

PO CH/GH/0172
PART A

PART A

DEFENCE EQUIPMENT
PROCUREMENT

1982

251.82

DD's 25 yrs NARS
25-4-97

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

Defence
equipment
procurement

IMPROVEMENT OF NATIONAL

Maillard
draft.

IN PROMOTING
CONVERGENCE
OF ECONOMIC
PERFORMANCE.

CONVERGENCE

- THANK FOR WELCOME. - MEMPHON
- HAPPY TO RENEW CONTACT
- A FULLY COMMITTED MSA
1977

Speaking Note

1. We have just been discussing the coordination of economic policy. I fully accept that action to promote the convergence of economic performance is in the first place the responsibility of the Member States. I have no illusions about the magnitude of the task I face as Chancellor of the Exchequer. In the UK we will make the efforts required. This will at times be painful. DIFFICULT
But will involve not just for some of us, but for many of us

AND
USE-
WHERE
IN,

2. There is however an important role for the Community. This was recognised by the European Council when they invited this Council to consider how the Community, through all its policies taken as a whole, can make a greater contribution to a greater convergence of economic performance amongst the Member States and to reducing the disparities between them. These objectives were amongst those laid down by the founders of the Community in the preamble to the Treaty of Rome. They are as valid today as they ever were. They are objectives that are crucial to the successful development of our Community, because they embody the principles of mutual concern and of justice. The question today is whether present Community policies are contributing to these objectives.

LEB?
QUESTION
@ ANY
TIME

3. It is the contention of the UK that they are not; but that, on the contrary, community policies, taken as a whole, are actively hindering a convergence of economic performance within the Community. This state of affairs creates in our view a Community problem of major dimensions.

increasing
work
against

4. The report submitted to us by the Coordinating Group is quite inadequate and unsatisfactory. DESPITE 2 HOURS - AND 7 MARK

DR SCHIEGEL

(a) First, it does not constitute the in-depth study commissioned by the European Council. In particular it contains no analysis of the non-budgetary effects of the CAP, of whose existence and considerable significance there can surely be no doubt;

ERMAM:
CAN - + DOD -
CONCERN
CONVERGENCE:
CRUCIAL

(b) Second, and much more important, is the treatment of net budgetary transfers. The figures in the report for 1978 highlight a wholly unsatisfactory situation. Preliminary calculations based on these same figures

/show

- 1% limit
- CAP REVISION
- NOT ENOUGH

GERMANY: "AN DIFFERENT DECISION OF DEVELOPMENT" "NOT - WANTS HANDICAP LIKE THIS"
② TRANSFER OF PUBLIC CAPITAL ALONE: "ACROSS."

show that the position in 1980 will be still worse, with the UK and Italy, which are apart from Ireland the two least prosperous members of the Community, being far and away the largest net contributors to the Budget.

UNSUSTAINABLE

(c) I note from the report that no-one seems to have disputed that this is an unhealthy situation for the Community. Yet the report contains no agreed assessment of what should be done, despite the precise suggestions put forward by the representatives of Italy and the United Kingdom. Indeed, the views attributed to several Member States seem to be based on the assumption that existing policies will in due course provide a cure. I recall that this is what we were told in 1973. What has happened since then has surely shown this assumption to be wrong. - COMMON MISTAKE - IMPLIED TERM: "MOORCOCK"

CLEARLY DOES CONTRIBUTE TO DIVERGENCE. MUST DO: NOT ALLOW TO CONTRARY. COMMUNITY PROBLEM

BUT WHY DO NOT OPPOSE? "CONTROL FINANCE FOR INVESTMENT" - THIS DIRECTLY CONTRARY: 10% OF PIB

It is the present pattern of net budgetary transfers is hindering a convergence of economic performance, not assisting it. It is vital for the future development of the Community that this situation be remedied, and remedied soon. Unless steps can be seen to be being taken before the end of this year, the Community will find itself in serious crisis.

WE DON'T WANT TO PROBLEM AS RESPONSIBLE: ON CONTRARY

... to put this right

OTHERWISE

HOWEVER, V. IMP. THAT ISSUES SHD BE CONSIDERED

5. In its present form the Coordinating Group's report is quite unsuited for consideration by the European Council. I suggest therefore that the COREPER draw up a concise summary of the Coordinating Group's report, including statements of the conflicting viewpoints. The paper should then go on to set out those issues on which the European Council at Strasbourg should focus attention and take decisions, so that solutions can be applied without delay. COREPER's draft report should be available for us to consider at our next meeting in June.

HAPPY AGREE WITH GERMANY + NO NEED FOR FURTHER WORK BY CO-ORDINATING GROUP

LUX:
ONLY ONE ASPECT

① FRENCH: - DO NOT DISCOUNT OTHER ADVANTAGES OF CTRY M/SHIP (B)
- BUT STICKS OUT LIKE SORE THUMB

③ LUX: SUPPORTS US PROCEDURALLY - ROLE FOR CONSENSUS

② BELGIUM: NOT TO BE TOO POLEMIC (A)
LOOK FOR COMMON GROUND (C)
~~INCL. E.G. LANDOLT~~
~~COORDIN. OF ECON. + MON. POLICIES~~ (C2)

IRELAND: GO TO CCL, WITH MINIMUM DIVERGENCIES (D)
ALSO
IF SO, WELL & GOOD
E.G. C.A.P.

1) COMMON COMMENTS

BUT: EVEN WITH
- CREDIT MECHANISM
- NON-RESPONSIBILITY
- MONEY TIER & RESERV

The agreed entry in the minutes might be on the following lines:-

EMEX (A) n (B)

"The European Council agreed that all less prosperous member states should have access to the interest rate subsidies, provided they were fully and effectively participating in the Exchange Rate and Intervention Mechanism. In the event of the UK as a less prosperous member state joining the Exchange Rate and Intervention Mechanisms, the Council agrees to take new decisions to ensure full and equitable access for the UK to fulfil this agreement of the European Council."

2. The Chancellor will wish to decide whether to include "as a less prosperous/^{member}state" in the formula that he offers. There may be some opposition to this phrase, particularly from the French who do not accept that the UK is a less prosperous member state. On the other hand, there have never been formal Council endorsement of this status which is helpful, although certainly not central, to our argument over the effects of the community's budgetary arrangements on convergence. From this point of view, it would be helpful for the Council to agree to the formula with these words in it. There is a risk that if the Chancellor advances the formula including these words, and then withdraws the words other member states may feel that they have secured Council rejection of the UK as a less prosperous member state, so that our position would be worse than if the words had not been included in the first place. We therefore suggest that the Chancellor should judge on the day whether his colleagues are likely to be sufficiently cooperative to allow this phraseology, and only advance the words in square brackets if he is reasonably confident that they will be accepted. If they are not accepted, or he does not advance them, this will mean that he has not achieved the first of the three objectives of the agreed entry in the minutes referred to in the brief, but as the brief argues this is not the vital objective.

3. Of the remaining two square brackets, the first represents a greater commitment by the Council than the second, and is therefore to be preferred. The second would be acceptable, and if necessary both

could be dispensed with. The minimum formula the Chancellor is recommended to accept is one with all the words outside the square brackets.

4. Others may try to make additions to the formula. In particular, it is likely that the Germans will argue that there should be inserted after "access to the interest rate subsidies" the words "within the financial limits mentioned", which also appear in the EMS Resolution. The Chancellor should resist the inclusion of these words, which would imply that the financial limits were absolute, and therefore that access by the UK to the facility could only be achieved at the expense of the Italians and the Irish. This would vitiate some of the benefit of the Council's commitment to take new decisions if the UK joined the Exchange Rate Mechanism. In rebutting any suggestions on these lines the Chancellor could argue:-

- i) That there is no point in referring to the financial limits as these are already enshrined in the regulation.
- ii) That he is not trying to dictate now what would happen if and when the UK joined the Intervention Mechanism, and neither should others; on the contrary, the whole Council should be doing its best to facilitate the participation of all nine member states in the EMS Exchange Rate Mechanism.

5. At the end of the day, however, if others insist on an insertion on these lines, it should be accepted, given that the wording appears in the European Council Resolution.

ACCEPTED BY PRESIDENT
PROPOSAL

* Mr Cargers will be discussing this formula on Sunday, and will be available to brief the Chancellor on the outcome.

① ✓✓✓✓
C

② C.R.D

cc Mr Ridley

CHANCELLOR
CHIEF SECRETARY
FINANCIAL SECRETARY
MINISTER OF STATE (COMMONS)
MINISTER OF STATE (LORDS)

③ WIND UP

TURCSHODS:

J - £3.50

M - £5.38

BUDGET: OVER TO THE OFFENSIVE ✓✓

The Treasury have provided extremely thorough defensive briefing on all aspects of the Budget. But we feel that it is of paramount importance that we should go over to the offensive, and repeat four simple points ad nauseam.

1. This is the biggest ever income tax give-away.
2. The pension increase is larger than Labour's and the biggest ever (in cash terms; in November the pension will be worth more than ever before in real terms).
3. The vast majority of taxpayers will be better off.
4. ^{income} Tax cuts create jobs.

We are of course both available for help with briefing for the debate.

NEARLY 100%: - PLE CUTS
 - DRINK & TOB
 - N.I. SURCHARGE
 - V.A.T
 - NO TAX CUTS

74+75: 380m
 ADDED > TO PRICES
 AND SH

PETER CROPPER
GEORGE CARDONA

13 June 1979

MOD

Whole Document

~~Mr Mountfield~~
~~Member~~
MPB ✓ 21/1

~~Mr Bagner~~

RA

NO 26

CHANCELLOR OF THE EXCHEQUER

MR PARRY	MR HANS
PPS FST EST	MR WOOD
MST(C) MST(L)	MR HANS
SIR P WASS	MR MANN
SIR A RAWLINSON	MR VERN
	MR HALL

DEFENCE EQUIPMENT PROCUREMENT

One of the root problems facing defence is the persistent real growth in the cost of equipment from one generation to the next. For example: the Harrier aircraft costs in real terms four times more than the Hunter it replaced; and a new artillery shell is double the real cost of its predecessor. These real cost increases are nothing to do with the tendency of defence equipment to rise faster in price than average prices (RPE), they are additional to the burden of higher defence prices.

2. The problem is not new. But in the past we have been able to mask it by reducing overseas commitments and foreign bases; by abandoning roles in the Middle and Far East; by running down our spares and combat stocks, and by generally lowering Service activity levels. This process is now exhausted. We cannot carry on as we are without now accepting a severe decline in our ability to meet the Soviet challenge or perhaps abandoning one of our four traditional NATO commitments (and we know the problems which this would create for an increasingly beleaguered Alliance).

3. Between 1975 and 1980 the percentage of the defence budget taken up with procurement (of equipment) rose from 33% to 44%. This year more than £5B will be spent with British industry. Defence procurement now accounts for about half of the output of our aerospace industry; some of our biggest firms (BAe and Rolls Royce to take but two) would be crippled or become terminal patients of the Exchequer if we were to change direction sharply; and there are thousands of small firms up and down the country which are vulnerable to a further moratorium or similar programme slow-down. MOD expenditure also

represents two thirds of UK expenditure on electronics R&D - including electro optics, and other critical areas at the forefront of technology. They are the industries of tomorrow and MOD is almost the only source of public money for their development.

4. The procurement of defence equipment is a unique process: it cannot be compared with the simple purchase of goods elsewhere in the economy. Given the comparatively modest size of British defence purchases, our defence equipment market in the UK is mainly one of monopoly/monopsony. For the most part, therefore, free 'market prices' do not exist for the domestic defence sector. In order to ensure we are getting fair prices from industry - and giving fair returns to industry - the MOD has a contracts process whose essential aim is to reflect our monopsonist position to counter the monopolist weight of industry. Our contracts negotiators - there are 1250 of them - have performed reasonably well in the past, but I aim to press ahead further with increasing the number of incentive and fixed price contracts let with industry - about 75% by value. (But it should be understood that a period of cost/plus development, for a unique product, can have a part to play in establishing costs for a fixed price contract. We cannot get into fixed price contracts too early without being taken for a ride by our sole suppliers). But I want to tighten up the managing of the contracts themselves to ensure, for example, that in cost/plus development contracts excessive wage settlements by our contractors are not passed on to the MOD (as in some cases they have been); and I also want to ensure that goods are delivered by industry only when we have planned, and can afford, to receive them. This will greatly help to control industry's cash demands on the Defence Budget - which has been one of the main difficulties I have faced over the last year. Part of our problems in facing rapid delivery in the recess with the consequent burden on our cash limits, is that the incentive contracts have deliberately encouraged higher productivity and early delivery. The success of these contracts has come

back to haunt us in the recession.

5. We are working generally towards achieving still better value for money for our expenditure with British industry. This will of course help us, but the trend of cumulative growth in our expenditure with industry must be reversed. We cannot, from a finite budget, continue to increase spending with British industry at the rate at which we have been doing without totally unacceptable degradation of our front line. Industry's expectations will need to be trimmed and this will have severe political, industrial and employment consequences in the next few years.

6. One of the ways we can help break this spiral, both of escalating costs and reducing numbers of equipment, is to sell more equipment overseas; but this is easier said than done. The Defence Sales Organisation has made excellent progress in boosting our defence exports since we came to power (our sales should be at least £1.5 billion this year against £1.2 billion last). The new Head of Defence Sales is considering how he can take this process further: but it is very clear to me that there are no quick answers. We could for example take a wholly irresponsible attitude and sell arms to allcomers without any concern for the wider political factors. Or we could deliberately cut our standards over a period of time and go 'down market' to sell. But in doing so we could find ourselves giving our Forces equipment quite unsuitable to meet the Soviet threat which grows ever more sophisticated - and could even exclude us from some mark

7. The problems, therefore, of the MOD's procurement from industry, our financial position, and our defence sales prospects are closely intertwined: and there are no easy answers. I recommend to my colleagues the enclosed paper written by my Permanent Secretary which makes interesting reading. It is a very thorough study of the fundamental dilemma facing defence

procurement and the consequences for British industry over the next two decades. It poses questions to which an answer has to be found: the only option that is not open to us is to avoid the issue by refusing, as we have done in the past, to face the political consequences of moving in this direction. The Ministry of Defence either needs more money, or we must face up to the traumas of deliberately creating a narrower industrial and R&D base.

8. I am copying this minute to the Prime Minister, to other Cabinet colleagues, and to Sir Robert Armstrong.

JW

Ministry of Defence

30th December 1981



DEFENCE COUNCIL

ESCALATION IN EQUIPMENT COSTS

Memorandum by the Permanent Under-Secretary of State

1. The Minister of State (DF) has rightly called attention to this phenomenon which largely underlay the review of the defence programme. We need to know more about it, what causes it, and how we can tackle it.

Experience of Cost Escalation

2. The steady growth in the real cost of equipment is not a new factor, nor is it confined to the military field. It has become more marked since World War II, with both the Warsaw Pact and NATO striving to exploit and extend the outburst of advanced technology in posing threat and response. It has three main components:

- a. the introduction of entirely new technology into warfare - for example, guided weapons, computers, thermal imaging, satellites, nuclear propulsion, jet engines;
- b. major new twists in technology; for example, switching to STOVL flight capability, turning torpedoes into true guided weapons, towed array sonar;
- c. straightforward cost growth as each mark or generation of equipment becomes more complex and is improved, in the light of experience or knowledge, to achieve greater effectiveness against the threat.

3. Nine years ago we tried to identify an overall cost escalation factor. Examination of procurement records and predictions suggested an average annual figure of 6-8% on capital production costs of major equipments. This year we re-worked a very small sample to produce Figure 14 in SDE 81. For obvious reasons, the examples quoted were the more spectacular ones; there are others - notably successive classes of nuclear submarines - where real cost growth has been nil or negative. Work in 1979 suggested that about 60% of the equipment budget was liable to significant cost growth.

4. It would not, in my view, be wise to attempt to arrive at a precise figure for the problems of weighting arising over such things as multi-role or changed-role equipments, the effects (not necessarily universal) of changed reliability and maintainability and the measurement of increased effectiveness. Whether the figure is 6%, 8% or 10%, we must all recognise that it is a major problem.

5. It is a problem which faces all countries with sophisticated forces. We cannot halt either the march of technology or the Soviet bid for arms superiority.

Research, Development and Production

6. A further manifestation of the problems we face shows up in our investment ratios. In each of the five years to 1979/80, we spent about £2.2 on production for every £1 spent on R&D. In preparing our forward programme there is a tendency to assume that the ratio will be more favourable particularly in the later years - for example, in LTC 74 the ratio in the first year was 2.3:1, and in the last year 3.9:1. As real time approaches, so too does the ratio fall - in LTC 1974 the ratio assumed for 1980/81 was 3.3:1 - by LTC 1980 it had fallen to 2.2:1. This clearly reflects greater realism both as to actual cost and cash restraints.

7. While it must be broadly true that a higher production to development ratio represents a better return on investment and is therefore a result devoutly to be wished for, it needs to be treated with some caution. The ratio tells us nothing about total procurement costs of particular equipments or the availability of off-the-shelf alternatives. High development costs aimed at reducing subsequent production costs could be advantageous; likewise a high production ratio can in some cases reflect unsatisfactory increases in production costs. Given these cautions, however, the ratio remains one which, if sustained, will lead us to bankruptcy.

Mitigating the Effects

8. We have survived with real cost escalation over the last 30 years mainly through a combination of:

- a. reducing commitments overseas;
- b. reducing numbers of equipment deployed (Annex A, but note that the Army pattern is distorted for a number of reasons, including the mechanisation of infantry battalions);
- c. abandoning (or not proceeding with) some equipments which were beyond our means, eg Blue Streak, or had ceased to be cost-effective;
- d. squeezing the so-called "tail" to release money for the so-called "teeth".

9. On a., we have effectively reached the limit of reducing commitments and we are having to talk about reducing other military commitments. On b., there comes a point where reduced programs no longer make operational sense. On c., the room for manoeuvre, while not exhausted, grows steadily smaller. On the other side, concentration on NATO for example has, if anything, put increased emphasis on sophisticated equipment.

10. The need for hard thought and action is compelling.

Initiatives

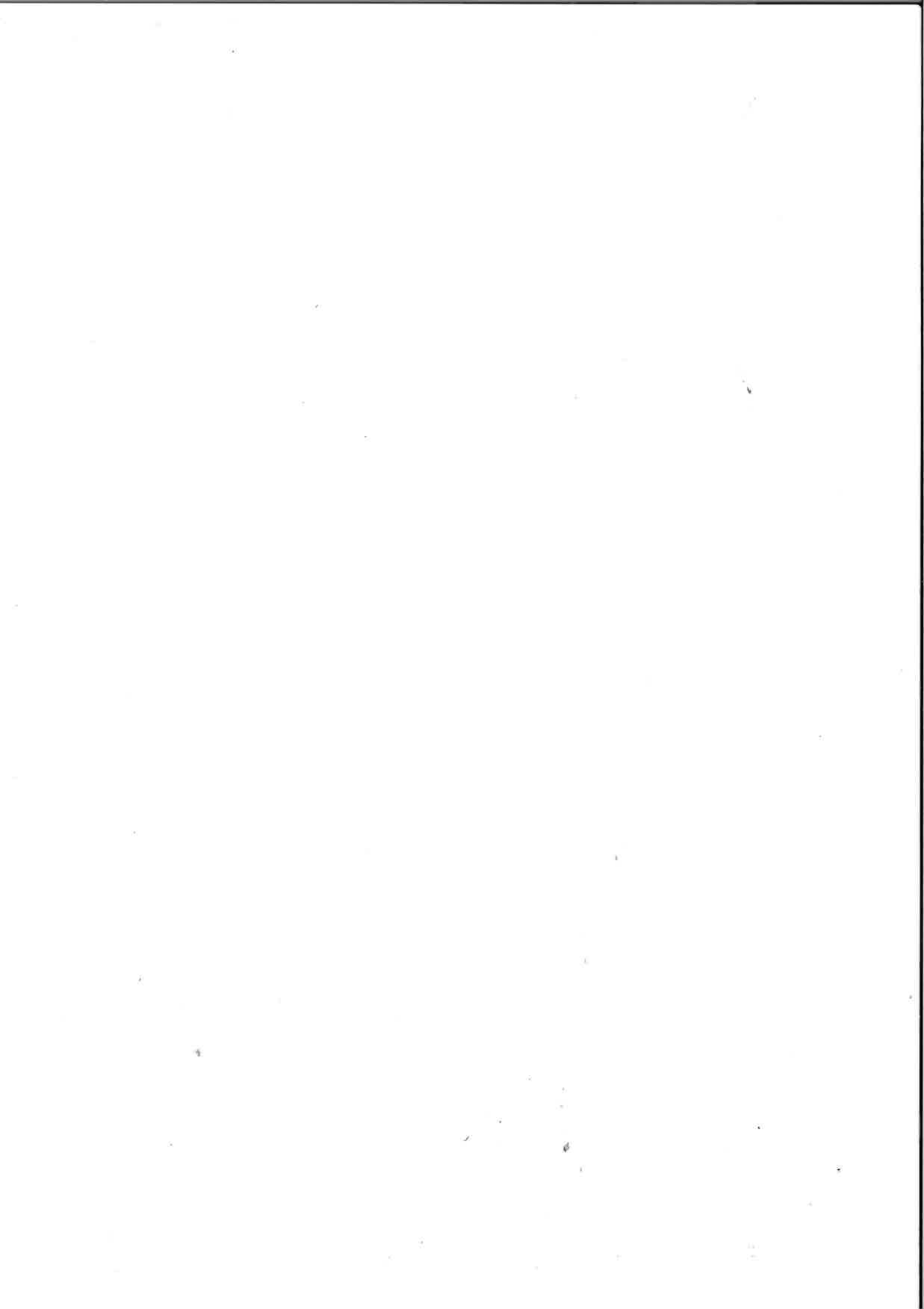
11. There are a number of relatively conventional initiatives which could be pursued more vigorously:

- a. avoidance of over-elaboration in requirements, coupled with maximum use of commercial work and a willingness to forego the last few per cent of performance;
- b. emphasis on collaboration with allies and/or UK industry where practical and advantageous;
- c. greater attention to sales potential, in collaboration with industry; together with joint ventures and encouraging private speculation;
- d. reducing through-life costs, through reliability and maintainability;
- e. spending more on project definition to ensure optimum cost solutions;
- f. tightening our relations with industry with tough negotiating stances, taking bad contractors to task and off the list, encouraging fixed price and incentive contracts when realistic;
- g. exploiting stretch potential of existing equipments - probably one of the most profitable and practical lines to pursue.

Handling of Requirements

12. Views on whether our requirements are over-elaborate are strongly held either way. The evidence is not conclusive. In the last analysis, it is the potential enemy's equipment which determines the characteristics and basic minimum level of sophistication of our weapons. I have not yet seen convincing evidence that our equipment is more sophisticated than the threat requires. Contrary to what might be expected, the main contribution of the micro chip has been to enable designers to design cleverer weapons and so push up the cost of countering them.

MOD



13. If, nevertheless, whatever the cause is, we are forced on us, we cannot seriously argue that in every aspect of every requirement our standards are as austere as they could be. By the very nature of things any good designer will seek to make his design as perfect as possible and every fighting man will seek to gain significant advantage in performance over his potential enemy. We must redouble our efforts to ensure tautness and maximum cost effectiveness. In particular:

- a. there could be more sensitivity analysis of the implications of foregoing particular elements of a requirement;
- b. we should beware of seeking to exploit all the benefits of new technology regardless of whether they are necessary or not;
- c. our procedures should be geared to looking at "areas of capability" rather than looking at new equipments essentially on a "replacement" basis;
- d. we should consider very carefully the wider use of a "design to cost" philosophy, wherever this seems appropriate;
- e. a greater readiness to buy equipment already available and to forego if necessary the full military specification.

14. Do we actually need - let alone can we afford - all the things we set out to acquire? There is a spectrum of options - from maintaining balanced forces and capabilities at one end to cutting our coat to suit our cloth and buying essentially what is available off-the-shelf.

Collaboration and Sales

15. European collaboration has had its successes, its disappointments and its failures over the past 20 years. It has not proved a panacea for keeping down costs. The Euro-US package concept is a fragile plant still in its infancy. We have to recognise as a hard fact the overpowering effect of the US - both the sheer size and inventiveness of US industry and the effects of the vigorous US defence lobby. Giving our equipment wider sales appeal involves difficult judgments, both as to the level of sophistication which we have to have ourselves and on the likely customers. It is by no means the case that all Third World countries require less sophisticated equipment - consider Saudi Arabia, India, Pakistan, Iran under the Shah, Iraq, the Gulf States. Even so, continued pressure in all these fields of activity is essential if we want to secure reductions in production costs (or simply to keep factories partially filled), and obtain savings in our own development costs.

Through-Life Costs

16. We must study through-life costs more deeply at the stage of project definition and really look hard at the trade-off between

MOD

could not support costs. The Public Inquiry Co. also...
recently and rightly called attention to the same point.

Through Project Definition

17. We should not be afraid to:

- a. devote substantial resources and time to Project Definition (PD);
- b. carry PD to the point where industrial understanding of, and confidence in, a development programme can be expressed in a fixed price or incentive contract;
- c. terminate programmes if PD shows the proposed solution not to be cost-effective, or alternatively, in such circumstances, proceed to further PD of a different solution (cf MBT 80 and the VJ 291 anti-armour weapon);
- d. resist the temptation to go ahead, for so-called urgent reasons, when programmes have not been well defined.

Relations with Industry

18. We are making some progress with a range of initiatives aimed at reducing our procurement costs. The field includes encouraging competition both in project definition and for production contracts (although, all too often we now have only one major UK contractor in a particular area); enhancing industry's understanding of our requirements; prompting private speculation and joint ventures, and pressing hard for incentive and fixed price contracts instead of cost-plus. We must pursue all this vigorously.

Longer-Term, Radical Solutions

19. None of this is particularly new or revolutionary. Taken singly or together, it must be doubtful whether they can do more than slow down the rate of cost escalation. Are there more radical solutions, and, if so, what?

20. The first thing we could do is deliberately to reduce the range of equipments, and thus of our capabilities. We have done this in a number of areas over the years - but generally on an ad hoc basis as the result of a battle over resources for a particular new weapon system. Acceptance of the need to go further down this road as an act of deliberate policy would be a major step. Can it be avoided? Are there areas where we could do more - for example, by reducing the range of weapons in the anti-armour or anti-surface vessel spectrum and their modes of delivery?

21. Beyond that, there are the more radical solutions of specialisation, either industrial or military, or both.

22. Industrial specialisation could take two forms:

- a. a deliberate UK decision to reduce and concentrate our industrial/technological base upon a limited range of weapon technologies - presumably high-value ones where we are already established such as electronics, GW and nuclear, although even this might be arguable;
- b. agreement within NATO that individual countries or groups of countries should concentrate on developing and producing particular types of weapon, thus eliminating wasteful duplication.

An extreme variation of both a. and b. would be total, or near-total dependence upon the USA as the primary arms supplier to NATO.

23. All of these solutions have basically the same objective - longer production runs with lower development and production costs per unit and more equipments. Other advantages such as common support arrangements and common training could follow. But they also have disadvantages. To a lesser or greater degree they make us dependent upon other people's judgment as to what the requirement is and the threat from the Soviet Union cannot be ignored.

24. Military specialisation could involve individual countries concentrating on certain military roles only, with the corollary that they would rely upon other countries to provide their defence in other areas. For example, in theory, the Dutch might concentrate exclusively on providing naval forces, leaving their air and land defence to others; conversely the Belgians might provide land forces and fighter aircraft but no naval forces. A more extreme example might be the UK agreeing to contribute only tank forces (although larger ones) - or no tank forces - to the Central Front. All this would mean taking a lot of things on trust and extremely long and complex negotiations. Is it a practical proposition?

25. Whether industrial specialisation necessarily needs to wait upon military specialisation, or whether the nature of a country's industrial specialisation must be linked to the nature of its military role, are open questions. What is clear is that the industrial, military and political problems are profound, not least in the transitional phase. They are likely to be insoluble as part of a grand design; what we may see instead is creeping specialisation as economic and industrial constraints bite. Indeed it could be said to be happening now with the smaller countries in NATO.

26. Specialisation particularly among the larger countries could introduce a new rationale for NATO in its second 30 years and a new cement. But it would take a long time to bring about. Ought we to be thinking harder about it? It can be argued that it is the most logical solution if NATO members are not to be overwhelmed by the relentless tide of the costs of advancing technology.

27. This paper is meant to provoke discussion. It is intended to put forward questions such as for how long can we continue to go on maintaining its present spectrum of equipment and capabilities? Can we change matters sufficiently to maintain our present numbers and quality? How might we carry forward our analysis? What possible initiatives might be pursued?

28. The Council may wish to have a preliminary discussion of these and other questions.

	1950-1	1955-6	1960-1	1965-6	1970-1	1975-6	1980-1
a) Defence Expenditure £M (1980 Survey Prices)	7,316	11,320	10,304	10,667	9,542	9,424	9,550
b) Fleet Carriers/ASW Carriers	3 6	2 7	1 3	3 3	2 2	1 1	1 2
c) Light Fleet Carriers/ Commando Ships	5 6	6 8	3 5	3 4	2 3	2 2	1 1
d) Cruisers	16 26	10 24	5 10	2 6	1 4	2 2	- -
e) Destroyers/County Class/GMDs	52 111	32 90	23 52	17 26	7 15	10 10	10 12
f) Frigates	42 165	52 167	51 100	56 63	57 67	51 61	38 51
g) Submarines	32 62	43 57	34 53	34 43	21 27	16 20	11 16
h) Nuclear (Fleet) Submarines	- -	- -	- -	2 2	3 4	5 8	10 12
i) Minesweepers/MCM Vessels	12 147	55 216	37 189	60 118	44 54	40 43	34 36
j) Bombers and Strike Attack Aircraft	184	336	260	176	118	142	122
k) Fighter, Ground Attack, OS & Ground Support Aircraft	960	1,236	394	219	210	188	186

/(m)

	1950-1	1955-6	1960-1	1965-6	1970-1	1975-6	1980-1
(m) Reconnaissance Aircraft (including photo and maritime)	213	290	169	151	87	82	82
(n) Transport Aircraft (including helicopters) and Tankers	120	150	200	291	242	168	122
(o) Tanks	1,148		772		758		791
(p) Armoured Cars, APCs and Scout Cars	2,041		1,791		2,242		3,614
(q) Light Artillery	450		357		225		266
(r) Medium and Heavy Artillery	64		164		156		157
(s) Army Helicopters	-		42		311		261

Notes

1. From 1965-6 onwards figures are for actual expenditure; actual figures for the earlier years are not available at constant prices and so the Estimates have been used. The figures take no account of changes in the definition of the Defence Budget.
2. In each ship category (columns (b) - (j)) the first figure is the strength of the Fleet including vessels engaged on trials and training; the second is this total plus vessels in reserve, on stand-by or undergoing long refit, modernisation or conversion.
3. Aircraft figures (columns (k) - (n)) are for Aircraft Establishments (AE) of Front Line Squadrons, adjusted where it is known that insufficient aircraft were available to meet the AE.

15/62
711

- 1.
- 2. CHANCELLOR OF THE EXCHEQUER

Mr. Cairnes

- Mr. ...
- Mr. Spatt
- Mr. Barnett
- Mr. Quinlan
- Mr. Kemp
- Mr. Mountfield
- Miss Peirson
- Mr. A. Perry
- Mr. Wilson
- Mr. Norgrove
- Mr. Ridley
- Mr. Harris

Copies attached for:

- Chief Secretary
- Financial Secretary
- Economic Secretary
- Minister of State (C)
- Minister of State (L)
- Sir Douglas Wass

DEFENCE EQUIPMENT PROCUREMENT

Mr Nott wrote on 30 December describing some of the problems facing defence procurement and enclosing a Defence Council paper on cost escalation in defence equipment. This approach from Mr Nott is relevant to the Chevening discussion on defence, which is one of the four protected programmes. This note offers some comments for the purpose of that discussion and suggests a possible response to the Defence Secretary, which might be sent after Chevening.

2. There is nothing new about the problems touched on by Mr Nott; they and many others not highlighted - will be familiar to anybody concerned with the defence equipment programme. Those he focuses on are only broadly interrelated:

- (a) real cost growth (ie Tornado costs more than the Spitfire but of course has greatly enhanced capability)
- (b) defence contracts in a monopoly/monopsony market (incentive versus cost plus)
- (c) importance of defence sales (eg in reducing unit production costs)
- (d) the link between defence spending and UK industry and employment.

Mr Nott's letter purports only to be a thought-provoking tour d'horizon; it makes no recommendations (although the Defence Council paper suggests a number of sensible actions which MOD ought to have put into effect long ago). But he concludes on the basis of a rather superficial appraisal that MOD must either be given more money or "face up to the traumas of deliberately creating a narrower industrial and R & D base".

3. The letter can only be the opening shot in Mr Nott's next bid for

who are susceptible to industrial or employment arguments - for further increases in the Defence Budget. It will be followed by an OD paper at the end of January emphasising the pain and grief which will be caused by the measures to be taken to live within the 1982/83 cash limit. This will in turn be followed by other papers calling for bigger defence budgets in 1983/84 and 1984/85 in the context of PES 82. If Mr Nott succeeds in getting even more money MOD will duck yet again the changes which are necessary in the defence programme but which have been avoided in the past because successive Governments have provided extra money to protect the programme and its industrial base. The problems he describes are there but they cannot be solved by continuing to sustain parts of the defence industrial base at the cost of even bigger subventions via the Defence Budget. If the nettle is not grasped the vicious circle will never be broken.

4. In his minute, Mr Nott makes a lot of the problems for defence contractors but he gives little acknowledgement to the fact that on existing plans the defence procurement programme will continue to grow in real terms. This growth will, of necessity, have to be at a lower rate than has been experienced in the past, and probably substantially lower than the contractors' expectations, but the defence industries have been doing very well and have been shielded from the effects of the recession. Like others they will have, at some time, to adjust to economic realities.


5. In the autumn the Defence Secretary based his case for more money on the importance of meeting the NATO target of 3% annual growth. Having achieved a large measure of success, his tactics have apparently now changed to emphasising the industrial tail that is to wag the defence dog. This may be because he believes the NATO pledge will carry less weight with his colleagues this year - in the light for example of other allies' failure to meet it - than last. But more probably, the change could be due to an MOD desire for volume growth in excess of 3% per annum: more than the NATO target will be necessary to fulfil all the aspirations of

6. There is no need at this stage to take up the marker Mr Nott implicitly puts down for an increased budget. The extent of the problem, and the size of the MOD bids, will become explicit in due course. Nor would it be desirable to take issue with the Defence Secretary on the various long-standing problems surrounding equipment procurement. It has always been recognised that the management of a high technology programme of over £6bn is a complex and difficult business (this is partly why MOD has a Procurement Executive and employs such large numbers of civilians). There never have been, and never will be, a set of easy answers to procurement issues. But the more money MOD is given, the less incentive there will be to solve them.

7. You will wish to consider, in the light of your Chevening discussions what response to make to the 30 December letter. It would be possible to give no reply, or merely an acknowledgement. After all, the papers were ostensibly intended only as background reading. The solution of the problems of how to improve the procurement process and make it more cost effective is very much in the MOD court; yet we understand that the Defence Council paper, which makes some very sensible points, has not even been discussed (although its number suggests it is several months old). Moreover, a low-key response to Mr Nott might avoid undue importance - eg in the DOI - being attached to his tactic.

8. My own preference, however, would be for a more positive reply recognising the problems of defence procurement emphasising the need for solutions which do not simply rely on greater expenditure and reminding Mr Nott - and Cabinet colleagues - of the even more difficult problems the Government faces on the public expenditure and taxation point. It is vital that defence expenditure should be considered not in isolation but in the context both of public expenditure overall and of the economy in general. This is the background against which Treasury Ministers will wish to set subsequent MOD bids for more cash. I attach a draft of the sort of letter on these lines that might be sent. It can of course be modified in the light of the Chevening discussion.

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(J E HANSFORD)

NO: DEFENCE SECRETARY

Copies to: Prime Minister
Cabinet
Sir Robert Armstrong

DEFENCE EQUIPMENT PROCUREMENT

Thank you for your minute of 30 December. As you say, the various problems facing defence procurement that you mention are by no means new; and not surprisingly - as you recognise - there are no easy answers.

2. I note that you do not rule out the possibility of seeking more money but I am sure we both recognise that cost growth is far too long-term and deep-rooted a problem to be solved in this way. It is reassuring to learn that fundamental and radical approaches are being considered instead; it will be interesting to see what conclusions the Defence Council reaches on the best way forward. It is a little surprising that some of the measures discussed in for example paragraphs 11 and 13 of DCP(81)5 have not already been implemented.

3. The progressive real increases in the defence budget of the sort of order that paper implies are out of the question. Although I do not underestimate the problems that continue to confront defence procurement, I hope these will also be considered in the wider context.

4. Recent work which I have had done here on longer term projections for public expenditure suggest that maintenance of the NATO 3% target throughout this decade could increase the defence share of GDP by nearly 2% to almost 7%, its highest level since the very early ^{sixties} ~~seventies~~. Our economic strategy continues to require a reduction in the proportion of GDP consumed by public expenditure so that resources can be released for the private sector, and so that the consequent benefits can be passed on in the form of lower taxes and interest rates. At present, largely

/because

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our scope for adjusting the economy is limited. I know that you accept that defence should play its full part in contributing to the Government's economic objectives. It is vital that the message about the wider problems which we all face should continue to be brought home to all those involved on both sides of the defence procurement field.

4. I am copying this letter to the Prime Minister, to other Cabinet colleagues, and to Sir Robert Armstrong.

CONFIDENTIAL

From: Sir A. Rawlinson
Date: 7 January 1992

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (L)
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Byatt
Mr Barratt
Mr Quinlan
Mr Hansford
Mr Kemp
Mr Mountfield
Mr Ridley
Mr Harris

DEFENCE EQUIPMENT PROCUREMENT

These papers may be relevant to part of the discussion at Chevening.

2. I agree with Mr Hansford's comments in his minute of 6 January on Mr Nott's minute of 30 December. I also agree with his suggestion that next week you might send a reply on the lines of the revised draft (marked A) attached.



A K RAWLINSON

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FROM: E P KEMP
DATE: 12 JANUARY 1982

PA
Miss Pearson

19/76
7/6
STT
MR BATTISHILL
MR MONGER

Copy to each

cc Mr Barratt
Mr Middleton
Miss Kelley
Mr Kitcatt
Mr Mountfield
Mr C D Butler
Mr Griffiths
Mr Goldman
Mr Robson
Mr Norgrove
Mr Kerr (for information)

CHEVENING - APPROACH TO THE BUDGET

Amongst other things, during last week end's discussions at Chevening the Chancellor asked that work should be put in hand to consider, against announcement of the Budget, the possibilities of an inexpensive package which might help the disabled and similar (the actual expression the Chancellor used was "the hal the lame and the blind").

2. It would be helpful, I think, if FP and SS could put some thinking in hand. If I may go back to this time last year, we did engage in something of the same exercise, of course, against (at that time) the International Year of the Disabled. No doubt all the most "doable" things were done then. But the Chancellor clearly wants some further ideas, or elements of some kind of package that he might put together, and there are obviously things that could be put forward. One particular point which came up, though not specifically in this context, was our old friend VAT on charities; I recollect we did find some very small relaxation last year, and there may be more this year. (But you will be glad to note that at Chevening Ministers were perfectly clear that the sort of major VAT relaxation for charities which some of the Charity Lobby are looking for was not on.)

3. The elements in the package could, I think, be either tax concessions, or public expenditure, or a mixture of the two. But again, I think the flavour of Chevening was that no more than minimal additions to public expenditure could be adopted at this stage.

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4. I am sure it would be wrong for DHSS or eg the Home Office to be consulted at this stage. But I see no reason why FP should not consult Inland Revenue and Customs so far as may be necessary, on a confidential basis.

5. I would think the Chancellor would look for a report, albeit of a preliminary nature, not much later than the end of this month.

EPK

E P KEMP

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SECRETARY OF STATE
FOR
NORTHERN IRELAND

The Rt Hon John Nott MP
Secretary of State for Defence
Ministry of Defence
Main Building
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LONDON
SW1 2HB

John Nott

NORTHERN IRELAND OFFICE
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Mr. Hansford
PPS EST EST
MST(0) MST(0)
Sir D. Warr
Mr. Payne

Mr. Burns
Sir A Rawlinson
Mr. Barrett
Mr. Quinlan
Mr. Kemp
Mr. Mountfield 3"
Mr. Redley
Mr. Harris

22 January 1982

I have read with interest your minute of 30 December to Geoffrey Howe about Defence Equipment Procurement and his reply of 11 January.

There are clearly issues of great national importance here. On a purely Departmental question, however, I simply want to underline the fact that defence work continues to be a very important element in the business of Short Brothers, a firm of particular importance to the Northern Ireland economy in a number of significant respects. Northern Ireland has been hit badly by defence economies over the years, through the progressive closure of various defence establishments here and the loss of the civil employment they provided. I would therefore very much like to be kept in touch with the further development of ideas on this front which could have an impact upon manufacturing industry generally and Short Brothers in particular.

I am sending copies of this to the Prime Minister, other Cabinet colleagues and to Sir Robert Armstrong.

John Nott

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FROM: MISS J M SWIFT
25 January 1982

MR HANSFORD

cc Chancellor
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (L)
Sir D Wass
Mr Barratt
Mr Wilding
Sir A Rawlinson
Mr Mountfield
Miss Brown
Mr Ridley
Mr Harris
Mr Kelly
Miss Peirson
Mr Allwood
Mr Wilson
Mr O'Donnell

DEFENCE PROGRAMME 1982-83

The Chief Secretary has seen your minute of 22 January and the draft paper for OD.

2. The Chief Secretary is not at all happy with the approach in the draft paper. He does not think we should refer to the Contingency Reserve or Cabinet - that is far too defensive and weak. The Chief Secretary notes that Mr Nott's paper makes a large number of factual statements which we do not agree with. If we put in a paper, the Chief Secretary does not see how we can fail to refute them. He does not think it is very telling to ask colleagues to note that there is a problem which will not go away. It must be resolved by taking the necessary action. The paper does not make it clear that we looked long and hard to see if there was any reason why the programme agreed last summer could not be financed as then anticipated; we found no justification for extra cash; but because it was clear that there were difficulties (because the programme was ill thought out - though we need not say so) we agreed to provide extra cash. That is the truth. MOD must now live within their agreed cash envelope.

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3. The Chief Secretary thinks that it is only by stating all this and refuting the red herrings that we have any chance of getting our case across and avoiding spending still more. The reference to NATO targets must be dealt with - are they, for example, 'real' in the sense of general inflation being taken into account, or 'volume'? Figures should be given for comparison with our allies and for spending on defence industries compared with others, showing the growth, past and anticipated, even on Treasury plans.

4. The Chief Secretary feels that the politics of this are such that it is only by arguing a firm, fully documented case, that we shall win the day. The Chief Secretary adds that he does not object to looking again at end-year flexibility - but surely we should point out that this is not just a defence matter and has to be looked at in a broader context.

5. Mr Mountfield has also pointed out that the reference to a £2 $\frac{1}{4}$ billion contingency reserve will have to be redrafted.



MISS J M SWIFT

