

PO-CH/NL/0201 PARTA

Part A.

SECRET

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Begins: 2/4/87.
Ends: 27/7/87.



PO -CH /NL/0201



PART A

Chancellor's (Lawson) Papers:

DEFENCE EXPENDITURE 1987

Disposal Directions: 25 Years

7/9/95.

NL/0201

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PART A

PO

SECRET AND PERSONAL

*Despite disappointment, that
is going to v.
with future.
② (87) / 1006 a*

FROM: F. E. R. BUTLER
2nd April, 1987.

CHIEF SECRETARY

Admission subject
c.c. Chancellor *Mr.*

DEFENCE EXPENDITURE

This minute gives an indication of how much we could "afford" for an agreement with MOD. Since Mr. Robson does not know the game plan for public expenditure generally, I have not copied this minute to him.

2. You will remember that the January economic forecast showed an excess over the 1988-89 planning total of £4.9 billion, and this implicitly included just under £1 billion extra for defence. GEP, however, thought that the increase in the planning total might be less, viz £1.9-2.9 billion, and this included £0.1 billion for defence.

3. GEP have looked at their projections again, taking account of the post-Budget forecast. The result has been to bring the forecasters' and GEP's views of the 1988-89 excess closer together. The post-Budget forecast includes some favourable developments, particularly a lower RPI for September 1987 (which determines the April 1988 uprating) and lower interest rates. In consequence, the forecasters' expectation of the excess for 1988-89 has come down to £4.2 billion. GEP, while thinking that the additions needed for civil service pay and local authority expenditure may be less than their earlier assessment by £2-300 million, expect a worse outcome on NHS expenditure (due to higher pay awards from the review bodies) and of course defence. Allowing a maximum of an extra £½ billion for defence (ie £300 million now and £200 million for the effects of the higher GDP deflator later), GEP's predicted excess is in the range £2½-3½ billion.

FERB
to
CST
2/4

4. Using the money GDP figure in the FSBR, it would be possible to keep public expenditure to the same proportion of GDP (41¼ per cent) as in the PEWP plans if the planning total were raised by no more than £3.1 billion. (This is after removing the presentational increases of £600 million in debt interest and other accounting adjustments included in the FSBR.) This is approximately in the middle of the range of GEP's expected outcome, on the basis described.

5. Of course, at this stage these are by no means exact figures. But we need to get away without conceding more than £½ billion for defence in 1988-89. If we expect that we may have to concede at the end of the Survey £200 million in 1988-89 and £300 million in the two subsequent years on account of the GDP deflator, we cannot afford to concede now more than a maximum of £300 million addition for 1988-89 and the same or less for the two subsequent years. This is what I recommend as a maximum in my separate minute. I hope that we could get away with less.

F.E.R.B.

F. E. R. BUTLER

*1 Volume para 11, from 1 attach gl
 replace.
 I do not quite
 understand para 9, how £311m 'includes' £7361m.*

SECRET AND PERSONAL

FROM: F. E. R. BUTLER
2nd April, 1987.

CHIEF SECRETARY

*we have not seen this. will obtain
 a copy if you wish. ————— you pro*

c.c. Chancellor
Mr. Robson

DEFENCE EXPENDITURE

Following my report of 25th March to you, Mr. Robson and I have had further meetings this week with Sir Clive Whitmore and Mr. McDonald. I have agreed with Sir Clive Whitmore that we cannot carry things further and the next step is a meeting between you and the Secretary of State. This minute contains our advice.

2. The MOD's assessment of the gap between their resources and the long term costings, after making the savings in Baskets 1 and 2 which they have accepted, is

£ million		
<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>
398	451	543

FERB
 to
 CST
 2/4

In terms of the cash they expect to have available, however, their position is not so bad. They expect to carry forward some cash from 1987-88 which after meeting pay increases, higher oil prices and changes in the deutschmark value, would result in a deficit of £361 million in 1988-89. They have not forecast how much carry-forward they will have in 1989-90 but if it amounted to the same as 1988-89 they would have a cash deficit of about £450 million.

3. The bid which Sir Clive Whitmore made to us was £450-500 million in each year. Others in MOD have talked about £400-450 million, and the Defence Secretary mentioned to you £400 million.

4. This does not however include the effect of the higher GDP deflators in the FSBR, which MOD estimate will cost them just over £200 million in 1988-89 and about £300 million in each subsequent year. We have suggested leaving this element on one side in these negotiations until we see what GDP deflators we are forecasting in the autumn. The agreement we reach now would therefore be a final resolution of the 1987 Survey, subject to re-opening on these grounds alone. But we must have in mind that there could be a further liability of £200 million in 1988-89 and £300 million in each subsequent year.

5. Mr. Robson put to MOD savings, totalling £137 million in 1988-89, from Baskets 3 and 4 which seem to us possible without undue political difficulty, and further suggestions for savings totalling £220 million in 1988-89. They are set out in the tables attached. If accepted in full (which we do not expect) they would have removed the problem in 1988-89.

6. MOD's performance in dealing with these suggestions did not seem to us very impressive. They did not dismiss them, but they were not prepared to adopt any of them. I suspect that the people we were talking to did not feel competent to endorse them without a wider study in MOD which would have given the game away. It also became clear in our discussion that there was likely to be further carry-forward from 1987-88 of £50 million, reducing the cash shortage in 1988-89 to £311 million. So, making clear that he was acting ad referendum, Mr. Robson suggested to MOD that we should provide half this deficiency in 1988-89 (ie £155 million) and the same again in 1989-90, leaving MOD to find the rest by using something under half of the additional savings we had suggested. He also offered an extra £100 million in 1990-91. All these amounts would be before any adjustment for the higher GDP deflator. MOD rejected this offer.

7. It was clear from our discussions that there is a serious difference of approach between MOD and ourselves. We see this exercise as giving the MOD enough to maintain their existing programme (subject to Baskets 1 and 2 and other savings which they could reasonably make) over the next few months. We are not aiming, and do not want, to remove their difficulties in the longer term. We are not pressing them to agree now to the sort of fundamental reassessment which would be contained in a Defence Review, but equally we do not want to concede increases which would remove the pressure for that in due course.

8. Sir Clive Whitmore, on the other hand, while not ruling out a Defence Review, argues that, even if Ministers were to decide on it, it would not produce savings quickly. He suggests that, even with the increases he is asking for, the Defence Budget would remain in difficulty and so the pressure for a fundamental reassessment will remain. I said that I was sceptical and in any case if by the 1988 Survey a defence review was not heading for early resolution we could tackle the consequence at that time. I said that anyway we could not possibly commit sums of the scale MOD were asking for out of the Reserve of £5½ billion in 1988-89, from which we are only likely to be able to allocate a maximum of £2½ billion for all programmes if we are to start 1988-89 with a Reserve of £3 billion. I also made it clear, and Sir Clive Whitmore seemed to accept, that we would not want to commit more in 1988-90 and 1990-91 than we gave in 1988-89: in fact, there is a good case for less in these years.

9. This is the point from which you will start with Mr. Younger. I suggest that you start from the MOD's projected cash deficit of £311 million in 1988-89. You should point out that during our talks it emerged that there would be an extra carry forward of £50 million from 1987-88, reducing this figure to £361 million. You should argue that they

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ought to be able, either by using some of our suggested further savings or by deferring decisions, to ease that problem further. You should leave the effects of the higher GDP deflators in the FSBR (but nothing else) for consideration later in the Survey. On this basis, I think that it would be a good outcome from our point of view if you settled with Mr. Younger for an additional £200 million in each year.

10. On the merits of the case as put to us by MOD, they have failed to convince us that the figure should be more than that or even as much. This should therefore be your stopping point unless Mr. Younger produces some much more convincing argument. If he does, you could remit it back to officials for a very quick assessment. Even if this assessment convinced you that MOD had a stronger case than we have hitherto thought, I strongly recommend that you do not, in the final outcome, go further than £300 million in each year which, for reasons set out in a separate minute, is anyway pushing the limits of what we can afford.

X | 11. I also mention that we are requesting, and Sir Clive Whitmore seems willing to consider, much closer involvement in MOD's internal discussions about the programme in future. It would be helpful if you could make this a condition of any agreement with Mr. Younger.

F.E.R.B.

F. E. R. BUTLER

Serial	Description	87/8	88/9	89/90	90/1	91/2	Reason for inclusion
<u>I. Basket 3</u>							
<u>Navy</u>							
2087	Defer NIS Q&A lyr	0	-0.8	-1.9	-1.4	-0.7	
3078	Delete Advanced Sea Mine	0	-4.2	-5.2	-6.2	-3.8)High risk development of)questionable value
3017	Delete New Minelaying System	-0.1	-0.1	-0.1	-1.3	-3.0)compared to more flexible)surface vessels or submarines
3061	Fire Fighting Training Unit - defer 2yrs	-1.3	-2.6	-0.7	1.8	2.0	Alternative facilities exist
3003	Reduce overtime (BB2) by further 2%	0	-0.7	-0.7	0	0	
2097	Reduce SCOT provision by 5M 88/89	0	-5.0	2.5	2.5	0	Temporary measure with limited operational penalty
2121	Orange Crop delete MLU	0	-0.6	-6.1	-7.0	-6.0	Reduces investment in aging equipment
3083	Lynx - delete replacement radar	-0.7	-3.6	-3.8	-14.2	-15.9	Reduces flexibility of ASV operations but preserves general capability
3084	Lynx - delete CTS	0	-6.3	-9.3	-8.7	-2.1	
3015	Reduce overtime (BB1) by further 10%	0	-0.6	0	0	0	
3016	Reduce overtime (BB2) by further 10%	0	-3.6	0	0	0	
9033	Defer Aviation Support Ship further 6 months	0	0	-3.4	-16.4	2.0	Marginal operational impact
9033	Defer AMRAAM lyr						
9034	Defer SHAR MLU lyr						
		-2.1	-28.1	-28.7	50.9	27.5	

Army

3201	Defer NIS Q&A 1yr	0	-0.6	-1.0	-1.0	-0.5	
3202	Disband TA Bands/ Medical Orderlies from 88	-0.4	-0.9	-0.9	-0.9	-0.9	Tolerable if no other TA measures taken. New, Jersey, medical company will offset to some extent.
3204	Future MBT - buy off shelf	0	-1.0	-3.5	-2.5	-5.0	Not essential UK Technology and doubt that UK can sustain FMBT capability
3206	Defer Chieftain AVRE 2 yrs	-0.5	-1.0	-4.0	-9.6	+0.8	Painful measure, but limited duration preserves capability
3209	Delete Multi Role Mortor Fuze	-0.2	-0.3	-0	-0	-4.4	
3210	Delete SSGCE for Chieftain	0	-3.0	-6.0	-6.7	-7.0	
3211	Defer Skynet D/E 2 yrs	0	-1.3	-6.1	-20.6	1.5	Realism
3213	Cash Limit Training Ammo	0	-5.0	-5.0	0	0	Limited Duration only
3214	Works - reduce by 2%	0	-8.0	0	0	0	Limited Duration only
3215	Defer Ptarmigan 3A 4yrs	-0.4	-6.0	-9.0	-5.0	4.0	Painful, but preserves eventual op capability
3218	Delete AFV TDPs	0	-3.9	-1.8	-1.5	-0.9	Not essential defence technology
3219	Defer DFWES 3yrs	-0.7	-4.5	-9.2	-10.2	-5.1	
		-2.2	-35.5	-46.5	-58.0	-17.5	

RAF

3301	Defer NIS Q&A lyr	-0.2	-4.0	-10.4	-8.1	-4.4	
3302	Secondary Surveillance Radar cancel 50% of buy	0	-0.5	-1.9	-0.7	0	
3303	Defer SKYNET D/E 2yrs	0	-0.6	-2.9	-9.7	0.7	Realism
3306	Reduce Hercules AE by 5	0	-2.2	-3.5	-4.2	-4.2	
3307	Defer Tristar tanker conversion lyr	0	-6.7	0.5	-23.1	6.1	Increased risk, but preserves capability
3308	Defer AMRAAM lyr	-0.3	-4.7	-8.9	-6.8	-4.8	
3310	Delete ECM Update for Jaguar/Buccaneer	-4.0	-6.3	-6.3	-0.5	0	Aging Asset
3312	Defer SRA 1238 lyr	2.2	-10.8	-12.0	-24.4	-1.0	Marginal deferment in controversial requirement
3315	Procure LRSOM off shelf	-3.0	-11.0	-11.0	-5.0	-12.0	
		<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	
		-5.3	-46.8	-56.4	-82.5	-19.6	

Others

3401	Reduce R&D equipment	0	-3.0	3.0	0	0	Minor slippage
3402	Reduce Vote 4 equipment	0	-2.0	2.0	0	0	Minor slippage
3404	cash limit IT to LTC 86	0	-1.0	-1.0	-2.0	-2.0	Maintains existing level of provision
3501	Reduce DGITS New systems	0	-0.8	-0.8	-0.8	0	
		<hr/>	<hr/>	<hr/>	<hr/>	<hr/>	
			-6.8	-6.8	-2.8	-2.0	

II. BASKET 4

Navy

3081	Golightly - delete	-0.9	-1.8	-1.4	0	0	Alternative means of meeting requirement exists
9026	SDMS - procure off shelf						No need for UK to maintain national capability when US alternative exists
9025	Reduce provision for CACS	0	-2.0	1.0	1.0		Should be possible without prejudicing current procurement of CACS 1+5

Army

4204	Disband UOTCs	0	-3.1	-3.0	-3.4	-3.7	implied benefits largely due to existing scholarships and bursaries
4208	Cancel rapid Bridge demolition	0	-1.0	-1.6	-3.5	-4.9	
3217 (Old)	MLRS III Buy off shelf	0	-8.9	-10.9	-10.3	-13.5	Preserves capability without cost of development

RAF

Other

4408	Delete logistic Vehicle Research	-0.2	-0.2	0	0	0	
4415	Delete RARDE Initiations research	0	-0.4	-0.4	-0.5	0	
4417	Delete Gun Steels research	0	-0.4	-0.4	-0.4	0	
4418	Delete B Vehicle trials	0	-0.5	-0.5	-0.5	0	
4501	Cancel CHOTS	0	-1.0	-7.7	-1.7	-1.5	Expensive of questionable IT benefit

-1.1	-19.3	-24.9	-19.3	-23.6
-10.7	-136.5	-163.3	-213.5	-90.2

TOTAL BASKETS 3 and 4

ANNEX B

Measures not included in Baskets but worthy of further consideration

Description	87/88	88/89	89/90	90/91	91/92	Reason for Inclusion
European Fighter Aircraft - slip 1 year		-25.0				Large item of future MOD expenditure which should not be immune from savings
ASRAAM - slip 1 year	0	-7.0	-4.0	-16.0	-4.0	In keeping with measure on AMRAAM. Realism?
Light Attack Helicopter - cancel (only possible if Basket 4 measure to delete LR TRIGAT is taken, though some slippage may be possible)	-2.1	-4.1	-27.1	-27.1	-23.0	If airborne ATGW is cancelled, need for LAH also falls
Future Light Armoured Vehicle cancel studies	0	0	0	0	-5.0	As with FMBT, no need for UK national capability
Trident - slip SSBN 06 and 07	-6	-20	-35	-25	-20	MOD estimate of maximum savings without prejudicing ISD
Armed Forces Allowances	-10	-54	-54	-54	-54	Forcing all potential savings identified in the Review of Allowances, without allowing any new improvements (could influence AFPRB award)
Civilian Manpower	-35	-35	-35	-35	-35	Remove a further 3000 post suggested in recent MOD report as surplus under industrial productivity schemes
Medical Services	-20	-20	-20	-30	-30	Remove current overmanning and increase recoveries from NHS (NAO report) plus closing or reducing some overseas Service hospitals (eg Gibraltar, Akrotiri, Falklands)

Defence Estate	-20m	-20m	-	-	-	Faster disposals of surplus land and property (Freeman initiative) without allowing reallocation to new works
Service Training	-37m	-37m	-37m	-37m	-37m	Assumed 2% efficiency saving on £1850 million pa spent on AF training
SDIPO	0	-0.6m	-0.6m	-0.6m	-0.6m	Close SDI Participation Office in MOD during 1987-88 transferring residual functions to relevant existing divisions.
	<hr/>					
	-130.1	-222.7	-212.7	-224.7	-208.6	

CONFIDENTIAL

Robson
to
Chief
30/4FROM: S A ROBSON
DATE: 30 April 1987

CHANCELLOR

cc: Chief Secretary
Mr F E R Butler
Ms Seammen**DEFENCE EXPENDITURE**

Mr Younger's letter of 30 April

2. Mr Younger puts everything in an "all or nothing" fashion, eg you take all of basket 3, or none. In fact it is possible, and sensible, to select items from baskets 3 and 4. And from the separate list of Treasury savings which we provided MOD.

3. The programme excesses after baskets 1 and 2 are (£ million):

<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>
398	451	543

Against this the Chief Secretary has offered:

250	300	300
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Mr Younger wants:

350	500	550
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4. Mr Younger claims the Chief Secretary's offer forces him into the wholly unacceptable basket 3 and 4. It is not wholly unacceptable. The Treasury identified some savings within basket 3 and 4 which are not high profile or damaging in military terms. MOD officials could not argue effectively to the contrary.

The Treasury basket 3 and 4 savings were:

136	163	214
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In addition the Treasury identified feasible savings which were not in any MOD basket. These were:

223

212

225

In short more than enough to bridge the gap between Mr Younger and the Chief Secretary.

5. The NATO impact would be limited. The UK has implemented in full 14 out of 17 "highlighted" force goals. We would still show full implementation of these 14 after all the Treasury cuts.

6. You should note that Mr Younger would, on his own proposal, not be on path to deliver the E(RD) decision on R&D spending beyond 1990.

7. The AFPRB award was £30 million a year below the amount provided by MOD in their budgetary plans. Mr Younger's problem is now that much less.

8. You should resist the proposal at the end of paragraph 6 of his paper - that the 1990-91 figure should be uplifted by 3 per cent not the standard $2\frac{1}{2}$ per cent. This would cost a further £100 million above the Chief Secretary's offer.

9. Finally, the last paragraph of the paper is wrong. The Treasury has given no undertaking to give automatic adjustment in the Autumn for changes in the inflation forecast between Autumn 1986 and Autumn 1987. We have merely said we would "look again without commitment", in the Autumn. You should go no further and avoid any suggestion of constant real provision between 1989-90 and 1990-91.

pp S A ROBSON

SECRET

FROM : S A ROBSON
DATE : 1 MAY 1987

CHANCELLOR OF EXCHEQUER

c.c. Chief Secretary
Mr F E R Butler
Ms Seammen

DEFENCE EXPENDITURE

A few points in advance of your meeting at No 10 on Tuesday.

2. I have spoken to Mr Norgrove (No 10). His immediate reaction was to describe as "very generous" the offer of (£ million) :

<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>
250	300	300

He felt that the best solution might be to give Mr Younger the £250 million for 1988-89 and leave the rest to be discussed in this year's PES.

3. This would be quite a good outcome. It would cut the ground from under Mr Younger's argument that he faces the need to make early, and public, cuts. If challenged on the defence budget he could say this would be discussed in the normal way in PES.

4. Discussions today with MOD officials have served to emphasise the points in the last two paragraphs of my minute of 30 April. They are trying to pretend they have got a guarantee of extra money to cover any change in inflation between PEWP 86 and PEWP 87. And they want 1990-91 to be based on a 3% uplift, not the standard 2½%. The cost of meeting these points is :

	<u>1988-89</u>	<u>1989-90</u>	<u>1990-91</u>
½% on base line	-	-	100
inflation risk (1)	230	330	340
CST offer	<u>250</u>	<u>300</u>	<u>300</u>
	480	630	740

(1) calculated on the assumption that 1987 PEWP shows the same inflation forecast as 1987 FSBR.

Either

- (i) no increase in the Chief Secretary's offer
- (ii) 1990-91 calculated on 2½% uplift and no more;
- (iii) no commitment on compensation for inflation. Simply an offer to "look without commitment" in the Autumn.

Or

- (i) £250 million for 1988-89;
- (ii) tackle 1989-90 and 1990-91 plus inflation in normal PES discussions.

5. One final point. Assuming some agreement is reached at No 10 there may be discussion on what should be said in public. In my view the right answer is "nothing explicit". Reasons :

- (i) announcing more money for defence will not help in PES discussions with other departments;
- (ii) the public does not know the budget in the PEWP was far adrift of the programme. So there is no need to say the two are now being brought into line;
- (iii) if there is a challenge about the adequacy of the budget Mr Younger can say that the Government has provided money in the past and will do so in future via the annual PES discussions. This would open the way to showing the increases at the time of the Autumn Statement.

SECRET

6. You should avoid any suggestion that the additional money is linked in public to the possibility of reductions in nuclear arms in Europe. The Treasury would be on a long slippery slope if we accepted that arms control meant more defence spending.

SAR

S A ROBSON

SECRET



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CHIEF SECRETARYPES 87

I have your request for bids, as required by the PES guidelines.

2. You will be aware of my discussions with John MacGregor about the problems which I face in light of the latest Long Term Costing. Your officials have the papers but it may be helpful if I set out the broader picture.

3. In recent PES rounds the defence budget has progressively been driven below the level run in real terms from 1985/86 implied in the programme constructed by John Nott in 1981 - a programme subsequently enhanced, for which we have taken political credit. In GDP deflator terms, the (Falklands exclusive) defence budget in 1990/91 is some £800 million below a level run from 1985/86. On another calculation, the cumulative cost above the cash factor of Service AFPRB awards (now nearly £500 million a year), the decision in PES 85 not to allow in 1988/89 the appropriate addition for Falklands expenditure, and the fall in the DM rate since June 1986 (the base rate for our Long Term Costing), taken together, also now total some £800 million a year.



4. On the other hand, as a result of successive Long Term Costing exercises responding to these PES decisions and the internal pressures within the defence programme itself and in which the frontline has been largely sacrosanct, it is no longer possible to rely on the traditional course of deferring expenditure on equipment, works and support, coupled with the benefits of efficiency measures and reduced civilian numbers. Some major changes are now in prospect if we are to achieve balance between operating and capital expenditure, between platforms and weapons and so on. Trident costs are well under control, but Trident (£600 million in 1987/88 and rising thereafter) now represents an increasing proportion of the budget, thus reducing room for manoeuvre.

5. In brief, the reduction in our resources has gone too far to maintain our planned programme. I have imposed severe programme cuts, which in my view take us to the edge of stability, and which run, on any reading, against the grain of this Government's perceptions of defence, and what is required of it. I see no solutions other than either further cuts in programmes, which would be militarily, politically and industrially very damaging, as well as damaging internationally, or some relief on the resource side, the difficulties of which I in no way underestimate.



6. I cannot long leave my programme in its present state of imbalance. I need to have a reasonable injection of resources which, while by no means closing the gap compared with prospective needs, would at least allow me to get ahead on a sensible basis with work on the next Estimates and LTC. Moreover, the present uncertainties are inevitably affecting the flow of business, with the obvious consequences for the cost effective running of our affairs.

7. I should be grateful if we could press ahead. I have in mind additions to the formal PES baseline of £300M, £450M and £600M together with a further adjustment in the Autumn in the light of the latest inflation forecasts. A settlement at that level would still leave a substantial gap compared with the cost of the programme. It would enable me to do no more than keep the programme largely intact until we are able to have a more fundamental look at the balance between defence resources and the Defence programme at the end of the 1988 Long Term Costing in the spring of next year, as John MacGregor and I envisaged. This examination would be without prejudice in either direction, although my own view is that to sustain in the medium and longer term a number of key capabilities we need to return to some real growth. I shall be very ready to come and see you within the coming weeks. Any settlement reached need not, of course, be announced until the Autumn.



8. There is also an urgent need to review our running costs provision which is currently set to decline significantly in real terms. This makes no managerial sense, especially given the pay pressures. My officials will be following up with the details.

9. I am sending a copy of this minute to the Prime Minister and the Chancellor of the Exchequer only at this stage.

Ministry of Defence

22 July 1987

A.Y.

CONFIDENTIAL

If in the Autumn Statement the GDP deflator for 1987-88 is 5% rather than 4.5% of FSBR 87, this would increase the cost of such an inflation adjustment by approximately £100 million a year. If the 1988-89 GDP deflator is also 4½% rather than 4%, that would add a further £100 million to all years.

B. Background

5. It is useful to begin by recalling the events of the last few months.

6. In March Mr Younger told your predecessor that LTC 87 MOD's 1987 long term costing (LTC 87) of the defence programme was then coming to an end and was showing excess of up to £1 billion a year over the PES baseline. He was prepared to take measures to get the excess down to some £400-£500 million (at 1986-87 prices) a year but he wanted agreement that this residual excess would be matched by an addition to his baseline in 1988 PES.

7. This pitch was set very much against the background of a forthcoming Election (the date of which was not then known). Mr Younger argued that economies to remove the residual excess would create highly damaging publicity. Essentially he wanted a quick fix to avoid this and to see him through the Election.

8. Ultimately your predecessor offered him :

- (i) £200m, £300m and £300m in the three PES years;
- (ii) to look again in Autumn 1987 without commitment in the light of any changes in inflation prospects.

This offer was on the understanding that after the Election the fundamental issues of balancing the programme and the budget would be addressed.

X | 9. Mr Younger refused this offer. He took his case to the Prime Minister. He got surprisingly little sympathy from her. He said he would implement his baskets 1 and 2 of savings and leave the residual excess. You may like to read the record of this meeting at Annex A.

10. Mr Younger's letter essentially builds on the offer made by your predecessor and which he refused. He is confusing an offer which was to meet a political need for a quick fix before an Election with the more systematic and complete PES process. In particular PES is a cash planning system. His approach of demanding an adjustment in the Autumn in the light of inflation has to be rejected at the outset: we must hold fast to cash planning.

C. Options

11. We do need to get the defence budget and programme aligned. There is no financial discipline if the programme is in excess of the budget. The issue is how we secure this alignment at minimum cost.

12. Sir Clive Whitmore has recently told Mr Butler how MOD see this happening. Sir Clive envisages that, while this year's Survey is being conducted, LTC 88 would continue in parallel. If, despite any PES increases this year, LTC 88 shows a gap remaining between the defence programme and resources available, radical options would identified. Next Spring at the end of LTC 88, a Cabinet Office chaired interdepartmental group, will be set up to conduct the review. The group will include FCO and DTI.

13. Against this background we need to consider :

- (i) whether MOD's proposed "holding operation" approach to the 1987 Survey is acceptable;
- (ii) whether a free-standing defence "review" is a useful mechanism;

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(iii) having assessed these questions, what approach is most likely to be in the Treasury's interests.

The Holding Operation

14. MOD's latest figures for its programme gap are as follows (£ million cash) :

	1988-89	1989-90	1990-91
LTC 87 excess. after baskets 1 & 2	566	635	803
Subsequent changes			
- assumed pay awards	+206	+351	+361
- oil/foreign exchange assumptions	+141	+146	+150
- carryforward assumption	-400	-	-
Gap at present	513	1,132	1,314
PES bid (without inflation adjustment)	-300	-450	-600
Residual gap after "holding operation"	213	682	714

15. The residual gap after the holding operation is already large. It is highly likely that the gap will get bigger as MOD's LTC 88 work progresses over the summer : currently MOD are considering "essential" additions to the programme amounting to at least £500 million in 1990-91. There are three implications :

(a) we will have given MOD a lot of money but they will have done nothing other than widen the gap. This means MOD would start the review next spring in a more favourable position than the Treasury. Almost

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inevitably the outcome of such a review will result in higher spending than if it started from the present PES baseline;

(b) the programme would remain in excess of the budget until after the end of the review. This means there would be no financial discipline within MOD until sometime in mid/late 1988. In the meantime a series of major defence projects will come forward. The pressures would be to let them go ahead to keep the defence programme "intact". There would be no financial constraint to counter this. As such projects are agreed, further options for cuts in the defence review will be removed.

(c) In the review next Spring, FCO and DTI will support MOD - the FCO for reasons of prestige and DTI for protection of British industry. The Defence Secretary's approach - "...my own view is that to sustain in the medium and longer term a number of key capabilities we need to return to some real growth" - makes his own ambitions clear.

16. The obvious alternative would be a true holding operation until after the review. This would involve :

- no additions to the PES baseline in PES 87
- no new spending commitments until after the review is finished

This would mean a complete moratorium. It would inevitably become public knowledge. It would be seen as a collapse of defence policy.

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As such it is unlikely to be acceptable.

Defence Review

17. So far we have established that the forum MOD have in mind for a defence review is unattractive. And the path they would take to get to the review is unattractive. We now look at the likely content of a review.

18. It would not be easy to achieve any shift in the range of commitments undertaken by the UK against the entrenched perception of the UK's international role and status. Arguments will be produced for maintaining every current NATO and out-of-area role, with dire warnings about the effects on the Alliance, Anglo-American relations etc if even the smallest part should be dropped.

19. It would also be difficult to win the arguments about how defence roles should be met - for example, by a different mix of capabilities or by a radical change in equipment procurement policy, or in the approach to Service pay and allowances. More generally it would be difficult to focus on questions of efficiency and value for money; the arguments about roles and required capabilities will tend to dominate.

20. In short, a formal, free-standing defence review of the sort MOD now envisage is unattractive for the Treasury. There would be no financial disciplines on the military and on the FCO.

21. This is not to deny that there are fundamental issues to be addressed in defence. Most fundamental is the imbalance between the UK's contributions to the Alliance and our comparative economic strength. The issue is how best to get them addressed in a disciplined manner.

Alternative Approach

22. The alternative would be to achieve the reconciliation between programme and budget as part of the normal PES and LTC 88 activity.

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This would restore financial discipline relatively quickly and minimise the period during which new spending commitments were made without financial constraint. It should also avoid the rigidities of a formal free-standing defence review described above. And it should keep the FCO and DTI at arms length.

23. This approach would mean an early PES settlement, i.e. during September if not this month. This would give MOD a clear target to work to in LTC 88. It would be made clear that this was a final settlement in the sense that it carried no presumption that it would be re-opened in the light of a subsequent review.

24. This is our preferred approach. Obviously MOD might dislike it for these very reasons that we like it. But this is not a forgone conclusion. Mr Younger is keen to avoid anything that looks like a formal defence review. So it may be possible to do a quiet deal with him on our preferred basis. The only risk is that he has a track record of deferring decisions. You will need to extract from him an undertaking to reconcile the programme with the budget you agree with him.

25. The tricky question is the size of each addition we have to give him to turn this trick. This has to be judged against the gap shown in the table in para 14 above. It is also necessary to consider how much creeping radicalism the Prime Minister could stomach in this area.

26. In this context our target outcome of £200, £400 and £500 million is ambitious. We need to make an offer which would tempt Mr Younger to negotiate, and to agree there would be no subsequent inflation adjustment. The best approach may be to say that :

- (a) you are not prepared to increase the defence budget now on the basis that radical options to bring programme and budget into line would not be looked at until next year : a holding operation would mean baseline

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plus a moratorium on new projects;

- (b) alternatively you are prepared to go for a full settlement now on the clear understanding that he will bring his programme into line with the cash then in his budget;
- (c) what does he say? If he opts for (b), open at 200, 300 and 400.

A draft letter to Mr Younger is attached

S. C. Kingwood
P.P. S A ROBSON

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PERSONAL AND CONFIDENTIAL

DRAFT FOR AGENDA LETTER

Thank you for your letter of 2 July. Since you asked for early discussion I am writing in advance of Cabinet on 23 July to propose an agenda for an early bilateral meeting.

2. I recognise that you currently face difficulties with the defence budget. At the same time, as I will explain to Cabinet, the overall public expenditure position is extremely difficult. The bids I have received, including yours, are quite incompatible with our policy objective of bringing public spending down as a proportion of GDP, as set out in the White Paper. In view of this it is essential that a substantial part of the gap between the costed defence programme and current PES provision should be met from within the programme. Other departments will face equally painful decisions.

3. Programme savings, including further cuts in equipment orders, are never easy. The defence programme has done well in the past. Programme cuts at this stage must be seen against the background of substantial orders of conventional equipment since 1979. Our contribution to NATO is greater than that of a number of countries with stronger economies. There has been a degree of over-ambition in your department's forward planning which needs to be rapidly rectified. I therefore welcome your agreement that a fundamental look at the balance between programme and resources should be undertaken. It will of course be essential for my officials to play a full part in this process.

4. I do not think that this fundamental look should be delayed or that for defence the 1987 Survey should be some form of holding operation, designed to allow business to continue as usual in the interim. At present there is no effective financial discipline on your forward programme. The normal test of whether a project can be contained within LTC and PES provision has no meaning in

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these circumstances.

5. There appear to be two options. First, a true holding operation in PES 87. This would involve holding the present PES baseline and undertaking no new commitments until after the fundamental look had been finished. I recognise that this amounts to a moratorium and will be unwelcome to you. But I see no other way of managing sensibly our affairs over a period when normal financial disciplines do not exist.

6. The second approach would be to re-establish a resource ceiling as a matter of urgency on the basis that you would then use LTC 88 to bring the programme back within this ceiling. This means reaching a full and final PES settlement as quickly as we can.

7. This is a demanding prospect but I consider it preferable to the other option. It would require us to examine now all opportunities for savings. There are a number of possibilities here, which I do not think have been adequately addressed so far. First, Armed Forces allowances. The recent review of the system, together with the various studies of individual allowances, has revealed scope for substantial and justifiable savings. Given the pressures on the defence budget, it is difficult to understand why this area has been excluded from the search. Second, the level of efficiency achieved in activities such as stockholding; in support services such as training, medical services, recruitment and movements; and generally in the use of Service and civilian manpower. Both Parliamentary investigations and your department's numerous internal studies suggest that there is room for significant improvements in efficiency in such activities. Third, and as your letter of 18 May acknowledges, there are clearly opportunities for increased receipts from the accelerated disposal of surplus land and buildings, particularly surplus married quarters.

8. Fourth, we must also look for significant savings in the procurement of equipment. The effort to improve value for money through increased competition is important. But it is not

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ufficient. The succession of troubled development projects - and of critical PAC and other studies of equipment procurement - indicate that we need to make rapid progress in improving the management of projects. We must also rigorously apply the approach to procurement set out in the latest Statement on the Defence Estimates, avoiding the duplication of successful equipment developments already achieved by our allies.

9. Finally, you will want to examine our defence commitments.

10. Such avenues could cover a large part of the gap between costed plans and PES provision. They could also provide a sustainable balance between defence commitments and the level of resources which our economy can sensibly allocate to defence .

11. We need to meet in the next few days to consider the options in paragraphs 5 and 6 above. I would emphasise one last point. I could not enter into any agreement which was open to variation in the light of the autumn inflation forecast. I appreciate my predecessor made an offer which included an expression of readiness to look again, without commitment, at inflation this Autumn. That offer - which you rejected - was to meet a perceived need for a quick solution in advance of the PES round. We are not in that position now. PES is a cash planning system.

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Annex A
 CC Mr FER Butler
 Mr Robson.
 ACSA
 6/5.



10 DOWNING STREET
 LONDON SW1A 2AA

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From the Private Secretary

5 May 1987

1. Mr Martin ^{PM 6/5}
 2. Mr Honeyford ^{6/5}
 3. SAR

DEFENCE EXPENDITURE

The Prime Minister this evening discussed with your Secretary of State, the Chancellor of the Exchequer and the Chief Secretary what might be said about pressures on the defence programme during the coming weeks if there is an Election.

Your Secretary of State explained that a number of academics, the House of Commons Defence Committee and others were now drawing attention to a gap between the content of the defence programme and the resources provided for it. A substantial gap did indeed exist. Officials in the Ministry of Defence had identified four "baskets" of possible savings measures. The first two baskets of measures, though painful and difficult, had become unavoidable. The third and fourth baskets were most unlikely to be acceptable to the Government. It would certainly be necessary to carry out a thorough scrutiny of the programme during the course of the next Long Term Costings exercise.

The Chancellor acknowledged that there would probably be a need for some increase in the provision for defence. However, some of the savings included in the third and fourth baskets should prove to be acceptable, and Treasury officials had identified others, outside any of the baskets, amounting to around £200m a year which were certainly worth pursuing.

The Prime Minister drew attention to the huge waste which had been incurred in the procurement of a range of weapons, and to the need to take a firm grip on military R & D.

In further discussion, your Secretary of State said he would instruct his officials to cease work on the third and fourth baskets. Increased funding to meet a shortfall would be a matter for discussion in the Public Expenditure Survey. Whilst accepting that increased funding would be a matter for discussion in the survey, the Chancellor said that individual items from the third and fourth baskets would also need to be discussed then, together with the other possible savings identified by the Treasury.

It was agreed that during an Election campaign the Government would be able to point to its excellent record on defence, and to say that increased expenditure provision would be a matter for discussion in the usual way in the Public Expenditure Survey. Your Secretary of State undertook to circulate to the Prime Minister and to Treasury Ministers the words he would be using tomorrow on this at the time of publication of the Defence White Paper.

I am copying this letter to Alex Allan (HM Treasury).

(DAVID NORGROVE)

John Howe, Esq.,
Ministry of Defence



SECRETARY
- 2000007
Ms Seaman

cc. Mr FER Butler
Mr Robson
Mr Turnbull
Mr Hansford
Mr Gier
Mr F Martin
Mrs Walker

MO 8V

CHIEF SECRETARY

PES 87

I have your request for bids, as required by the PES guidelines.

2. You will be aware of my discussions with John MacGregor about the problems which I face in light of the latest Long Term Costing. Your officials have the papers but it may be helpful if I set out the broader picture.

3. In recent PES rounds the defence budget has progressively been driven below the level run in real terms from 1985/86 implied in the programme constructed by John Nott in 1981 - a programme subsequently enhanced, for which we have taken political credit. In GDP deflator terms, the (Falklands exclusive) defence budget in 1990/91 is some £800 million below a level run from 1985/86. On another calculation, the cumulative cost above the cash factor of Service AFPRB awards (now nearly £500 million a year), the decision in PES 85 not to allow in 1988/89 the appropriate addition for Falklands expenditure, and the fall in the DM rate since June 1986 (the base rate for our Long Term Costing), taken together, also now total some £800 million a year.



4. On the other hand, as a result of successive Long Term Costing exercises responding to these PES decisions and the internal pressures within the defence programme itself and in which the frontline has been largely sacrosanct, it is no longer possible to rely on the traditional course of deferring expenditure on equipment, works and support, coupled with the benefits of efficiency measures and reduced civilian numbers. Some major changes are now in prospect if we are to achieve balance between operating and capital expenditure, between platforms and weapons and so on. Trident costs are well under control, but Trident (£600 million in 1987/88 and rising thereafter) now represents an increasing proportion of the budget, thus reducing room for manoeuvre.

5. In brief, the reduction in our resources has gone too far to maintain our planned programme. I have imposed severe programme cuts, which in my view take us to the edge of stability, and which run, on any reading, against the grain of this Government's perceptions of defence, and what is required of it. I see no solutions other than either further cuts in programmes, which would be militarily, politically and industrially very damaging, as well as damaging internationally, or some relief on the resource side, the difficulties of which I in no way underestimate.



6. I cannot long leave my programme in its present state of imbalance. I need to have a reasonable injection of resources which, while by no means closing the gap compared with prospective needs, would at least allow me to get ahead on a sensible basis with work on the next Estimates and LTC. Moreover, the present uncertainties are inevitably affecting the flow of business, with the obvious consequences for the cost effective running of our affairs.

7. I should be grateful if we could press ahead. I have in mind additions to the formal PES baseline of £300M, £450M and £600M together with a further adjustment in the Autumn in the light of the latest inflation forecasts. A settlement at that level would still leave a substantial gap compared with the cost of the programme. It would enable me to do no more than keep the programme largely intact until we are able to have a more fundamental look at the balance between defence resources and the Defence programme at the end of the 1988 Long Term Costing in the spring of next year, as John MacGregor and I envisaged. This examination would be without prejudice in either direction, although my own view is that to sustain in the medium and longer term a number of key capabilities we need to return to some real growth. I shall be very ready to come and see you within the coming weeks. Any settlement reached need not, of course, be announced until the Autumn.



8. There is also an urgent need to review our running costs provision which is currently set to decline significantly in real terms. This makes no managerial sense, especially given the pay pressures. My officials will be following up with the details.

9. I am sending a copy of this minute to the Prime Minister and the Chancellor of the Exchequer only at this stage.

Ministry of Defence

2nd July 1987

A.Y.

PERSONAL AND CONFIDENTIAL

FROM: F. E. R. BUTLER
27th July, 1987.

CHIEF SECRETARY

c.c. Chancellor
Mr. Robson

1987 SURVEY: DEFENCE

The news in Mr. Allan's minute of 27th July that the Defence Secretary has given presentations to the Prime Minister and Lord Whitelaw on his defence needs prompts the idea that you might similarly give the Prime Minister and Lord Whitelaw a presentation. The material in the briefing submitted with Mr. Martin's minute of 24th July could, I think, impress the Prime Minister and Lord Whitelaw with the scope for MOD to solve their problems by managing their resources better.

2. If the Chancellor and you were attracted by this idea, the Chancellor might mention it to the Prime Minister at a bilateral. We could then work up the material in the briefing into a draft presentation for you to make, presumably in September.

Ch
worth doing?
AA

F. E. R. B.

F. E. R. BUTLER

Yes. Worth doing. A single presentation to PM & LW together. Assume F. E. R. B. involved.