlantic row in a crucial year for the Alliance. Domestically, the likelihood of the row becoming public could be politically very damaging in present circumstances. On the other hand, there may be US pressures to toughen up the 3% formula to stress it as the minimum required (the US are, of course, planning annual average increases in defence spending of 7% over most of the NATO planning period). But the FRG have already made clear that they would not support any substantive strengthening of the 1981 formula and I believe the UK should lend them support in resisting any such US pressures.

4. I therefore propose that the UK should go along with a repeat of the 1981 3% formula but should support the FRG in resisting any US pressures to go beyond this. Additionally, if the opportunity arises, I am content that we should - as suggested by Treasury officials - support any move by others in seeking deletion from the 1981 formula of the phrase 'notwithstanding economic and financial constraints'.

5. Subject to any views of my colleagues, I propose that Sir John Graham should be instructed to proceed accordingly at the meeting of Permanent Representatives on 24th May and subsequently at the Ministerial session.

6. I am copying this minute to the Chancellor of the Exchequer, the Foreign and Commonwealth Secretary, the Chief Secretary to the Treasury, and Sir Robert Armstrong.

Rummm

*Approved by the Defence
Secretary & signed in*

Ministry of Defence
20th May 1983

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Specific promises have been made, eg, that Nato countries should spend in real terms 3% a year more on defence—do you think you will manage that? General Rogers has suggested that 4% will be necessary.

We have had a good record on this in previous years. We will have to see how it turns out next year. Then you have to ask, what is 3%? What does it include? All these percentages have their own significance—you can do anything with statistics. If the Nato supreme commander says he needs 4% that doesn't mean that the Germans—the two chambers in parliament, the government, business and so on—will all meet and declare that this will be carried out. I am a partner in an alliance, and in my view a partnership means that you talk to each other and not about each other. I may add that from my talks with General Rogers I gained the impression that he sees the matter in exactly the same way.

That raises a philosophical question: how can western countries increase their Nato commitment and defence expenditure when they are facing such economic difficulties, with choices necessary between social and military spending?

That is an important question, an elementary political question, and it needs a political answer. This has to be very drastic: the German chancellor must do all he can to stimulate the economy. I must do all I can to reduce unemployment, youth unemployment above all. But it would all be a waste of time if I could not guarantee peace and freedom for our country.

But then the question arises: how do you set which is your priority?

You have to do both. I cannot say: I am going to cut down the army and cut down military service because I have to combat unemployment first. You have to take the middle route.

But there is only so much in the kitty. Yes, of course, and so I have to spread the sacrifices as best I can. I don't really see this as a problem. Perhaps I am rather old-fashioned. Politicians have to behave as people do in their private lives; in my view a bad housekeeper makes a bad politician. You can't simply eliminate certain areas of expenditure altogether. We must remain capable of defending ourselves. And we will not do that if we adopt a policy of "either-or". Our young people must realise that there is a point in what they are doing, when they are being asked to defend our country. They must come to see that they are defending freedom and peace. It must be a freedom that appeals to them, that makes sense to them. The principle of social justice and the will to defend are closely related.

PS/CHANCELLOR

From: I P Wilson
 8 November 1983

cc: PS/Chief Secretary
 Mr Middleton
 Mr Bailey
 Mr Scholar
 Mr Kitcatt
 Mr Hart
 Mr Richardson

PUBLIC EXPENDITURE SURVEY 1983: DEFENCE

I mentioned to you that we have had an indication that Mr Heseltine might be advised to reopen the agreement on 1986-87 recorded in Mr Turnbull's letter of 7 November to the Lord President's Office.

2. Apparently, when Mr Heseltine returned from the No 10 meeting last Friday, he reported to his officials that he had secured agreement to 1% real growth in 1986-87. They are, therefore, of the view that the No 10 record misreports the agreement.

3. As Mr Heseltine has now left for the Bonn Summit it is very unlikely that he will raise this issue, if at all, before Cabinet on Thursday. I have told MOD in unequivocal terms that there could have been no question of Treasury Ministers conceding an extra £200m in the final year except in exchange for a strict cash deal.

4. If Mr Heseltine seeks to reopen the agreement at Cabinet I recommend that the Chancellor and Chief Secretary should argue robustly for the formula recorded by No 10:

"The agreed figure for 1986-87 would be £18,650m. This was on the understanding that it was a cash figure, with no implied volume commitment, and that it would not be qualified in any way."

5. You agreed to warn No 10 of this potential problem. Perhaps Mr Scholar could alert Cabinet Office.

I P WILSON

From: N BEVAN, Head of DS1

127
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cc: Mr Richardson.



MINISTRY OF DEFENCE

Main Building, Whitehall, London SW1A 2HB

Telephone (Direct Dialling) 01-218 2617

(Switchboard) 01-218 9000

D/DS1/317/6

Ivan Wilson Esq
HM Treasury

21 November 1983

Dear Ivan,

DEFENCE EXPENDITURE PLANS

In the light of Mr Heseltine's remarks at his attributable press briefing last Thursday afternoon, I think that we shall need to supplement the briefing material which we have provided to our Press Office. I shall be grateful to have your comments as soon as possible on the attached supplementary material.

Yours ever,

Nicolas

Q12 FUTURE DEFENCE EXPENDITURE PLANS/EXTENSION OF 3% COMMITMENT?

A12 Detailed figures for 1985/86 and 1986/87 will be announced in the Public Expenditure White Paper to be published in early 1984. These will provide for 3% real growth in 1985/86 over 1984/85 and some further ~~real~~ growth (but less than 3%) in 1986/87, with Falklands costs on top in each year.

← real

Q13 WHY ABANDON THE 3% COMMITMENT?

A13 The Government undertook in 1981 to plan to implement the 3% target until 1985/86. On current plans defence expenditure in 1985/86 will be nearly 20% higher in real terms than in 1978/79, excluding substantial additional provision for the Falklands. The UK spends more on defence than any major European ally in absolute terms, per capita and as a proportion of GDP. The level of defence expenditure must take account of economic circumstances and, in that context, it would not be right to plan on continued growth in expenditure after 1985/86 at the same rate as before. We shall place continued emphasis on achieving the greatest possible output from our expenditure, capitalising on the substantial transfer of funds to the equipment programme that has taken place in recent years.

