

PART 3

CONFIDENTIAL FILING

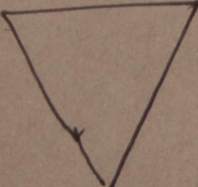
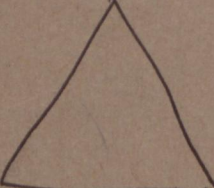
FUTURE UK DEFENCE POLICY

DEFENCE

["BRITISH DEFENCE POLICY 1988-89" (attached folder)  
~~DISCRIMINATE DEFERENCE in Attached Folder~~]

PART 1: OCT 1979

PART 3: NOV 1987

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
<del>10.11.87</del>		<del>21.7.88</del>					
<del>21.12.87</del>		29.11.88					
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<del>18.1.88</del>		PART					
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PREM 19/2064



PART 3 ends:-

COP to MOD 29.11.88

PART 4 begins:-

Fes speech to RUSI 11.4.89



## Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

1. CM 443 Ministry of Defence

The Future Size and Role of The Royal Navy's Surface Fleet.  
Government Response to the Sixth Report from the Defence  
Committee Session 1987-88, HOC 309.

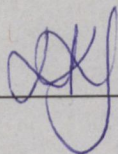
Presented to Parliament by the Secretary of State for Defence by  
Command of Her Majesty July 1988

Published by HMSO ISBN 0-10-104432-1

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2. *British Defence Policy, 1988-89, MoD, May 1988*

Signed



Date

*27/01/2015*

**PREM Records Team**





10 DOWNING STREET

LONDON SW1A 2AA

29 November 1988

*From the Private Secretary**Dear Brian,*

PROPOSAL FOR A MULTINATIONAL DIVISION OF AIRMOBILE AND  
ARMOURED FORMATIONS AS AN OPERATIONAL RESERVE FOR NORTHAG

The Prime Minister has noted the German idea of a multinational division as an operational reserve for NATO's Northern Army Group, to which your letter of 28 November refers. Her instinctive reaction is that proposals for multilateral or multinational forces have foundered in the past because they did not make any real military sense. She notes that in this case the brigades would be of one nationality, with integration taking place above that level. That would to some extent ease practical problems, although in the Prime Minister's view you could only operate such a division on the basis that English was the sole language for its command and operational control. In short she does not view the proposal with great enthusiasm and would not wish us to strive officiously to encourage it. But she agrees that we should not oppose a study if the Germans do indeed come forward with the idea.

I am copying this letter to Alex Allan (H.M. Treasury), Stephen Wall (Foreign and Commonwealth Office) and Trevor Woolley (Cabinet Office).

*van nick,*  
*Charles Powell*  
(CHARLES POWELL)

Brian Hawtin, Esq.,  
Ministry of Defence.



cc/c ①



2 in Minister

MINISTRY OF DEFENCE  
MAIN BUILDING WHITEHALL LONDON SW1A 2HB

Telephone 01-218 2111/3

MO 13/1/12L

he General as to propose the creation of a multinational division in NATO. The Secretary wants to go along with a study.

28 November 1988

Dear Charles, All earlier attempts to establish multinational/multinational forces have foundered for the good reason that they make no 'military sense'. In this case

PROPOSAL FOR A MULTINATIONAL DIVISION OF AIRMOBILE AND ARMoured FORMATIONS AS AN OPERATIONAL RESERVE FOR NORTHAG

The Prime Minister will wish to be aware that the German Ministry of Defence has stated an intention to propose at the NATO Military Committee on 29th/30th November, and to support at the DPC the day after, that a study be carried out on the establishment of a multinational division as an operational reserve for NATO's Northern Army Group (NORTHAG). They envisage that the division should be drawn from existing UK, FRG, Netherlands and Belgian forces and should include airmobile and armoured formations. (Luxembourg might also be called on to provide some staff officers.) Brigades would be essentially of one nationality with integration taking place above that level.

integration would take place only above brigade level, which is a different concept. It's value would be

The Defence Secretary considers that the question of operational reserves in NORTHAG merits a thorough examination. They are an essential component of the Northern Army Group concept which we finally achieved in 1986 after so much difficulty; and we are anxious to ensure that future German plans are consistent with this requirement. This proposal gives us an opportunity to influence their planning in a helpful direction.

political. Content to go along with a study?

The Defence Secretary also considers that the proposal for a multinational force has attractions. We need to be sure that we are making the best use of the available airmobile forces (in our case this is the recently formed, but not yet operational, 24 Airmobile Brigade) and we have been examining a number of options for joint operation of airmobile forces in view of their high cost. It could also be of political value in the burdensharing context as a positive response to the US demands that we strengthen the European pillar of the Alliance. Consideration of the proposal will, of course, have to be pursued through the NATO integrated military structure; indeed we would insist that the study should be led by SACEUR. There are precedents for multinational forces of this kind, for example the ACE Mobile Force.

CBP 20/1/88

So long as they all speak English - Yes. no

Charles Powell Esq  
10 Downing Street





It is too early to say what the implications for the UK of establishing a multinational division would be: we will clearly need to be sure that a joint division would be militarily useful, and we will also have to keep a careful eye on any additional costs that might arise, for example in the field of support. However, the Defence Secretary believes we should support the proposal for a study while emphasising that it must look at the overall requirements for operational reserves within NORTHAG and that it should not focus exclusively on the suggestion for a multinational division. He considers that we should not take the initiative in bringing the matter to public knowledge for the time being since this might give rise to unrealistic expectations. If, however, the Germans are successful in their bid to include mention of the issue in the DPC Communique, he proposes to take the line that a study of operational reserves in NORTHAG should be carried out by the NATO Military Authorities in consultation with the nations concerned, to include the possible establishment of a multinational division. He would emphasise, however, that no decisions had been taken.

The Defence Secretary would be grateful to know whether the Prime Minister is content with this approach. I am copying this letter to Stephen Wall (FCO), Alex Allen (Treasury) and Trevor Woolley (Cabinet Office).

*Your sincerely*  
*Brian Hawtin*

(B R HAWTIN)  
Private Secretary





Treasury Chambers,  
Parliament Street, SW1P 3AG

With the Compliments of the  
Private Secretary to the  
Financial Secretary



Seafarers: foreign earnings

RA Needel  
copying

Mr John Major

NC40

To move the following Clause—

—(1) In paragraph 3 of Schedule 12 to the Taxes Act 1988 (qualifying period for relief for foreign earnings) after sub-paragraph (2) there shall be inserted—

“(2A) In relation to emoluments from employment as a seafarer, sub-paragraph (2) above shall have effect—

(a) as if the number of days specified in paragraph (a) were 90 instead of 62, and

(b) as if the fraction specified in paragraph (b) were one quarter instead of one sixth;

and for the purposes of this sub-paragraph ‘employment as a seafarer’ means employment consisting of the performance of duties on a ship (or of such duties and of others incidental to them).”

(2) This section shall have effect for the year 1988-89 and subsequent years of assessment; but the relevant period and the earlier qualifying period referred to in paragraph 3(2) of Schedule 12 to the Taxes Act shall not be treated as a single period by virtue of this section if none of the intervening days falls after 5th April 1988.’



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ceBG

SLH

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

17 June 1988

*Dear Alex,*

**MERCHANT SHIPPING AND DEFENCE: TAX RELIEFS**

The Prime Minister has seen the Chancellor's letter of 15 June to the Secretary of State for Transport. She is content for the new clause of the Finance Bill to be tabled without the ring-fencing condition.

I am copying this letter to the Private Secretaries to the Secretaries of State for Transport and Defence.

*Yours,  
Paul*

**PAUL GRAY**

Alex Allan, Esq.,  
H M Treasury

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*SLH*



cc BG



DEPARTMENT OF TRANSPORT  
2 MARSHAM STREET LONDON SW1P 3EB

My ref: C/PSO/7460/88

Your ref:

The Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer  
HM Treasury  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

NBSM

REC 6  
17/6

Dear Nigel.

11.6 JUN 1988

MERCHANT SHIPPING AND DEFENCE: TAX RELIEFS

Thank you for your letter of 15 June. <sup>with PG</sup>

The practical arguments against tying the relaxation of the FED relief to a commitment to serve in wartime are very strong. Moreover, I am advised that we already have adequate powers to ensure the availability of British seamen in a time of crisis. I therefore fully support your proposal not to ring-fence the relaxation. The announcement of this change will be of major interest to the industry and will need careful handling with the Commons Transport Committee, whose report on shipping and defence is due to be published on 21 June. I understand that our officials are in touch about the arrangements for making the announcement.

I am sending a copy of this letter to the Prime Minister and to George Younger.

*[Handwritten signature]*  
*[Handwritten signature]*

PAUL CHANNON



9B  
CC 8/8?



Prime Minister  
Content to accept that,  
regrettably, your ring-fencing  
idea wouldn't work; and that

Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

Need for the  
Finance Bill  
clause should  
be tabled without  
ring-fencing?

15 June 1988

The Rt Hon Paul Channon MP  
House of Commons  
LONDON SW1A 0AA

Rec 6  
10/6

*Paul Channon*

*Yes*

**MERCHANT SHIPPING AND DEFENCE: TAX RELIEFS**

At the Prime Minister's meeting on 8 June it was agreed that the relaxation of the foreign earnings deduction rules discussed in my paper of 3 June should be implemented in this year's Finance Bill. I was, however, also asked to consider the possibility of making the more generous relief conditional on the seafarer joining a reserve available for service in wartime.

I have considered the practicalities of this further proposal following a report to me by the Revenue of discussions with Transport and Defence officials. My reluctant conclusion is that, on examination, this is not a practical proposition. I understand that this is a view shared by officials in both your Department and the Ministry of Defence.

It would be relatively easy - as a matter of administration for the Inland Revenue - to make it a condition of granting relief under the specially relaxed rules for the foreign earnings deduction for seamen that evidence be produced of current membership of the reserve (or membership throughout the period of claim).

However I understand that the Merchant Navy Reserve for which the recent Merchant Shipping Act made provision does not come into being until next year. Moreover, its purpose is to recruit people such as retired seamen who have the necessary skills and experience but are no longer at sea. Such people would not, of course, qualify for the new foreign earnings deduction since they would no longer be working overseas on ships. It follows that a direct and immediate link between membership of a reserve and the claim for tax relief would not be possible.

It might, of course, be possible to require claimants to give some undertaking to join the Merchant Navy Reserve when they eventually left the sea. But that would be a much more complicated



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proposition because, for example, provision would have to be made for all the changes of circumstance (eg health, going abroad) which could occur between the claim for tax relief and the point at which the reserve should be joined. It would not be possible to sort out all the details of such a link in the short time available. The main practical stumbling block would probably be enforceability. What would appear to be binding undertakings to join the reserve would, I suspect, in practice turn out to be little more than declarations of intent made at the time. Would you, in practice, want to take these people to Court to compel them to join the reserve if they had claimed tax relief? To the extent that there was a perception that these undertakings would not in practice be enforceable, in many cases at least, the credibility of the whole arrangement would be undermined.

**CONCLUSION**

As will be clear from the above, I do not think the suggested ring-fencing of the relaxation is practical.

If the new rules are to be introduced, as we have agreed, at the Committee stage of the Finance Bill, a new clause will have to be tabled within the next few days. Drafting is already in hand on the other aspects but we must settle this additional point very shortly. If possible, I would like to table the new clause at the end of this week if it is ready. So could I please ask you and recipients to let me know by Friday, lunchtime, at the latest, if you see any objection to my tabling the new clause then without the ring-fencing condition?

I am copying this letter to the Prime Minister and to George Younger.

A handwritten signature in dark ink, appearing to read 'Nigel Lawson', written over a light-colored background.

**NIGEL LAWSON**





Deface

UK Deface Poly RT 3



SUBJECT  
cc MASTER

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DAS



file

bc BG.

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

8 June 1988

Dear Roy,

SHIPPING

The Prime Minister yesterday held a further meeting to discuss merchant shipping. I should be grateful if you and copy recipients would ensure that this record of the discussion is shown only to those with an operational need to see it.

Those present at the meeting were the Chancellor of the Exchequer, the Secretaries of State for Defence, Trade and Industry and Transport, the Minister of State at the Foreign and Commonwealth Office (Mrs Chalker), the Parliamentary Under Secretary of State, Department of Health and Social Security (Mr Portillo), Mr Wilson and Mr Monger (Cabinet Office) and Mr Bourne (No 10 Policy Unit). The meeting considered minutes dated 3 June by the Chancellor and the Secretary of State for Transport.

The Secretary of State for Transport said that the group had earlier agreed that action should be taken to ensure that the United Kingdom's wartime shipping requirements could be met. In his minute he had, as requested, developed a proposal for a scheme for contracting with shipowners to keep their vessels available for wartime use when needed. If applied to product tankers, where at present the need seemed greatest, it would ensure that 150 would be available for a cost of about £20 million a year. It could also be applied to other classes of vessel as necessary. Such a scheme was well targeted and seemed the most cost-effective solution to the problem. But by itself it would not be enough, since it would need primary legislation and so take until 1990 or later to implement, whereas once the changes in PAYE were known there could be an early exodus of ships on to foreign registers. He therefore believed that there should also be an early tax change, to offset the PAYE change. Of the options described in the Chancellor's paper, he favoured the second: the relaxation in the rules governing seafarers' eligibility for the 100 per cent foreign earnings deduction.

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In discussion, the following were the main points made:

- (a) There were strong objections to a subsidy scheme. It would involve extra public expenditure and lead to pressure for further subsidies elsewhere. There was a risk that it would simply encourage shipowners to raise wages at public expense. And we could not be quite sure that it would be proof against challenge by the European Commission as a defence measure.
- (b) It would also be wise to avoid any commitment to a subsidy scheme until the NATO studies on requirements and availability were complete. Some indications of the outcome of these studies should be available in three or four months' time.
- (c) The relaxation for seamen of the rules for the foreign earnings deduction also ran some risk of being repercussive, although the Government could resist pressure to extend the concession to others by pointing to the defence case for it for seafarers. It would arguably be less well targeted than the subsidy scheme, although it was also true that any increase in the number of British seafarers was in our long term strategic interest. Finally the tax concession would have the major advantage that it could be effected very quickly by an amendment to the Finance Bill now going through Parliament.
- (d) One way of improving the targeting of the extension of the foreign earnings deduction would be to apply it only to those seafarers who were prepared to join a reserve which would be available for service in wartime. Such a condition would also make it easier to resist pressure for a similar concession to other groups.

The Prime Minister, summing up the meeting, said that, subject to satisfactory ring-fencing, the group agreed on the relaxation for seafarers of the rules governing their eligibility for the 100 per cent foreign earnings deduction which had been described in the Chancellor's minute. The necessary amendment should be introduced during the Committee Stage of the Finance Bill so that the change would have effect for this year. As to ring-fencing, the group were attracted to the possibility that eligibility for the extension of the relief should be conditional upon joining a reserve available for service in wartime. This possibility should be considered further by the Chancellor of the Exchequer, in consultation with the Secretaries of State for Defence and Transport. If it was found practical to impose such a condition, the Finance Bill amendment should provide for it.

The Group saw serious disadvantages in a subsidy scheme, and believed that it would be wrong to have both a subsidy and a tax concession. They had therefore decided against the introduction of such a scheme at present. If, when the NATO studies were complete, there appeared to be a possible need



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- 3 -

for such a scheme, there might be a case for working it up in detail as a contingency. But no public indication should be given that such a scheme was under consideration.

I am sending copies of this letter to the Private Secretaries to the Ministers attending the meeting, and to the others present.

*Yan.*  
*Paul*

PAUL GRAY

Roy Griffins, Esq.  
Department of Transport

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- 1. Mr Wilson 8/6
- 2. Mr Gray

Draft minutes of this morning's meeting.

8/6

G.R.  
Re-type,  
done 9/6.

Draft letter for Mr Gray to send to  
Principal Private Secretary, Department of Transport

Recs.

Shipping

DASAM1

The Prime Minister yesterday held a further meeting to discuss merchant shipping. I should be grateful if you and copy recipients would ensure that this record of the discussion is shown only to those with an operational need to see it.

Those present at the meeting were the Chancellor of the Exchequer, the Secretaries of State for Defence, Trade and Industry and Transport, the Minister of State at the Foreign and Commonwealth Office (Mrs Chalker), the Parliamentary Under-Secretary of State, DHSS (Mr Portillo), Mr Wilson and Mr Monger (Cabinet Office) and Mr Bourne (Policy Unit). The meeting considered minutes dated 3 June by the Chancellor and the Secretary of State for Transport.

The Secretary of State for Transport said that the group had earlier agreed that action should be taken to ensure that we could meet ~~our~~ <sup>the UK's</sup> wartime shipping requirements. ~~He had~~ <sup>could be met.</sup> ~~I~~ <sup>be last,</sup> in his minute, as requested, developed a proposal for a scheme for contracting with shipowners to keep their vessels available for ~~our~~ <sup>wartime</sup> use when needed. If applied to product tankers, where at present the need seemed greatest, it would ensure that 150 would be available for a cost of about £20m a year. It could also be applied to other classes of vessel as necessary. Such a scheme was well targetted and seemed the most cost-effective solution to the problem. But by itself it would not be enough, since it would need primary legislation and so take ~~time~~ to implement, whereas once the changes in PAYE were known there could be an early exodus of ships on to foreign registers. He therefore believed that there should also be an early tax change, to offset the PAYE change. Of the options described in the Chancellor's paper he favoured the second: the relaxation in the rules governing seafarers' eligibility for the 100% foreign earnings deduction.

until  
1990 or  
later

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In discussion the following were the main points made:

a. There were strong objections to a subsidy scheme. It would involve extra public expenditure and lead to pressure for further subsidies elsewhere. There was a risk that it would simply encourage shipowners to raise wages at public expense. ~~Finally, although it might well be proof against challenge by the European Commission as a defence measure, we could not be quite sure that it would be.~~

b. It would also be wise to avoid any commitment to a subsidy scheme until the NATO studies on requirements and availability were complete. Some indications of the outcome of these studies should be <sup>available</sup> ready in three or four months' time.

c. The relaxation for seamen of the rules for the foreign earnings deduction also ran some risk of being repercussive, although the Government could resist pressure to extend the concession to others by pointing to the defence case for it for seafarers. It would arguably be less well targetted than the subsidy scheme, although it was also true that any increase in the number of British seafarers was in our long term strategic interest. Finally the tax concession would have the major advantage that it could be effected very quickly by an amendment to the Finance Bill now going through Parliament.

d. One way of improving the targetting of the extension of the foreign earnings deduction would be to apply it only to those seafarers who <sup>joined</sup> a reserve which would be available for service in wartime. Such a condition would also make it easier to resist pressure for a similar concession to other groups. ~~This possibility should be considered further.~~

WVE  
prepared  
to

subject to editorial  
ring-fencing

The Prime Minister, summing up the meeting, said that the group agreed on the relaxation for seafarers of the rules governing their eligibility for the 100% foreign earnings deduction which had been described in the Chancellor's minute. The

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(As to ring-fencing)

necessary amendment should be introduced <sup>being</sup> in the Finance Bill so that the change would have effect for this year. <sup>(Committee Stage) of the</sup> The group were ~~also interested in~~ <sup>attracted to</sup> the possibility that eligibility for the extension of the relief should be conditional upon joining a reserve available for service in wartime. This possibility should be considered further by the Chancellor of the Exchequer, in consultation with the Secretaries of State for Defence and Transport. If it was found practical to impose such a condition, the Finance Bill amendment should provide for it.

The Group saw <sup>serious</sup> ~~considerable~~ disadvantages in a subsidy scheme, and believed that it would be wrong to have both a subsidy and a tax concession. They had therefore decided against the introduction of such a scheme at present. If, when the NATO studies were complete, there appeared to be any <sup>possible need</sup> ~~case~~ for such a scheme, ~~it~~ <sup>there</sup> ~~could be worked up~~ <sup>might be a case for working it</sup> in detail as a contingency. But no public indication should be given that such a scheme was under consideration.

I am sending copies of this letter to the Private Secretaries <sup>to</sup> ~~of~~ the Minister attending the meeting, and to the other members.

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28/6/88

PRIME MINISTER

7 June 1988

MERCHANT SHIPPING AND DEFENCE NEEDS

Introduction

The responsibility for being adequately prepared for wartime rests with the Government.

The responsibilities of the shipping companies is to their shareholders, not to Government.

There is a conflict between Government wartime requirements and Government peacetime requirements.

Only the Government can choose what level of "war insurance" they are prepared to pay during peacetime.

Requirements in Times of War

Fundamentally there are two requirements in times of war:

1. **Hulls** - the actual hardware. At the moment a deficit is seen in the product tanker fleet. Next year market forces may change the balance!
2. **People** - The officers especially but also some of the specialised crew should be British or at least "loyal".

/a The suggestions put forward by the Secretary of State and the Chancellor are complementary. Together they tackle both of the above requirements.

Applying one and not the other would be like taking out only one part of an insurance policy, ie Third Party insurance, but forgetting about fire and theft.

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## Climates to be Created

Two climates have to be created, one for the shipping companies, one for the men.

- a. Shipping companies - must know that there are no free rides. They must know that in times of peace, market forces rule. They must learn that it is the MOD/D/TP who have the responsibility for defining wartime needs and that they (MOD/D/TP) are willing to pay certain insurance premiums. Elsewhere the companies are on their own.

(The Government should continue working against protectionism and unfair practices).

- b. The Men - must know that the country wants and needs a viable efficient shipping industry. They must know that they have a role to play in times of war and that the Government is prepared to recognise that by way of some additional tax relief.

Most importantly the industry must be attractive to new entrants, especially to the officer/technologist. The new entrant will probably be the engineering graduate if we are to progress in the shipping business.

## Decisions to Take

I believe you should support both of Paul Channon's proposals:

- a. To introduce an amendment to the current Finance Bill to extend the length of time which seafarers may spend in the UK while remaining exempt from UK tax to 90 days - (this will help solve the men's motivational problems and help stop the shipping companies flagging out).



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- b. To press ahead urgently with the introduction of a scheme for contracting for vessels in short supply for wartime needs - (this provision should help solve the mismatch between the peacetime economically defined merchant fleet and the strategically defined wartime fleet).

I further believe that the Government is best served by making a statement as to its intentions with regard to the British merchant fleet along the following lines:

"The Government remains committed to ensuring that the UK has access to sufficient merchant shipping during times of hostilities. During peacetime the Government will continue to fight against protectionism and unfair practices internationally but where necessary to protect its wartime strategic requirements, the Government will provide means of assistance commensurate with those requirements".

Only by making such a statement will the Government clearly say that this is a strategic decision and not a subsidy to a "needy" industry.

Conclusions

1. Support both of Paul Channon's recommendations.
2. Make public the Government's attitude towards the British merchant fleet.

Janet Enison .

pp. GREG BOURNE

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PRIME MINISTER

## MERCHANT SHIPPING AND DEFENCE: MEETING ON 8 JUNE

You saw the main papers for this meeting - by Mr. Channon, the Chancellor and the Cabinet Office brief - over the weekend.

The one further paper now enclosed is a note by Policy Unit supporting Mr. Channon's two-prong attack, and also advocating an early government statement on its intentions.

Charles' letter of 6 June to the Department of Transport conveyed your request for information on research done on the likely take up of the contracts scheme; I understand Mr. Channon plans to speak to this point at the meeting.

In some respects, tomorrow's discussion will involve a replay of today's meeting on the NHS, with the Chancellor resisting pressures for specific tax exemptions. You will obviously want to consider how hard to press him.

PCCG.

(PAUL GRAY)

7 June 1988

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*me MJ*  
*cc PG*  
*GG*  
*PC*

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

6 June 1988

*Dear Jenny,*

MERCHANT SHIPPING AND DEFENCE

The Prime Minister has seen the paper by the Transport Secretary for the meeting on 8 June on Merchant Shipping and Defence. She has asked what research has been done on how many companies would be likely to take up the contract scheme, what levels of subsidy would have to be set for the various different sorts of ship to attract them to do so, and what a realistic estimate of the cost of the scheme would be.

*Yours sincerely,*  
*Charles Powell*

Charles Powell

Miss Jenny McCusker  
Department of Transport.

*mm*



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Reference E 0570

PRIME MINISTER

MERCHANT SHIPPING AND DEFENCE

(Meeting of Ministers at 3.30pm on 8 June)

Relevant Papers

Minute from Mr Channon of 3 June 1988 ✓ with PAB?

Minute from the Chancellor of the Exchequer of 3 June 1988 ✓ with PAB?

**DECISIONS**

The purpose of the meeting is to decide what action should be taken, on strategic grounds, to counter the recent decline in the UK merchant shipping fleet.

2. There are two options before the meeting:

- Mr Channon's paper describes the option of a contractual scheme for payments to shipowners who would make vessels of a specified kind available in a time of emergency.
- The Chancellor's paper discusses options for providing UK seafarers with tax concessions which could reduce the costs borne by UK shipowners in employing British crews.

3. The Chancellor's paper argues that a contractual scheme offers the best way of targetting help so as to meet our strategic requirements. Even though such a scheme would involve public expenditure, it may well be that the meeting could, if you wished, agree fairly readily that a scheme is desirable in principle. But Mr Channon is likely to argue that some tax concessions are needed as well. This will be partly on the ground that a contractual scheme needs legislation, and so is unlikely to come into effect until 1990. He will argue that the extension of PAYE to Manx crews supplied by offshore manning agencies may lead to an early move of UK vessels to foreign flags unless action is taken that would be effective now. The Chancellor will argue that a contractual scheme and tax concessions should be regarded as alternative options and

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that any of the proposed tax concessions would be contrary to the Government's general tax policy. The question whether there should be a tax concession as well as a contractual scheme is likely to be the most contentious issue in discussion.

4. Mr Channon will wish to announce relatively quickly whatever measures are agreed, in order to counter criticism by the shipowners about the Revenue's ruling on PAYE administration. If you decide that a tax concession such as a change to the foreign earning deduction rules should be made, swift action will be needed to incorporate this into the current Finance Bill. You will wish to consider whether an early announcement should be made, and what further work should be commissioned.

#### BACKGROUND

5. When this group of Ministers last met on 4 May, it was agreed that some action had to be taken to ensure we could meet our wartime shipping requirements. You saw some attraction in tax concessions, but the meeting agreed that more work had to be done before a final decision could be taken. Papers were therefore commissioned as a matter of urgency on the options of making tax concessions and of introducing subsidies for shipowners, for discussion at this meeting.

#### ISSUES

##### Contract Scheme

6. Mr Channon proposes that shipowners be invited to contract to maintain medium sized product tankers, and other categories of vessel which become in short supply, so that these can be made available to Government in an emergency. Contracts would be awarded by competitive tender to keep down costs. Such costs are likely to correspond broadly to the additional expense of employing UK officers (and, if needed for military reasons, UK crew) as opposed to Third World officers and crews. These might amount for





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product tankers to some £130,000 per vessel per year, or £20 million a year if 150 such tankers are required. The costs could be greater if other types of vessel have to be covered later.

7. You could probe three points on this scheme:

- What effect will the NATO pooling arrangements have on the working of the scheme? Mr Channon acknowledges (paragraph 16 of his paper) that one result would be to transfer vessels from other NATO flags to our own. This would not add to the number of vessels available to the alliance. Again, would we be at risk of spending our money to increase the vessels available, through the pool, to NATO as a whole? Or do we only have to pool vessels surplus to our own needs? You might also ask Mr Channon or Mr Younger about progress on the NATO studies of their requirements.
- The cost estimate of £20m (paragraph 10) apparently assumes that the scheme applies only to product tankers. Last time Mr Channon said there were potential shortages also of container ships and larger general cargo vessels and paragraph 11 talks about its possible extension to other classes of vessel 'as necessary.' What is the maximum potential cost?
- Will the scheme create difficulties under EC rules? Paragraph 19 is not clear on that.

8. The main objection to the scheme is that it involves public expenditure, but the Chancellor apparently accepts the broad outline and subject to these and any other points raised in discussion the group would probably be ready if you wished to endorse it in principle.





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9. On 4 May you also asked for the option to be considered of making payments to shipowners which would enable them to gross up UK seafarers' wages to offset their liability to tax and leave them no worse off than in their current anomalous position. Mr Channon suggests that such support would be less well directed and less effective than a contractual scheme (paragraph 11). It would also be administratively complex. Are you therefore content that the option of making grossing up payments is not pursued further?

**Tax Concessions**

10. The Chancellor was asked to consider what fiscal changes would best meet the Government's strategic objectives with minimum danger of repercussions elsewhere. His minute discusses:

- Tax relief for crews of ships registered in Crown Dependencies. (Annex A). He opposes the proposal made at the last meeting that the crews should be regarded as resident in the Dependencies, mainly on the ground that seafarers change jobs too often for a residence rule to work. He says that the least unworkable variant would be to exempt UK seafarers from tax on earnings from overseas voyages on both UK and Crown Dependency registered ships. But he is firmly opposed to any concession in this area.
  
- Extension, from 2 to 3 months per year, of the period which UK seafarers can live in the UK and still attract the foreign earnings deduction from UK tax (Annex B). The Chancellor accepts that this would be workable.

11. In discussion, you may wish to concentrate on the possibility of extending the foreign earnings deduction since, as the Chancellor says, it is workable, would not be too expensive and would give relief to a substantial number of seafarers.





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12. Mr Channon may suggest that this change would have the following main advantages:

- it would keep the majority of those affected by the decision on PAYE administration out of UK tax, and therefore be a most helpful concession to make when the decision on PAYE is made known (the General Council of British Shipping have specifically suggested this extension in their representations on the recent Budget);
- it could be implemented quickly (probably in this year's Finance Bill) and ought therefore to reduce the current incentive for UK shipowners to reflag abroad;
- it would appear a more detailed and technical departure from the Government's general fiscal policy of reducing exemptions than the changes suggested in Annex A to the Chancellor's minute; and
- in addition to reducing the commercial incentive to reflag abroad, it would be of significant benefit to the employment prospects of experienced UK officers and crew, both of whom will be required in any period of emergency.

13. The Chancellor's main arguments against an extension are as follows (paragraph 10 to Annex B of his minute):

- the benefits to UK shipowners will only be indirect, and there will be some leakage in higher salaries for UK seafarers (as against this, it may be in our longer term strategic interest to make seafaring more attractive to British citizens).





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- exemption is not as well targetted as a contract scheme (as against this, although the criticism is true as regards types of vessels, any increase in the number of British seafarers will help with our strategic needs);
  
- there will still be repercussive dangers, (as against this, we could argue a case on national interest grounds for seafarers which would not apply to air crews or international consultants).

Announcement

14. The group will want to decide whether an early announcement should be made. If it decides on a tax change, with an amendment to be inserted in the Finance Bill, there will clearly need to be an announcement. If it decides to pursue only the contractual scheme, the position is more open. There would be an argument for working up the scheme in more detail first. But an early announcement would still provide some signal to the shipping industry that the Government recognised its concern and would make it easier to reveal the PAYE change, which the Chancellor is likely, for reasons of propriety, to want to do. If there were any doubts about the EC Status of the contractual scheme, you might want it resolved before an announcement was made. The limited extension of the Business Expansion Scheme, to allow unlisted companies operating ships to raise up to £5 million a year through this Scheme, can be included in any announcement.

15. If an early announcement seems desirable you may want to consider a reference to E(A) or Cabinet.

HANDLING

16. You may wish to begin by inviting the Secretary of State for Transport and the Chancellor of the Exchequer to introduce their





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papers. The Secretary of State for Defence may wish to speak next. The Minister of State, Foreign and Commonwealth Office (Mrs Chalker) may wish to comment on the European Community implications. The Secretary of State for Trade and Industry, and the PUSS/DHSS (Mr Portillo) may also wish to contribute to the discussion.

GD

Cabinet Office  
3 June 1988

G W MONGER



cc ~~By~~

PRIME MINISTER

MERCHANT SHIPPING AND DEFENCE

You are to have a further meeting on Wednesday. The questions to be addressed are:

- should we introduce a contract scheme to encourage ship owners to maintain and make available, in an emergency, certain types of ship? This in essence involves direct subsidies which are likely to amount to at least £20 million a year and probably much more. It would also require legislation and cannot be implemented before 1990;

Have we done any research on who would take it up - would the bulk seafarers to demand - whatever sum they chose?

- should we, as an alternative or in addition, introduce an amendment to the Finance Bill to extend the period for which UK seafarers can live in the UK and still attract the foreign earnings deduction from UK tax? This could be done quickly but is less targeted and effective than the contracts scheme.

Your colleagues, including the Chancellor, are likely to agree to the first option. But the second will be more controversial. In my own view this is not the right way round. For this Government to introduce new subsidies is a major step: and the scope for new legislation is very limited. Perhaps the best course is to try the tax relief route and see if it works.

CDP

CHARLES POWELL

3 June 1988

CO5AVD





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 ce Bop

Treasury Chambers, Parliament Street, SW1P 3AG  
 01-270 3000

PRIME MINISTER

mt

**MERCHANT SHIPPING AND DEFENCE**

At our meeting on 4<sup>th</sup> May <sup>Prop.</sup> it was agreed that I should consider the possibility of introducing new tax reliefs for seafarers. I was asked to look at two options in particular:

(i) To deem British seafarers crewing ships flagged in the Isle of Man or the Channel Islands (the Crown Dependencies) to be domiciled in those islands.

(ii) To relax the rules governing seafarers eligibility for the 100% foreign earnings deduction.

The first option is discussed in Annex A. As formulated it would not work. Any workable variant would be repercussive, in clear conflict with our general tax policy, and would not meet our main objectives. I recommend that we firmly reject it.

The second option is considered in Annex B. This would provide a workable scheme, which could be brought into operation quickly at limited cost and which would provide an offset for the majority of those who would otherwise start to pay tax on the reintroduction of PAYE. It would also give relief to a substantial number of UK seafarers in the deep sea trades who are currently still paying UK tax. Unlike option(i), it has been advocated by the GCBS.

But as a measure for dealing with the problem of securing an adequate supply of merchant ships in wartime it suffers from some very serious disadvantages:





- There is no guarantee that exempting seafarers from tax will feed through into lower costs for shipping companies, and hence discourage flagging out.
- It would not be focused on the types of ships which are in short supply for defence purposes. Much of the cost of the relief might therefore be wasted.
- To the extent that shipping costs are reduced, we have no idea whether the reduction will be more or less than is needed to discourage further flagging out and to encourage re-flagging of ships currently off the UK register.

In short a seafarer tax relief would have a limited and uncertain effect on shipping companies' costs with no assurance whatsoever that it would contribute more than marginally, if at all, to our defence objectives.

While for obvious reasons I have no enthusiasm for explicit subsidies, they do in the present case at least offer the prospect of a better targetted policy, producing guaranteed results if we can put the shipping companies under contractual obligations. In particular they could be:

- paid directly to shipping companies, thus definitely reducing their costs by the full amount of government assistance
- related specifically to classes of ships in short supply
- fixed only at the level necessary to increase (or maintain) the number of UK registered ships available for defence purposes.

We agreed at our last meeting that we should use either tax reliefs or subsidies to ensure that we could meet our wartime shipping





requirements. A workable tax relief scheme can be devised. However tax relief schemes seem very unlikely to be as cost effective an approach as a specifically targetted subsidy. We would, of course, have to be satisfied that the latter was permissible under EC rules. Subject to looking at Paul Channon's proposals in detail, I recommend that we should not pursue the tax relief scheme.

There is, however, one small tax concession that I propose we offer to the shipping industry. It involves the Business Expansion Scheme (BES), which gives income tax relief to an individual who subscribes for ordinary shares in an unquoted company. The company can carry on a wide range of activities, including shipping. The Finance Bill introduces a general £500,000 limit on the amount of BES finance which can be raised by a company in any year. But for companies letting ships on charter the limit is £5 million. I propose that the Finance Bill be amended to allow this, higher, limit to apply also to a company which operates its own ships. Although we cannot be sure that the ships involved would be of the kind that would help meet our defence needs, this concession would be a signal to the industry that we have its interests in mind.

I am copying this minute to Geoffrey Howe, Douglas Hurd, George Younger, David Young, Kenneth Clarke, and Paul Channon, and to Sir Robin Butler.

A handwritten signature in dark ink, appearing to be 'NL'.

[NL]

3 June 1988



**TAX RELIEF FOR CREWS OF SHIPS REGISTERED IN THE CROWN DEPENDENCIES**

1. To deem a British seafarer to be "domiciled" in one of the Crown Dependencies (as suggested at our last meeting) would be of little advantage to him if in fact his home and family were in the UK. In certain limited circumstances he would only be taxed on a remittance basis, but if he lived in the UK he would probably have to remit all, or virtually all of his earnings in any event. "Residence" rather than "domicile" is the relevant concept to consider. A seafarer who was non-resident in the UK would be liable for tax only on earnings which for tax purposes are treated as performed in the UK.

2. However, if relief from UK income tax for the overseas earnings of UK seamen on ships registered in the Crown Dependencies were to be offered, it would be better to go for an explicit exemption rather than to try to achieve the same result indirectly through a deemed non-residence rule. Such a rule would be highly artificial and difficult to operate. Residence is a concept which essentially works by reference to the whole tax year. A seaman may be employed for a shorter or longer period on a Crown Dependency registered ship, with this work interspersed with periods of unemployment, work ashore, or on ships registered elsewhere. Thus a non-residence rule would be complex, arbitrary and uncertain in its effect.

3. The simpler, more direct proposition would be to exempt from tax earnings related to periods of duty on a ship registered in a Crown Dependency or Dependent Territory. As it stands this would be both too wide and too narrow. It is too wide because it would exempt the earnings of seamen working on, for example, Isle of Man registered ferries operating in home waters. It is too narrow because it would discriminate against UK registered ships and provide a further incentive for shipping companies to transfer vessels from the UK to the IOM register. To make any sense, the exemption would have to relate to periods of duty on overseas voyages of both UK and Crown Dependency/Dependent Territory registered ships.

4. Such a tax exemption would be undesirable for the following reasons:

- It would conflict with the Government's general tax policy of sweeping away special reliefs and tax shelters and going for across-the-board reductions in tax rates. It would also be open to EC challenge.
- It would be highly repercussive, giving rise to similar claims from other industries. The taxation of air crew and seamen has usually gone hand in hand. Other industries hard pressed by competitors with low third world labour costs could be expected to advance similar "national interest" arguments for tax relief. There would inevitably be adverse pay and taxation comparisons with Royal Navy personnel.
- any financial benefit to the shipping companies (and thus inducement to retain ships on the British register) would



be indirect and imprecise, since there would be no mechanism for ensuring that the seafarers' reduced tax liabilities were reflected in lower pay levels which reduce the shipping companies' crewing costs. (The GCBS have themselves commented that some mechanism would be needed - they have not been able to specify one - if their balance sheets were to benefit from reduced seafarers' tax liabilities)

- insofar as shipping companies benefit indirectly, it might be in respect of any class of ship, not only the types required for defence purposes
- because the relaxation would affect the shipping companies indirectly and generally, and without any commitment on their part, it could not be guaranteed to deliver any improvement - or even the maintenance of the present position - in the supply of ships required for defence purposes.



## RELAXING THE RULES FOR THE FOREIGN EARNINGS DEDUCTION

1. This Annex looks at the possibility of relaxing, for British seafarers, the rules governing the 100% foreign earnings deduction.

### Present rules

2. This relief was introduced in the mid-1970s, when tax rates were much higher, to help British exporters. The basic rule is that where the duties of an employment are performed wholly or partly abroad, and there is a "qualifying period" of at least 365 days, the pay attributable to that period is exempt from UK tax.

3. A qualifying period has to consist essentially of days outside the United Kingdom, but where there are spells here between periods when duties are performed overseas they can still count towards a qualifying period provided they are not longer than 62 days or 1/6th of the total period.

### Possible Relaxation

4. One possibility for relaxing the rules would be to extend the 62 day period which can be spent in the United Kingdom to 90 days, making a corresponding increase in the fraction from 1/6th to 1/4. This is a proposal which the GCBS themselves have raised in Budget Representations in the last year or two.

5. It would be for consideration whether the extended relief should be limited to time served on British ships. There is an obvious presentational point in favour of that. But in practice it would make little difference since for one reason or another British seamen on foreign ships pay little UK tax. It would greatly complicate the operation of the relief making it more difficult for seamen to understand and to be certain that they would qualify. And confining the relief to British ships might raise EC difficulties. On balance, it would probably be better not to restrict the relief to British ships.

6. An extended relief of this kind would not present any legislative or operational difficulty. The Revenue are already planning to discuss with the shipping companies whether the administration of the foreign earnings deduction for seafarers can be simplified.

### Effect

7. With help from the Department of Transport the Revenue have been able to make a very broad estimate of what the effect of this change might be to the 15,000 UK seafarers in the deepsea trades

- of the 4,000 for whom PAYE is not at present operating, approximately 1,000 are exempt under the present rules, and a relaxation of this kind would probably exempt another 2,000
- of the 11,000 for whom PAYE is still operating, about 3,000 are already exempt and this relaxation would exempt another 5,000



- the cost would be of the order of £15m to £20m.

8. These figures are not only broad estimates, but also take no account of behavioural effects. To the extent that seafarers arranged for the pattern of their voyages to be changed so that they came within the relaxed rules - this is already happening to some extent with the present rules - the numbers qualifying for exemption, and the cost, would increase.

#### Evaluation

9. On the one hand, a relaxation

- would fairly comprehensively offset the reintroduction of PAYE, and in addition give relief to a substantial number of UK seafarers in the deepsea trades who are currently still paying UK tax
- would respond to a specific GCBS suggestion.

10. On the other,

- it would run counter to the main thrust of tax policy which has been to accompany reductions in tax rates with the restriction of special tax shelters; and since other occupations (such as airline staff and consultants working abroad) benefit from the present relief there would be pressure to make the relaxation apply generally, at additional cost
- any financial benefit to the shipping companies (and thus inducement to retain ships on the British register) would be indirect and imprecise, since there would be no mechanism for ensuring that the seafarers' reduced tax liabilities were reflected in lower pay levels which reduce the shipping companies' crewing costs. (The GCBS have themselves commented that some mechanism would be needed - they have not been able to specify one - if their balance sheets were to benefit from reduced seafarers' tax liabilities)
- insofar as shipping companies benefit indirectly, it might be in respect of any class of ship, not only the types required for defence purposes
- because the relaxation would affect the shipping companies indirectly and generally, and without any commitment on their part, it could not be guaranteed to deliver any improvement - or even the maintenance of the present position - in the supply of ships required for defence purposes.



DEFENCE: UK Policy PT3





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SERIAL NO: 1826  
COPY NO 1 OF 20

Prime Minister

MERCHANT SHIPPING AND DEFENCE

1. We are due to meet on 8 June to consider what should be done to secure our wartime requirements for merchant shipping.
2. My paper - which I attach - outlines a proposal for a scheme for contracting with shipowners to keep their vessels available. An annex to the Chancellor's paper will, I understand, outline a proposal for relaxing the rules governing tax relief on foreign earnings by seafarers.
3. The two sets of proposals represent different ways of approaching the problem. But they can be seen as complementary; and I believe that both are needed if we are to respond effectively to a problem which we have agreed must be tackled urgently.

Contracting for Defence Requirements

4. The main advantages of contracting by competitive tender to meet our requirements for classes of ship in short supply are that the expenditure can be closely targeted at an identified need. We should be paying no more than we must to achieve our objective of securing the availability of an exact number of vessels.
5. The scheme is also flexible; by changing the terms of the tender and contract it can quickly be adapted to meet any potential shortages which might arise.
6. The disadvantages are that the scheme would be relatively complicated, would require primary legislation, and would take time to implement.

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7. The scheme would do nothing in the short term to offset the impact of the re-introduction of PAYE. Indeed the PAYE changes are likely to make the scheme more expensive because of the need to attract back to the British register ships which will have been forced off the Isle of Man register on to foreign registers by the changes.

#### Tax Relief on Foreign Earnings

8. The main advantage of a change to the rules on tax relief is that the change can be made quickly and easily and would meet the need for urgent action to stem the continuing decline of the fleet. It would go a considerable way towards compensating for the re-introduction of PAYE for Isle of Man vessels and would positively help deep-sea vessels on the UK register.

9. The change would reduce the cost of employing British seafarers and would help stem the fall in the number of British seafarers employed on ships. This is in itself an important objective for defence purposes as we have recognised in the assistance we are giving towards seafarer training and crew relief costs in the Merchant Shipping Act. By reducing the differential between British and Third World crew costs it will also reduce the cost of the contracts scheme if and when it is introduced.

10. The main disadvantage of the tax changes is that they are less precisely targeted on the need for specific types of ship. But they would be limited to the deep-sea sector which is where most of the ships in short supply operate. It would improve the position not just for product tankers but for container vessels and would therefore have a wider effect than the contracts scheme without unnecessarily benefiting the short-sea sector - particularly the ferries - where our wartime requirements are adequately served.



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Conclusion

11. The two sets of proposals represent the most practicable options through public expenditure and through changes in the tax regime for seafarers (although we have not considered the alternative of changes to National Insurance Contributions in respect of seafarers). We have considered other forms of subsidy, including the proposal made at the last meeting for a subsidy to enable shipping companies to gross up seafarers' wages to offset their liability to tax. But other subsidies are less well targeted to our wartime needs and tend to have more deadweight.

12. I am satisfied that my proposals for a contracting scheme are the most cost effective type of subsidy to assist us in securing our wartime requirements. But without the tax changes there is a clear danger that there will be a further decline in shipping on the British register before the contracts scheme can be implemented, which will mean that the scheme will need to recover much more ground at greater expense. We agreed at the last meeting that action was urgently needed. The tax changes would have immediate effect and, by helping to reduce crew costs and to halt the drift away from the British register, they will make the contracts scheme cheaper to operate in the longer term.

13. I hope therefore that at our meeting we can decide:

(a) to introduce an amendment to the current Finance Bill to extend the length of time which seafarers may spend in the United Kingdom while remaining exempt from UK tax to 90 days or one quarter of the qualifying period of at least 365 days; to come into effect at the same time as, or before, PAYE is re-introduced, and

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(b) to press ahead urgently with the introduction of a scheme for contracting for vessels in short supply for wartime needs.

14. I am sending copies of this minute to Geoffrey Howe, Nigel Lawson, Douglas Hurd, George Younger, John Moore, David Young and Sir Robin Butler.

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P.C.  
PAUL CHANNON

3 June 1988

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## CONTRACTING FOR MERCHANT SHIPPING

### WARTIME REQUIREMENTS

#### PAPER BY THE SECRETARY OF STATE FOR TRANSPORT

##### Introduction

1. The Prime Minister's meeting on Merchant Shipping on 4 May invited the Chancellor of the Exchequer and me to work up, in more detail, schemes for ensuring that the United Kingdom's wartime requirements could be met. This paper examines the option, discussed at our meeting, for a scheme of contractual arrangements with owners of vessels in short supply to secure their availability in time of emergency.

##### Current Requirements

2. The United Kingdom has a wartime requirement for merchant shipping for military support and for civil resupply. To meet the requirement we rely on powers to requisition vessels on the British register or vessels owned by United Kingdom interests and operated on foreign registers. Ships engaged in direct support of defence forces should be registered in the United Kingdom or Isle of Man and manned by crews acceptable in terms of security. For vessels engaged in civil resupply the place of registry and to some extent the crewing arrangements are less critical. But to avoid our having to rely on the market to provide sufficient vessels it is important that sufficient vessels should be subject to requisitioning. In practice there is a gradation of availability from UK registered ships which almost all have British crews, through ships registered on dependent territory registers, which may well have mixed crews, to ships on foreign registers with foreign crews working in foreign waters. This is illustrated in respect of product tankers in Table 1. To ensure



that the Government's requirements can be met it is important therefore that sufficient vessels of particular types are maintained on the United Kingdom and wider British registers.

### Objectives

3. The objective of the contract scheme would be to ensure that the Government had access to an adequate supply of particular types of vessel in order to meet defence and civil resupply requirements. This would be done by:

- (i) ensuring that British flag vessels already easily available remained so;
- (ii) providing an incentive for owners of vessels whose place of registry and crewing arrangements made them less easily available, to transfer to registers and crewing arrangements which made requisitioning easier;
- (iii) encouraging existing or new owners to make additional ships available.

### Coverage

4. The scheme could in theory be used for any particular class of ship but it is more appropriate for those types where there is a general and continuing demand in world markets. As explained in previous papers the category which demands immediate attention for defence requirements is that of product tankers. Product tankers are smaller tankers used for carrying refined petroleum products. They are essential in wartime for transporting fuel for defence forces and for supplying the United Kingdom's energy needs. On the latest projections there is a very fine balance between available supply and demand for military and civilian resupply. Demand for product tankers of 10-80,000 dwt has been critically re-examined to reflect latest thinking by the Department of Energy and is estimated at a minimum of 121 (28 for military and 93 for civil purposes).



5. There are at present only 122 British owned product tankers. This is a maximum figure which assumes that all suitable vessels on British registers (that is UK, Isle of Man and dependent territories) are requisitioned regardless of owner and vessels which are owned directly or indirectly by UK companies on other registers can be made available. But some are on registers and operate in areas which would make it difficult to effect a rapid recovery. In addition no allowance is made for loss of cargoes and ships due to enemy action although the figures do take account of reduced operating efficiency in wartime. Future supply may drop for a number of reasons. First there is the uncertain effect of changes in PAYE arrangements for seafarers employed by manning agencies on ships owned by UK companies and registered in the Isle of Man and elsewhere. Secondly, there is competition from other registries being set up to offer tax/social security concessions in eg. Norway and Denmark. This could lead to owners deciding to flag outside the UK and dependent territories and to employ foreign crews. To the extent that such movements are to other NATO flag countries they should not diminish the total number of tankers available in the NATO Pool for civil resupply (see para 15). But such movements will deplete the numbers of British crews and vessels under our control and this will ultimately have an effect on the core fleet available for military purposes. For these reasons a prudent target for the scheme might be assured availability of 150 tankers.

#### Outline of Scheme

6. Shipowners would be invited to contract to maintain product tankers (or any other type of vessel) under conditions which guarantee ready availability and appropriate crewing in the event of an emergency.

7. We need further study in consultation with the industry to work out the most economic and reliable set of contract conditions. But it seems clear that the contract would need to control:



- (i) The number, type and size of ships
- (ii) The flag of registry
- (iii) The nationality/certification of the crew
- (iv) The availability of the vessel
- (v) The duration of the obligation.

It would be possible to vary the type of contract according to need. If the UK and Isle of Man registers were to decline substantially we might need to contract for tankers needed for direct support of defence forces, in which case we would envisage stringent conditions specifying a United Kingdom or Isle of Man registry and at least all UK officers. We might also need to specify availability in geographical terms eg. at a UK Port within fifteen days.

8. The immediate requirement is, however, for tankers to be used for civil resupply. For these it should be enough to specify:

- United Kingdom, Crown Dependency or Dependent Territory registration
- UK senior officers
- Availability after completion of current voyage.

#### Cost

9. A key feature to keep down public expenditure would be competitive tender. Owners would be invited to submit bids for the compensation payment which they would require to operate ships under the conditions specified in the contract. The use of competitive tendering should ensure that the level of subsidy is set at the minimum necessary to achieve the objectives of the scheme. But there will inevitably be some deadweight in the scheme as it would have to cover tankers operating commercially which already meet the requirements of the contract and are available without subsidy. Any attempt to exclude ships already available could be circumvented by owners taking their ships off the register temporarily and then flagging in to benefit from the scheme. There are, however, still strong commercial pressures encouraging owners to flag out and without action we would expect the drift from the UK flag to continue. The availability of the



scheme should therefore encourage owners to stay on the British register who would not otherwise do so and to that extent the subsidy would not be wasted. Moreover, competitive tendering should help minimise the deadweight as shipowners already meeting the requirements of the contract commercially could be expected to submit lower bids.

10. The total cost of the scheme will depend on the conditions attached to the contract, in particular the degree of difference between the cost of crews operated on a commercial basis and those required under the contract. For those companies already operating commercially in line with the requirements of the contract a somewhat smaller amount than the actual difference in costs would be required. For product tanker of 40,000 dwt currently operating on a foreign register with a third world crew the additional crew cost of transferring to a dependent territory register and operating with UK senior officers is estimated as £50,000 per annum. Transferring to the Isle of Man register and employing a full UK crew on an offshore agreement would raise this figure to £200,000 per annum. We think most operators would find it unsatisfactory to re-crew with UK senior officers without at least employing British (or Commonwealth) junior officers, though they could be more flexible as regards the nationality of ratings. An average re-crewing cost would therefore be around £100,000 per vessel per annum. In addition we would expect to have to pay an annual premium to cover the initial cost of transfer to the British register and to compensate owners for the loss of flexibility. This might add about 30% to the simple crew costs. For a requirement of 150 vessels on a less restrictive contract the total cost would therefore be of the order of £20m per annum (150 vessels at £100,000 crew costs + £30,000 premium = £19.5m + some administrative costs falling on my Department.)

11. Although the scheme has been outlined and costed on the basis of its application to product tankers it could be used for other classes of vessel, as necessary, to take account of any shortfalls in the supply of types of ships relative to our defence requirements.



## Legislation

12. The scheme would require primary legislation.

## Assessment

13. The advantage of the scheme as outlined is that it provides a method of targetting subsidy most accurately at the specific categories of shipping where our needs are most urgent.

14. The scheme is intended to have a twofold effect on the supply of vessels in an emergency - to make those already available more readily available and to attract additional tonnage into the pool of available vessels. There are a number of tanker owners, both oil majors and independents on the UK register eg. Cunard, Canadian Pacific, Furness Withy, Maersk, Swire, Silver Line, BP, Shell etc., who might find it attractive to expand again under the terms of a subsidy contract. However, the degree to which the oil majors would be willing to transfer ships from other registers/direct ownerships may be constrained by the operational requirement to have them flagged and/or owned in certain countries. There are also other possible sources of ships which already have links with the UK -eg. ships managed or owned by Hong Kong interests (eg. World-wide Shipping) or Greek shipowners based in London - who may also be attracted by the scheme.

15. The effectiveness of the scheme might therefore be assessed by the extent to which it encouraged the switch of existing UK owned vessels from less to more desirable registry and manning arrangements as well as the extent to which it increased the total pool of product tankers available.

16. The effect of the scheme on the number of vessels available for civil resupply, for which NATO resources are pooled, needs to be considered in a NATO context. The scheme will increase the number of vessels available to NATO to the extent that it adds to the pool of vessels firmly available to all NATO countries. Table 2 summarises the present supply position of tankers which could carry products. On the assumption that pooling arrangements operate as planned there would be no value, in NATO terms, in



movements within the NATO pool. Such movements would, however, be of value to the UK as they would add to the number of vessels which would be under our direct control and would minimise the extent to which we needed to rely on the, possibly uncertain, operation of the NATO pool. In addition, if other NATO governments follow our example and contract with their owners on a similar basis, the pool will be further enhanced.

17. The effectiveness and cost of the scheme will also depend on the general attractiveness to shipowners of operating on the British register and particularly the ease of employing British crews. Measures we have taken in the new Merchant Shipping Act to assist with training and crew relief costs are designed to make it easier to employ British crews. But it will take some time for these to take effect and, in the meantime, shortages of British junior officers might make it difficult for owners to take advantage of the scheme even if they wanted to. And decisions on the personal taxation of seafarers will also clearly influence the likely attractiveness of the scheme.

#### Political Reactions

18. I would expect the scheme to be widely welcomed in Parliament and outside. There would be pressure for early legislation to give it effect. We would clearly have to resist Opposition pressure to use the scheme to secure protected employment for British ratings on NUS terms.

19. We would need to handle the scheme carefully in international organisations. The European Commission have been under pressure to come forward with ideas for 'positive measures' to help Community fleets, and there will, rightly, be concern that a proliferation of different schemes of assistance in Member States could be counter-productive. In general terms, any form of assistance to the shipping industry will weaken our position in arguing against protectionism. But a scheme that was very clearly tied to our strategic requirements would be less damaging to that cause and should be proof against any action under the state aids provisions of the Treaty of Rome.



Conclusion

20. The next step would be to work up the necessary legislation, the terms of the contract, and a programme for assessing the effectiveness of the scheme with a view to having the scheme in place to use, as necessary, to secure the supply of particular types of vessel.



TABLE 1

Distribution by Register of Vessels available to the UK to carry  
Products

UK Mainland	31	
IOM	36	
Sub Total		67
Bermuda	11	
Cayman	3	
Gibraltar	3	
Hong Kong	18	
Sub Total		35
Other Registers		20
Grand Total		122

Notes 1. Figures include Royal Fleet Auxiliaries.

2. Figures exclude Shell vessels in Argentina and Australia - assumed not to be available for UK purposes. Other registers made up of 14 Liberia, 3 Bahamas, 2 Panama, 1 Malta.

3. Figures for UK mainland, IOM and dependent territories include all vessels in those registers which meet the size and type specification regardless of ownership.



Table 2

Distribution of Vessels Which Can Carry Products by  
Owner and Register (numbers)

<u>Register</u>	<u>British or National</u>	<u>Open Registers</u>		<u>Total</u>
		<u>Liberia &amp; Panama</u>	<u>Other(1)</u>	
<u>Allegiance of owner</u>				
<u>UK(2)</u>	102	14	6	122
<u>Other NATO</u>				
Belgium	4		5	9
Canada	11			11
Denmark	24		5	29
France	10			10
Greece	86	32	45	163
Italy	72			72
Netherlands	7	7		14
Norway	20	19	6	45
Portugal	5			5
Spain	16			16
Turkey	14			14
US	133	58	13	204
West Germany	6	2		8
	<u>408</u>	<u>118</u>	<u>74</u>	<u>600</u>
<u>Uncommitted</u>				
Algeria	5			5
Argentina	24			24
Australia	8			8
Brazil	34			34
Ecuador	7			7
Hong Kong		34		34
India	37			37
Indonesia	19	35		54
Iran	12			12
Iraq	7			7
Japan	32	61		93
Korea	7			7
Kuwait	3	6		9
Mexico	28			28
Peru	7			7
Saudi Arabia	11			11
Singapore	12			12
UAE	12			12
Venezuela	17			17
	<u>282</u>	<u>136</u>		<u>418</u>
<u>Neutrals</u>	22			22
<u>Communist Bloc</u>	279			279



Table 2

Distribution of Vessels Which Can Carry Products by  
Owner and Register

Notes

- (1) Includes Bahamas, Cyprus, Malta and Singapore.
- (2) All vessels on British registers are taken to have allegiance to the UK regardless of actual nationality of owner.

Explanatory Note

The top line of Table 2 shows the available tankers to the UK as recorded in Table 1. The section below shows the number of tankers owned in NATO countries. The first column shows the number registered in the country of ownership while the second column shows the number registered elsewhere. Most of these vessels are probably available to NATO in times of crisis though there may be some problems with suitable crews of vessels currently on open registers. The next section of the table shows tankers owned and registered in non NATO countries. There is a wide variety of ownership here both by nationality and type of owner (oil company, private or state ownership). One of the targets of the contract scheme would be the group of uncommitted owners who did not need to be on particular registers or have particular nationality of crews for trading purposes.



135  
1  
2



10 DOWNING STREET

Lynn

Merchant Shipping Meeting

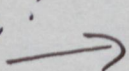
Those involved are: Strauss, S/Det,  
H/S, FCS, Cdr, L/Ex, S/TL, R/W,  
Mr. Perkins, FERB. + Ruled with

The week beginning 6th June is  
difficult but everyone except the  
Foreign Sec. could do the afternoon  
of Wed. 8th June. (The FCS is  
abroad all week).

Looking at the following week  
the S/Det is away all week.

Can you talk to the Foreign Office  
to see if the FCS can send a

deputy?



Tessa

||  
||

Tcr.

1715

Pr. 50 ~~for~~ ~~on~~

8 June and tell the  
FCO they must send  
a deputy - refer them to  
me if they're difficult. PREG  
1965





10 DOWNING STREET

PRIME MINISTER

---

Merchant Shipping

You saw the paper over the weekend; I am putting them back in the box in case you want to take a second look this evening.

---

ARC 6

3/5



MERCHANT SHIPPING REQUIREMENTS IN EMERGENCY AND WAR

Note by the Secretary of State for Defence and the Secretary of State for Transport

INTRODUCTION

1. At the meeting on 23 February the Prime Minister asked for a further paper on the supply of the particular types of merchant shipping which cause the greatest concern. This paper covers the supply of ships to meet the 3 main tasks.

- a. the direct support of the UK armed forces;
- b. the UK contribution to transatlantic reinforcement (which includes US Military Sealift, also referred to as the Rapid Reinforcement Plan);
- c. civil supply of the UK from overseas

These tasks are examined separately but it should be noted that they draw to some extent on the same types of ships: particularly with regard to product tankers and general cargo vessels, meeting the demands of one task is possible only at the expense of the others.

DIRECT SUPPORT OF THE UK ARMED FORCES

2. Direct support of the UK armed forces is a UK national responsibility. A table showing the UK military requirement is at Annex A. With one exception the requirement can currently be fulfilled by ships on British registries: and within that, mainly by ships on the mainland UK, Isle of Man, Channel Islands and Bermuda registers. As such they will generally be manned by British or Commonwealth officers and in many cases British ratings, who will continue to serve in war. Some crew changes may be necessary where non-NATO seafarers are employed, but this will depend on the nature of the operation assigned to the vessel, the crew's willingness to serve, and the attitudes of their governments. (Throughout the paper 'availability' refers to the number of vessels of a particular type which can be presented at a specified port within the required timescale. It does not however take account of the time needed for any necessary modifications for naval or military roles.



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3. Only one requirement cannot be met from the British fleet. There is cause for concern, however, in the supply of several types of ship for military requirements: either on grounds of total numbers, or their availability in sufficient quantity within a reasonable timescale. In more detail, by ship type, the issues are:

- a. Fishing vessels and North Sea Support Vessels for a variety of naval tasks. Most requirements are well covered, though for some specialised roles - submarine support, forward repair, and MCM command and support - the number of ships which closely approach the specifications is very limited. Number required 8, now 10 or fewer available on the British registry. Future vessel availability is related to activity levels in the UK offshore oil industry. Similar ships may be available for purchase, or charter from European NATO allies.
- b. Product tankers to support RN operations at sea, on convoy duties, and for harbour support. Because vessels in the most useful size range (15-60,000 dwt) trade widely around the world there will be difficulty in acquiring product tankers of this size in sufficient numbers to meet the planned phased naval requirement for some vessels at an early stage (within 7 days) and the remainder within 30 days. In order to ensure their availability at the required locations within this timescale very early notice will have to be given of the total number needed in transition to war or war itself. The final naval requirement is for 38 product tankers of all sizes: the supply on the British register worldwide of 101 is considered just sufficient to meet the demand within the required timescale. A recent trend has been for product tankers on the UK registry to transfer to the Isle of Man and Bermuda, which is likely to reduce the number of UK nationals in their crews, and may be a preliminary step towards foreign flagging. Total product tanker numbers are insufficient to meet the full requirement for naval support and civil resupply. (Annex D).

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- c. Cruise ships to transport troops from the UK to Norway and to return casualties. Requirement 2 within 5 days, 1 within 10 days: number available 2 within 5 days plus 2 within 10 days. (RoRos could also be used, though at the cost of a reduction in the lift capacity from UK to the Central Region).
- d. RoRo ferries for the UK armed forces reinforcement of the Central Region, mainly within the first 10 days; for the UK/NL ATG to Norway; and a small number for naval tasks (eg minelaying). Total requirement 69, number available 74. Numbers currently in service are sufficient to cope with the peak reinforcement demand over 4 or 5 days in the worst case situation now foreseen, when the maximum number of reinforcement plans would be running concurrently: but with very little margin for civil requirements or complicating circumstances. The effect of the Channel Tunnel and stricter safety standards may be to reduce the size and capacity of the RoRo ferry fleet below the requirement in the early/mid 1990s. However, conclusion of Host Nation Support agreements with Belgium, Germany and the Netherlands over use of their modern RoRo ferry fleets would provide an ample cushion of over-capacity to meet the Central Region reinforcement requirement into the foreseeable future, but no negotiations have been initiated.
- e. Heavy Lift Ship requirement 1, none available. A relatively new requirement for the joint Royal Marine/Royal Netherlands Marine force deployment to N Norway, this could not have been met in the past from UK assets and cannot now. No British shipowners possess suitable vessels. Negotiations are taking place with the Netherlands to obtain a suitable vessel to support the joint force within the required (5 day) timescale.

UK CONTRIBUTION TO TRANSATLANTIC REINFORCEMENT

4. The Rapid Reinforcement Plan (RRP) is a vital element in NATO's strategy of deterrence, and would ideally be completed before the outbreak of war: though that could not be guaranteed. The Pentagon has estimated that 600 large fast dry cargo ships from the total NATO pool need to be earmarked in order to ensure the availability of the 400 needed for RRP. The figure of 400 makes no allowances for attrition or other losses. The RRP requirement is likely to rise to about 450 as a result of a

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US review to be issued by the summer. The number of suitable ships has declined steadily over the past 5 years (Annex B). In September 1985, 574 were earmarked, of which 124 were British registered. Two years later the number earmarked had fallen to 448 of which 94 were British. A particular concern is the world-wide commercial trend towards containers and away from break bulk general cargo ships, the type most suited to handling much of the military equipment which cannot easily be containerised. The trend is illustrated at Annex C.

5. Although provision of shipping for transatlantic reinforcement is a shared NATO responsibility the UK has historically played a major role. While the UK share of the total number of ships earmarked has remained stable at around 21%, since 1982 the UK contribution of containerships for Sealift has fallen from 52 (31%) to 41 (21%). Over the next 10 years replacement or reinvestment decisions will have to be taken on the entire UK/IOM/Bermuda registered large containership fleet of 41 ships.

CIVIL RESUPPLY OF THE UK

6. It is clear that even in the early days of a war, because of the needs of the armed forces and the Rapid Reinforcement Plan, there would be shortages of general cargo vessels and product tankers. The extent of the shortfall is difficult to quantify, as it would depend on:

- a. progress on transatlantic reinforcement, and the other demands of military resupply;
- b. availability of Hong Kong registered shipping in particular beyond 1997, and the general availability for requisitioning of British owned foreign registered shipping;
- c. continued availability of non-British owned shipping for civil resupply;
- d. success in mustering adequate crews (even taking into account the proposed Merchant Navy Reserve) to man British Dependent Territory or foreign registered ships which were not British officered.

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7. The table at Annex D shows the heaviest demand for shipping, with both the Rapid Reinforcement Plan and civil resupply running concurrently. Taking both the worst case (reliance on British flagged ships only, and excluding Hong Kong registered ships) and the best case (British flagged ships including Hong Kong, plus UK owned but foreign flagged ships), substantial deficits would arise in the 3 critical categories:

	Best (British flag incl HK and flagged out)	Worst (British Flag excl HK)
product tankers (10-40,000 dwt)	- 39	- 81
general cargo (above 5,000 dwt)	- 478	- 534
containerships	- 34	- 63

On the more favourable assumption that Rapid Reinforcement had been completed before the outbreak of hostilities, demand would ease slightly but deficits would remain:

	Best	Worst
product tankers (10-40,000 dwt)	- 39	- 81
general cargo (above 5,000 dwt)	- 435	- 494
containerships	+ 7	- 22

8. Figures for civil demand are inevitably less precise than for military requirements, but are the best estimates made by civil departments in 1985 of the numbers of ships, based on typical ship loads by commodity, required to transport the volumes of imports judged essential to the economy of the UK in wartime. The figures take account of the effects of some switching to more distant sources of supply, and cessation of exporting. The figures for essential imports compare with the average ship arrivals in Britain per month in 1986:

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	1986 monthly average arrivals ship nos	essential imports ship nos employed
container, under 5000 dwt	130	
general cargo, under 5000 dwt	3641	601
dry bulk and general cargo over 5000 dwt	634	
container, over 5000 dwt	178	63

9. The NATO shipping pool will help the situation regarding both ships and crews, but in view of the contraction of the pool in recent years there can be no expectation of surpluses from NATO allies making up these shortfalls to provide for civil supply of the UK. A clearer picture of total NATO demand and supply of shipping will emerge when the NATO study reports in 1989/90.

CONCLUSIONS

10. A number of general conclusions can be drawn:

a. the requirements of the UK armed forces can be met at present almost entirely from ships on the UK mainland, Isle of Man, Channel Island and Bermuda registers, though the supply of certain types of ships is limited and could worsen in the near future. The following provisos apply:

- i. heavy lift ship - MoD agreement with the Netherlands
- ii. RoRos - numbers are just adequate to meet the worst-case peak requirement. Conclusion of MoD Host Nation Support agreements with Belgium, the Netherlands and Germany would assure ample supply.
- iii. North Sea supply vessels - numbers of some specialised types are just adequate to meet RN support requirements. If UK offshore oil activity declines numbers are likely to fall. Vessels could probably be purchased or chartered from European NATO allies.
- iv. Product tankers - availability rather than total numbers is the problem. To ensure timely provision the whole requirement would have to be declared at a very early stage in TTW.

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b. Provision of both container and break bulk dry cargo shipping for US Military Sealift (RRP) will become more difficult as NATO merchant fleets decline and the industry continues to switch away from break bulk ships. Position will worsen unless US military switch from break bulk cargo vessel requirement, and as RRP cargo volumes increase.

c. The same categories of ships - container and break bulk general cargo - as well as product tankers will be in short supply both nationally and within the NATO pool, to meet civil supply requirements.

d. With the decline in NATO allies' national fleets and reductions in the numbers of seafarers from the high cost North American and West European countries, manning of requisitioned shipping with loyal and reliable crews is a growing problem.

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MERCHANT VESSEL REQUIREMENTS FOR MILITARY REINFORCEMENT  
AND SUPPORT OF RN OPERATIONS

TYPE OF VESSEL	ROLE	REQ'T	REMARKS
<u>Large Stern Trawler</u>	Minesweeper	4	Requirement was for 20. Balance made up by North Sea support vessels
<u>Other Fishing Vessels and offshore supply vessels</u>			
Offshore supply or anchor handler	Balance of minesweepers	16	
Fishing, standby or supply vessel	Danlayer	17	
Large fishing or supply vessel	Administrative escort	31	
Comercial survey vessel	Survey ship	6	
Rig maintenance or diving support	Submarine support ship	1	
Rig maintenance or diving support	Forward repair ship	5	
Rig maintenance or diving support	MCM command and support ship	2	
<u>Product Tankers</u>			
Self propelled barge/tanker	Clyde river tanker	2	
Coastal tanker 2,000-4,000 dwt	Harbour tanker	11	
Product tanker 4,000-15,000 dwt	Amphibious support tanker	4	
Product tanker 15,000-60,000 dwt	Freighting tanker	4	
Product tanker 15,000-60,000 dwt	Convoy escort oiler	7	
Product tanker 15,000-60,000 dwt	Auxiliary support tanker	12	



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Break Bulk General Cargo

(Mostly shortsea trading. earmarked for Sealift not included)	Vessels	Support of JTPs	50	Will support JLPs later.
		Survival stores carrier	3	Small cellular container vessel could be used for moving TEUs
		Armament carrier	4	

---

Large Passenger Ships

Troop/hospital ferry

3

For UK/NL ATG

---

RoRo Ferries Pax and Freight

Support of JTPs

67

Will support JLPs later

(Mostly trading shortsea from UK)

Minelayer

2

---

Heavy Lift Ships (Dock Type)

Small landing craft transporter

1

For UK/NL ATG

---

Tugs

Coastal/ocean/offshore

Rescue/Salvage

13

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Annex B

NATO SEALIFT; DRY CARGO VESSELS:

	Apr 82	Apr 83	Apr 84	Sept 85	Sept 86	Sept 87	Change 82-87
Belgium	18	16	15	15	13	13	- 5
Denmark	59	61	56	45	41	51	- 8
Germany	102	103	101	101	98	99	- 3
Greece	85	72	119	106	84	75	- 10
Italy	35	35	33	28	28	28	- 7
Netherlands	85	84	80	76	73	62	- 23
Norway	69	53	57	50	39	9	- 60
Portugal	14	14	14	14	7	3	- 11
Turkey	15	15	15	15	15	14	- 1
United Kingdom	138	115	117	124	100	94	- 44
<b>Total</b>	<b>620</b>	<b>568</b>	<b>607</b>	<b>574</b>	<b>498</b>	<b>448</b>	<b>- 172</b>

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## UK CONTRIBUTION TO NATO SEA LIFT SHIP LIST

TYPE	Apr '82	Apr '83	Apr '84	Sept '85	Sept '86	Sept '87
Break Bulk	68	49	49	51	43	40
Container	54	51	52	51	43	41
Ro/Ro	16	15	16	22	14	13
Total	138	115	117	124	100	94

## NATO SEA LIFT SHIP LIST

TYPE	Apr '82	Apr '83	Apr '84	Sept '85	Sept '86	Sept '87
Break Bulk	361	301	325	297	229	183
Container	175	181	195	194	191	192
RoRo	84	86	87	83	78	73
Total	620	568	607	574	498	448

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Annex D

UK WARTIME SHIPPING SUPPLY DEMAND

SHIP TYPE	*D E M A N D	E X C E S S / D E F I C I T		
		Using British Flag Exc' Hong Kong	Using British Flag inc' Hong Kong	Using British Flag inc' Hong Kong and Flagged Out
<u>Tankers</u>				
1,000-10,000 dwt	26	- 67	78	92
10,000-40,000 dwt	197	- 81	- 59	- 39
40,000-80,000 dwt	18	6	8	9
80,000-150,000 dwt	11	- 1	4	18
Over - 150,000 dwt	29	- 4	0	2
<u>Dry Bulk Carriers</u>				
5,000-40,000 dwt	67	- 7	46	54
40,000-80,000 dwt	11	1	54	66
80,000-150,000 dwt	28	- 19	0	13
Over 150,000 dwt	4	2	14	16
<u>General Cargo</u>				
Below 5,000 dwt	449	- 252	- 230	- 162
5,000 dwt and over	588	- 534	- 507	- 478
<u>Containerships</u>				
5,000 dwt and over	120	- 63	- 40	- 34
<u>Ro/Ro</u>				
	129	18	20	29
<u>Tugs</u>				
	56	208	230	262
<u>Large Passenger Ships</u>				
	3	5	6	9
<u>Heavy Lift Vessels</u>				
	1	- 1	- 1	- 1
<u>Others</u>				
	192	384	394	456

\* Demand = Total of military reinforcement, naval support, US military Sealift and identified civil requirements.

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Annex E

VESSELS IN NATO POOL: 1983-1987

The main figures in the table below show the total numbers in the NATO pool; the bracketed figures show the UK contribution.

VESSEL TYPE	1983	1984	1986	1986	1987
Tankers (all types)	1486	1402 (290)	1285 (232)	1246 (227)	1106 (186)
Dry Bulk Carriers	1490	1501 (249)	1398 (243)	1306 (243)	1188 (227)
General Cargo	1697	1597 (176)	1451 (132)	1324 (146)	1082 (115)
Containership	330	415 (77)	438 (73)	432 (74)	420 (62)
Ro/Ro	262	239 (40)	283 (38)	297 (46)	289 (38)
Large Passenger	303	227 (16)	190 (16)	188 (13)	183 (12)
Other (inc helicopter carriers, salvage vessels etc)	-	47 (5)	147 (4)	160 (29)	124 (21)
	5568	5410 (853)	5054 (738)	4953 (778)	4392 (661)



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OFFSHORE MANNING CONTRACTS

Note by the Secretary of State for Transport

PREAMBLE

1. The prime concern addressed in this paper is the need to ensure the availability of sufficient merchant ships and seafarers to meet requirements to support the Armed Forces and supply the civil needs of the UK in times of tension and war. The importance of having ships on the Isle of Man and dependent territory registers is that these ships are required to operate with a minimum number of British (or certain Commonwealth) officers, whereas if the ships are transferred to foreign registers, there is no such requirement. The presence of British officers is an important factor governing the availability of these ships

2. Decisions on the tax treatment and the associated application of national insurance contributions regulations on seafarers employed under offshore manning contracts could have major implications for this availability.

BACKGROUND

3. The recent moves by UK owners to follow the precedent of open registry companies by distancing themselves from involvement in the direct employment of seafarers by the use of foreign and offshore manning contractors has enabled them to reduce operating costs and yet continue to have their vessels manned to a large extent by well qualified British seagoing personnel.

4. The facility to develop new offshore remuneration arrangements with gross wage packages has provided the catalyst for a radical change in the conditions of service of seafarers employed on offshore agreements. These involve a significant reduction in fringe benefits, longer voyages and shorter leave periods. Overall savings in wage costs of up to 25% have been quoted by a number of companies as a result of instituting these changed working practices. Within these savings, those directly related to income tax are small. Companies have not encouraged tax evasion; in fact they have often paid for reputable consultants to advise seafarers on their tax affairs. Many of

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the seafarers qualify for 100% foreign earnings deduction. Savings on secondary Class I NI contributions are more significant but the greatest savings arise from the changed conditions of service in the offshore package, for which the gross wage structure was the essential starting point.

5. It is a crucial benefit to owners who use the services of manning contractors that it is possible to control the labour costs which are often the only significant cost variable in this international business. A gross wage structure is controllable simply because there are no unforeseen 'knock on' effects. A remuneration structure which has, as a major element, a range of fringe and social benefits can easily be disturbed by external forces. Recent examples of such changes which have affected companies with direct employment responsibilities have been the decisions to abolish the Upper Earnings Limit on Secondary NI Contributions thus creating a large and unplanned increase in employers' costs and the announcement of the removal of seafarers' EPA rebates.

6. Thus offshore agreements with manning contractors provide a stable environment in which UK shipowners can seek to narrow the gap between gross costs and net wages, and this enables them to compete more effectively with those owners who operate under open registers with seafarers recruited from the international labour market.

7. These developments have allowed UK owners to maintain in employment significant numbers of UK officers and ratings and to continue to register their ships in the Isle of Man and Dependent Territory constituent parts of the British register, where a minimum level of British (or certain Commonwealth) manning is required by statute, rather than to utilise total foreign manning and ship registration.

CURRENT POSITION

8. The Inland Revenue have concluded that there is a general obligation on UK shipping companies to collect PAYE in respect of UK domiciled seafarers employed by offshore manning contractors to crew the companies ships. DHSS may reach a similar conclusion in respect of secondary Class I NI contributions, although the situations are not exactly parallel and some companies' offshore arrangements may well escape this obligation.

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9. The shipping companies think that the responsibility for the control and management of these seafarers rests with the manning contractor who performs the primary employment functions of recruitment, promotion, allocation to ships, imposing discipline and monitoring performance as well as making payment of wages. If, as is the case, the manning contractors are not liable to operate PAYE because they are not based in the UK, the obligations should not fall on the shipping company which only has responsibility for the day-to-day operation and maintenance of the ship and deciding where it will trade. Most of the companies involved have legal advice supporting this contention. Some of them thought they had cleared the position in the soundings they had taken of Inland Revenue before they moved to their offshore arrangements. If the establishment of tax liability becomes a matter between the individual seafarer and the Inland Revenue, those who qualify for 100% foreign earnings deduction will not have their gross wages unnecessarily distorted by PAYE. If it becomes a matter for the shipping company, it means a return to direct involvement in employment.

10. The companies use the same basic argument to contend that in similar circumstances they have no liability to pay secondary Class I NI contributions.

IMPLICATIONS

11. Although the Inland Revenue and DHSS decisions would apply to UK owned vessels flagged anywhere, by far the most immediate and important implication for our strategic planning is the potential effect on the Isle of Man register.

12. Currently there are 104 vessels totalling 4 million deadweight tonnes registered in the Isle of Man (equivalent to two-thirds of the tonnage registered in the United Kingdom). A list of owners and vessels is annexed. These vessels employ some 4,000 seafarers, of which some 2,700 are British residents (UK or Isle of Man). There are very few aliens amongst the remaining 1,300 - a few Phillipinos, but mostly Commonwealth. Around 1,400 British officers are employed, 1,300 British ratings, and 1,300 ratings of other, predominantly Commonwealth, nationality.

13. Unlike at Dependent Territory locations, there are at present no advantages in terms of NIC liability for shipping companies or crews in operating from the Isle of Man. The Manx have their own NI scheme under which the NICs levied are the same as in UK. We know that the Manx authorities have considered but decided against exempting deep sea seafarers

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from this scheme, in order to put them on a par with Dependent Territories. However, the advantages gained by the use of Manx manning contractors employing British crews on offshore terms are still substantial. It has been estimated at a saving of £150k per vessel per year or 20% of total crew costs.

14. If British seafarers working for Manx manning contractors are brought within the PAYE net, there are two courses of action they can take:

- i. The significant number of seafarers who qualify for 100% foreign earnings deduction (FED) may seek employment with foreign owners. To some of these seafarers FED is a relatively new experience brought about by the longer tours of duty involved in offshore employment terms, but many others have previously worked for foreign companies, without any question of PAYE. They have been attracted back to working on British registered vessels by manning contractors providing crews for expanding companies such as Maersk. It is reasonable to suppose that those seafarers will be unwilling to return to, or begin, having PAYE deductions, even if they have the tax paid fully refunded at the end of each tax year.

or

- ii. Those seafarers who are liable to tax may seek a renegotiation of their offshore packages, with the result that shipowners will once again become involved in direct employment. The hard won advantages of recent years, gained at considerable cost, would be lost with the reintroduction of the type of employment packages, including redundancy compensation, which has made UK ships so uncompetitive in the past.

15. If the UK shipping companies involved are not prepared to accept the loss of the British seafarers currently employed by contractors to man their Isle of Man registered vessels, or a return to direct, and costly, involvement in employment, there are three courses of action they can take:

- i. transfer the ownership of the vessels to a foreign subsidiary, removing the registration from the Isle of Man to that country. In this way, British crew could still be employed on the vessels, but no PAYE obligation would fall on the foreign owner. Such

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transfer of ownership would not be difficult in such an international industry, and it should be noted that 90% of the tonnage on the Isle of Man register is ultimately beneficially owned by foreign parents (if Shell is included);

or

- ii. remain on the Isle of Man register, but to a large extent or entirely order the replacement of British crews by other, acceptable, nationalities, eg Irish or certain Commonwealth nationals. PAYE obligations would be reduced because few, if any, British residents would be involved. It should be noted that CP Bulkships have already experimented with an all-Indian crewed vessel on the Isle of Man register. The success of this experiment could persuade others to follow suit;

or

- iii. transfer for registration of the vessel to a foreign flag, ordering the replacement of British crews by foreign nationals, thus avoiding any PAYE obligations. It should be noted that the 3 leading owners on the Isle of Man register already have other vessels; registered under foreign flags.

CONCLUSION

16. The perceived problems arising from the imposition of PAYE and NIC obligations as a result of the Inland Revenue and DHSS investigations are likely to cause companies which have already established new manning practices under offshore agreements to consider other options open to them to retain the benefits of these gross wage agreements.

17. On PAYE the Inland Revenue will have no option but to apply the law according to their interpretation. We believe companies will not involve themselves in the expense of challenging such an interpretation in the Courts. Some will shed their UK nationals, and at least one major operator of Isle of Man registered vessels will transfer the ownership and registration of his vessels to a foreign company. We fear that the Departure of these vessels will encourage others to follow, with, in a very short space of time significant reduction in the tonnage currently registered in the Isle of Man.

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18. Some of this re-registration may be averted if the Inland Revenue would establish a simplified procedure for those seafarers entitled to FED. Instead of those seafarers being made to accept PAYE deductions and then claim a full refund of their payments, Inland Revenue might be able to reach a decision, on sight of the manning contract, to allow the deduction in advance, subject to unforeseen circumstances affecting the contract during the year and producing a subsequent tax liability. It is not possible at this stage to judge whether such an administrative simplification would be sufficient to prevent a flight from the Isle of Man. It would do nothing to save the companies from becoming directly involved again in the employment of those seafarers liable to tax.

19. So far as National Insurance Contributions are concerned, the legal provisions are rather different from PAYE. A mariner's contributions liability depends on a number of factors including where his ship is registered, whether he is normally resident in the UK, where his contract of service was entered into, and whether his employer has a place of business in the UK. With foreign-based manning agencies with no place of business here, a crucial factor governing liability will be the relationship between the agency and the UK-based shipowner. A British shipowner might have no NIC liability for members of the crew on his British registered ship if he used a genuinely independent manning agency, which had no place of business in the UK, to engage and employ them. But much would depend on the contract of employment and the agency's responsibility once the crew was on board ship, and each case would need to be judged on its merits.

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Now therefore it is hereby agreed by the parties as follows:

1. The owner commits himself to make available to Her Majesty's Government the committed vessels, during any period following an Order in Council made under prerogative powers empowering the requisitioning of ships, or on the passing of emergency legislation in defence of the Realm empowering the requisitioning of ships.
2. During a period referred to in clause 1, the owner shall make available any committed vessel identified in the request for use by or at the direction of Her Majesty's Government, wherever such vessel may be, for such period or periods of time as required by Her Majesty's Government.
3. Any committed vessel which is taken up pursuant to this Agreement will be taken up on the comparable terms and conditions as any British vessel requisitioned under the same powers.
4. The Secretary of State undertakes to provide the owner with a certificate to enable the owner to obtain Queen's enemy risk cover during the period referred to in clause 1 for the committed vessels with a War Risks Association reinsured by Her Majesty's Government pursuant to an agreement under the Act of 1952 (and that the committed vessels will accordingly be reinsured by the Secretary of State).
5. This voluntary contract of commitment shall not affect any other rights of Her Majesty's Government to requisition any committed vessel.
6. The owner undertakes to advise the Secretary of State immediately that he ceases to be the owner of, or to have authority to commit, any of the committed vessels.
7. This contract may be terminated on 6 months notice by either party.



DEFENCE - FUTURE UK DEFENCE POL PT 3



## ISLE OF MAN REGISTER (over 500 grt)

Total 104 vessels; 4,069,569 deadweight tonnes

Owner	No	(Type) Vessels	dwt
Shell	20	(11 product tankers, 7 tankers, 2 bulk carriers)	2,647,811
Maersk	16	(9 product tankers, 3 gas tankers, 3 OSVs, 1 ro-ro)	570,341
CB Bulkships	12	(12 product tankers)	376,579
Ocean	5	(3 general cargo, 2 ro-ro)	139,665
Rowbotham	17	(17 product tankers)	79,690
John Swire	3	(3 product tankers)	72,663
Ellerman	4	(4 containers)	60,265
Denholm	3	(1 bulk carrier, 1 general cargo, 1 OSV)	36,820
Blue Star	1	(1 container)	27,978
Gibson Tankers	5	(5 gas tankers)	16,713
OIL	4	(4 OSVs)	11,508
Britship	1	(1 product tanker)	8,706
Cenargo	1	( ro-ro)	3,890
Wallem	1	(1 product tanker)	3,290
Triport Ferries	1	(1 ro-ro)	2,920
Belfast Car Carriers	1	(1 ro-ro)	2,838
Gotland	1	(1 ro-ro)	1,950
James Fisher	1	(1 ro-ro)	1,658
IOMSP	2	(2 ro-ro)	1,422
Tidewater	1	(1 OSV)	1,200
Sealink	1	(1 ro-ro)	879
Ramsey Steamship	1	(1 coaster)	756



## MERCHANT SHIPPING DECLINE: OTHER COUNTRIES' RESPONSES

## NOTE BY THE SECRETARY OF STATE FOR TRANSPORT

Shipping in NATO Countries: Previous Assistance

Throughout the NATO alliance, experience since about 1975 has been of general contraction in the domestically-registered fleets. In most European countries, the impact of this decline on national war and emergency planning seems not to have been recognised until very recently. The widespread assistance that has been given to merchant shipping owes far more to other factors.

2. In Scandinavia, for instance, the industry's historic role has been as one of the major employers in the economy; it has occupied the kind of position reserved to agriculture further south. In the Mediterranean area too shipping has enjoyed special help, though more perhaps because of the political sensitivity of the maritime communities. In Germany and The Netherlands, assistance has tended to be given as a by-product of aid to ship-building.

3. The North American scene is quite different. In the USA there has been a perception ever since 1938 that a certain minimum fleet under the national flag is needed to support the US Navy. Most US cargo liner companies have as a result received subsidies to offset the extra cost of employing US seamen. The cost of this programme in 1986 was \$288 million, or an average of over \$2.5 million per vessel concerned. Similarly, the US has maintained a Ready Reserve Fleet, partly laid up, to supplement the merchant marine. Canada meanwhile has until recently pursued a policy of allowing market forces to determine the size of its fleet (except for its coastal and offshore vessels). There are now however governmental proposals for a second ship register, mirroring developments in Europe, which would exempt Canadian shipping companies from domestic tax liabilities as a means of improving the competitiveness of the Canadian fleet.

New Trends

4. Certain new trends are now beginning to emerge in the policies of Alliance members in response to the challenge posed by Third World fleets and the depression in the industry that has compelled so many owners to retreat to flags of convenience. Although investment grants and special depreciation allowances are still prevalent (notably in France, Italy and Germany) there is a growing awareness that aids for new investment have aggravated the over-tonnaging that was largely provoked by Japan and Korea. Denmark and The Netherlands have recently withdrawn part of their schemes. Attention instead has focussed on the problem of the high cost of employing European crews. A variety of measures have been taken as a result:-



- France is implementing a 23-point plan, costing about £140m over two years for a fleet significantly smaller than the UK's. Measures include re structuring grants to companies who are prepared to reduce manning levels and special adjustments to the arrangements for social security payments.
- In 1987, Norway set up a parallel register on which owners could use crews of any nationality with minimal Norwegian tax liabilities.
- Denmark is expected to announce any day now the creation of a similar special register with wide exemptions from personal tax and social security obligations for Danish seafarers employed on its vessels. (Sweden is also on the point of adopting a scheme of assistance which is widely reported to lay the emphasis on personal tax relief).
- In The Netherlands, it has been announced that tax and social security concessions will be granted to shipowners and seafarers; details are being worked out by the Ministries concerned.
- Belgian owners have been in negotiation with the Luxembourg government over the establishment of a new register there which would probably entail low corporation tax as well as the freedom to employ foreign crews.
- In Greece, where seafarers have long enjoyed a 5% rate of personal tax against the national average of 40%, steps have been taken to reduce crew costs by allowing the use of a certain percentage of foreign nationals.
- Germany, apparently, have earmarked a sum of some £250m by way of assistance to German flag vessels for allocation between now and end 1991. Details of the scheme have not been made public but it is believed to be planned to supplement the present shipbuilding assistance arrangement.

5. Within the EEC, the Council of (Transport) Ministers has called on the Commission to make proposals for arresting the decline of the Community fleet. In discussion of the options, the majority of Member States have suggested that the cost of employing EEC seafarers would most appropriately be reduced by fiscal action.

6. It is notable that the US programme of regular direct operating subsidies has not been imitated in any other NATO country; nor has any interest been shown in buying up old vessels for moth-balling.



## Conclusions

7. Within Europe, support for merchant fleets has in the past been provided mainly through schemes to assist capital investment. There is now a strong tide flowing in the direction of helping owners to reduce their crew costs, so as to encourage them to stay on national registers. Partial relaxation of nationality requirements, which has enabled foreign ratings to be employed, generally while national officers are retained, is one method. But increasingly attention is focussing on the creation of special personal tax and social security regimes for seafarers. There is little evidence of these arrangements being limited to seafarers who do not maintain a residence in the country concerned, though in Norway (and probably under the new Danish scheme) concessions are not available to those employed in coastal shipping or off-shore trades.



## ACCESS TO MERCHANT SHIPS IN CRISIS AND WAR

Note by the Secretary of State for Transport

Introduction

1. In crisis and war we would obtain access to merchant ships through requisitioning or chartering (on the market or through multilateral and bilateral arrangements with other governments). Provision of war risks reinsurance by HMG provides a valuable incentive to ensure the availability of ships at such as time.

Requisitioning

2. In a period of tension, before the assumption of emergency powers need to be taken, ships would be requisitioned by use of the prerogative power when there is an imminent threat to the United Kingdom or its dependencies. The prerogative was last used to requisition ships for the Falklands Task Force. The power extends to British ships on the United Kingdom register and the registers of dependent territories; but it has not been tested whether this power extends to any ship beneficially owned by an individual or company entitled to register a vessel in the United Kingdom or its dependent territories.

3. During a developing crisis, the Government of the day would need to consider the implementation of emergency powers. Draft legislation has recently been comprehensively reviewed by officials. These would enable HMG to requisition any ship in which a British company or national has a majority controlling interest, either direct or indirect, regardless of its current registration.



4. Despite the potential availability of such wide powers we have considered it prudent to reach agreements with major Flag of Convenience countries to ensure that they would not seek to impede the requisitioning of any British controlled ships on their registers during an emergency. Negotiations through the FCO with Bahamas, Liberia, Panama and Vanuatu are progressing well. A Memorandum of Understanding with Bahamas should be signed shortly, and it is our intention to complete the remaining agreements by the end of this year. There are currently on these four registers about 150 ships owned in the UK and a further 540 ships owned in dependent territories (mainly Hong Kong). The former have already been included in our tables of available ships.

#### Chartering

5. Apart from requisitioning, we could obtain access to ships through chartering either from shipowners on the market or from other governments through multilateral arrangements in NATO or through separate bilateral agreements.

6. We have developed plans for and exercised our shadow organisation (National Shipping Authority) which would, amongst other things, be responsible for obtaining ships on the market. It is not possible to determine how many ships could be obtained by this means, although the number could be significant.

7. Through our membership of NATO we have developed pooling arrangements for ocean-going ships of 1600 GRT and over. These ships would be allocated to members in the overall interests of the Alliance. The NATO pool should provide some mitigation of the more acute supply problems although we cannot be sure that the UK would be a net beneficiary from the arrangement. Unfortunately the figures indicate that the pool will be short of ships that are in currently short supply in the UK, and so it is doubtful whether the pool would compensate significantly for our deficiencies of deep sea ships.



We have long standing bilateral agreements with Denmark and Norway under which we agree to reinsure their merchant fleets in war against a common enemy in return for a first refusal on any ships not required by them. With the subsequent development of NATO plans for ocean-going ships, the agreements with Denmark and Norway effectively cover only smaller ships such as coasters. We intend shortly to open discussions with the Scandinavians to bring these agreements up to date. We have also begun discussions with the Netherlands Government about a similar arrangement covering their smaller ships.

9. Bilateral agreements with Denmark, Norway and the Netherlands would make available up to 1500 coasters for our use. They have not been included in the supply figures since the numbers are not certain; although this substantial additional supply should easily compensate for our deficiencies of coasters and go some way towards meeting our shortage of general cargo ships.

#### War Risks Reinsurance Agreements

10. Agreements between HMG and UK Mutual War Risks Associations have existed since the Second World War. We have recently completed a comprehensive overhaul of the agreements to take account of changes in insurance practices in the market and the lessons we learned during the Falklands hostilities. The agreements have been extended to enable HMG to provide reinsurance cover for ships that are not on British registers. To qualify for reinsurance such ships will have to be on one of the registers with which we have negotiated agreements on availability; and the owners will have to have signed a Contract of Commitment (Annex I). This contract will guarantee that ships covered will be made available to HMG in crisis and war. Our arrangement for war risks insurance are more comprehensive than those developed by any other NATO country including the United States and provides us with a major incentive by which access to ships can be obtained in war.



Summary

11. The prerogative power was used effectively to requisition United Kingdom ships during the Falklands hostilities; and could be used rapidly in a future emergency. Comprehensive draft emergency legislation has been prepared, and could also be introduced quickly. It includes provisions for requisitioning all British controlled ships. We are negotiating agreements with the major Flag of Convenience States to minimise any legal difficulties that might be experienced if we requisition ships on their registers (which will help to ensure the availability of up to 150 ships subject to their owners signing contracts of commitment). We have developed machinery, that can be activated at short notice, to charter ships on the market. We have negotiated comprehensive multilateral arrangements for access to ships owned by our NATO Allies; we have bilateral agreements (which are being reviewed and extended) which will make available up to 1500 coasters. To underpin these arrangements we have extended our war risks reinsurance arrangements to cover both British and foreign registry ships. Reinsurance of Flag of Convenience ships will only be provided for ships that will be made available to HMG in crisis and war. A draft Contract of Commitment for this purpose has been prepared.

12. The UK has been to the fore in planning in this area and there is no other country in the Alliance that has developed such comprehensive and up to date powers, agreements, and machinery that can be activated at short notice to obtain access to merchant shipping in crisis and war.

23 March 1988



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(MReed)

10 DOWNING STREET

LONDON SW1A 2AA

4 May 1988

*From the Private Secretary*

SHIPPING

The Prime Minister this morning held a meeting to discuss merchant shipping. This letter records the main points discussed; I should be grateful if you and copy recipients would ensure that it is circulated only to those with an operational need to see it.

The meeting considered your Secretary of State's minute of 19 April with four attached papers and the paper circulated by the Chancellor of the Exchequer on 30 March. Those present were the Foreign Secretary, the Chancellor of the Exchequer, the Home Secretary, the Defence Secretary, the Secretary of State for Trade and Industry, the Secretary of State for Transport, the Parliamentary Under-Secretary of State, DHSS (Mr. Portillo), and Mr. Richard Wilson and Mr. George Monger, Cabinet Office.

In discussion the following points were made:

- a. The decline of the merchant shipping fleet raised issues of great importance. Action by the Government was now clearly necessary to ensure that our wartime shipping requirements could be met. All other major seafaring nations provided assistance to their merchant shipping fleets in one form or another.
- b. In deciding what needed to be done the main consideration must be that seafarers were unusually mobile. They could readily go to work for foreign owners if they thought it was to their advantage. Because of this mobility, and the importance of our strategic needs, the case for measures of tax relief or extra expenditure to reduce the cost of employing crews was stronger than it would normally be.
- c. It was agreed that PAYE arrangements should not be applied in the Isle of Man retrospectively. For the future one option was not to apply PAYE to crews on ships flagged in the Isle of Man who had been recruited through Manx crewing agencies. But legislation would be needed:

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it would be wrong to condone evasion.

- d. Other ways of providing tax relief for seafarers needed to be considered. There were some arguments against this approach. It risked being too indiscriminate and encouraging demands from other groups for similar concessions. But there were a number of arguments for it. Tax relief would avoid increasing public expenditure and was unlikely to raise difficulties under European Community rules. Greece, Norway, Denmark and the Netherlands all had special tax reliefs for seafarers. In discussion in the Community Council of Transport Ministers most Member States had supported fiscal action as the best way of reducing the cost of employing seafarers.
- e. There were two possibilities for tax concessions. One was to deem British seafarers crewing ships flagged in the Isle of Man or the Channel Islands to be domiciled in those islands. Another was to relax the rules governing their eligibility for the foreign earnings deduction. But there might be others. The need was to establish what system would best meet the Government's objectives with minimum danger of repercussions elsewhere.
- f. National insurance contributions for seafarers did not present the same difficulties as income tax; the Isle of Man authorities had established arrangements for collecting NICs and paying them over to the UK Exchequer.
- g. The alternative to tax relief was some form of subsidy. This could take the form of such payments to the shipping companies as would enable them to gross up seafarers' wages to offset their liability to tax and leave them no worse off than they were now. Another option was the contract with owners of vessels in short supply to secure their availability in time of war which the Transport Secretary had suggested. More work was needed on these options. But any system of subsidy would increase public expenditure: the examples of France and Germany suggested that the increase might have to be substantial. In principle an expenditure subsidy provided the opportunity for better targeting - on ships rather than seafarers - but it would need to apply to the pool of ships from which vessels would be made available in time of war and not just to those actually made available. It would need to be drawn up sufficiently generously to achieve its purpose.

The Prime Minister, summing up the discussion, said that the group were agreed that action must be taken to ensure that we could meet our wartime shipping requirements. This could take one of two forms: the introduction either of new tax reliefs for seafarers, or of a system of subsidies. No final decision could be taken until the options had been worked up in more detail. The Chancellor of the Exchequer and the Transport Secretary should now arrange for this to be done. All the options proposed at the meeting should be considered.



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The work should be done urgently, so that it could be completed before any move on PAYE was announced or implemented.

I am copying this letter to the Private Secretaries of the Ministers at the meeting and to the others present.

PAUL GRAY

Roy Griffins, Esq.,  
Department of Transport.

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P 03098

PRIME MINISTER

MERCHANT SHIPPING AND DEFENCE

(Meeting of Ministers at 9.30am on 4 May)

Relevant Papers

(Minute from Mr Channon of 19 April with four papers attached;  
Note by the Chancellor of the Exchequer of 30 March  
on the taxation of seafarers)

DECISIONS

The purpose of this meeting is to consider the work commissioned in February on the strategic implications of the recent decline in the UK Merchant Shipping Fleet, and to decide what action to take.

2. You will wish to decide:

- i. whether a scheme should be worked up for contracting with owners of vessels in short supply to secure their availability in war. The best course may be to commission further work so that the scheme can be considered at another meeting of the group;
- ii. whether there should be any further consideration of the case for giving special tax or national insurance relief to merchant seafarers. This is more difficult. The Chancellor will be opposed;
- iii. whether the effect of the Revenue's decision to require ship owners to operate PAYE can be mitigated; and
- iv. whether there should be any announcement of work proceeding under (i) or (ii) above. This is likely to be contentious, not least because it would effectively

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commit the Treasury to the introduction of some sort of scheme.

#### BACKGROUND

3. At the meeting of this group of Ministers on 23 February it was agreed that there was no question of providing a general subsidy for the UK shipping industry to bolster its international competitiveness, but that the strategic problem caused by the declining merchant fleet could not be ignored. Work was commissioned to identify options for dealing with specific strategic shortcomings, and the papers now circulated are the result.

#### MAIN ISSUES

##### Strategic Needs & Current Availability

4. This is covered in attachment I to Mr Channon's paper which follows up the discussion on 23 February. Mr Channon says that there are likely to be substantial shortages of three categories of vessel: product tankers of 10-40,000 dwt, large general cargo ships and containerships. The position on product tankers is most serious, and requires urgent action. There is a substantial shortage of general cargo ships (outside the Third World) as more efficient container ships have come to dominate the market. Mr Channon suggests that greater containerisation of military equipment should be pursued. At present the supply of containerships is not so critical; Mr Channon proposes to keep it under regular review.

5. In attachment IV to his paper Mr Channon lists a range of measures for improving availability in time of war. Whatever the outcome of the remainder of the meeting, you will wish to press Mr Channon for as much action as possible on:

- agreeing with foreign owners that their ships will be made available to the UK when needed in exchange for War Risks Reinsurance;

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- rapid completion of the NATO study on the merchant shipping needs of the Alliance as a whole, so that we can establish whether vessels useful to us might be available from the NATO pool;
- re-organisation of the long standing bilateral agreements with Denmark and Norway to cover wider categories of ships, and negotiation of a similar agreement with the Netherlands;
- conclusion of agreements with major flags of convenience that no significant difficulties will be encountered if UK owned vessels registered with them are requisitioned in times of emergency under the Royal Prerogative; and
- greater containerisation of military equipment.

Responsibility for some of these items rests with Mr Younger and Sir Geoffrey Howe.

6. Depending on the discussion, you may also wish to ask Mr Channon to arrange for this group of Ministers to receive regular reports of supply and availability; perhaps once every six months instead of on the present ad-hoc basis. This would ensure that attention was drawn to any further deterioration - or improvement - in the position.

#### Tendering Scheme for Vessels in Short Supply

7. Mr Channon's minute suggests that a scheme for competitive tendering is needed in order to retain under British registration certain categories of vessel which are in short supply. His main arguments are as follows:

- i. it targets the Government's contribution precisely on the vessels most needed for strategic reasons;

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- ii. there will be a competitive process for owners to supply the number of vessels needed for strategic reasons, so costs should be minimised (he mentions a figure of £20m but the actual costs would depend on the results of competition);
  - iii. the Government cannot keep rejecting schemes to meet a strategic need which at the last meeting Ministers agreed has to be faced; and
  - iv. given the international nature of the shipping market, such a scheme may be successful in persuading foreign owners to switch to British registration, thus solving some of our perceived strategic difficulties.
8. The Chancellor may well argue:
- i. that such a scheme could turn out to be highly expensive, particularly if other categories of vessel are brought in later;
  - ii. such a scheme is likely to have to be funded from the Contingency Reserve and might not provide value for money when judged against the Government's other priorities; and
  - iii. it would be necessary to check that such a scheme was consistent with the Treaty of Rome. This could be considered as part of the study. (It may well be permissible as the Commission have been consulted about the assistance under the Merchant Shipping Bill and have not objected).
9. We understand that the Chancellor may be prepared to agree that further work should be done to work up such a scheme, so long as no commitment is implied by this that it will ever be implemented. Depending on the discussion, you may wish to agree

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to Mr Channon's proposal that he works up a scheme along the lines suggested. If so, you will wish to ask how long this will take: two months, in time for discussion before the Summer Recess, might be appropriate.

Special tax relief for seafarers

10. It is not clear whether Mr Channon will choose to pursue his proposal for special tax relief for seafarers. The Chancellor will argue strongly that it should not be considered further on the grounds that:

See  
Paper  
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- i. relief from tax and national insurance relief for seafarers would not be sufficiently targeted;
- ii. special reliefs would be contrary to the tax policy of recent years of minimising exemptions and thereby being able to reduce tax rates; and
- iii. special reliefs would be very unfair to members of the Royal Navy, who have to pay full tax and national insurance however long they are at sea.

You may wish to endorse the Chancellor's line. The possibility of Commission proposals for special fiscal relief for seafarers may be raised. We understand that such proposals are at a very early stage and that no progress on them is anticipated in the foreseeable future.

11. If there is any suggestion of special relief from national insurance contributions for seafarers, Mr Portillo is likely to take the same line as the Chancellor. IoM crews already pay national insurance to the Manx authorities, so the shipping companies will only save such costs by further reflagging.

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Implementation of the Revenue's decision on PAYE

12. In recent years, many owners have transferred ships from the British flag to the Isle of Man (IoM) flag. Where crews have been recruited through IoM crewing agencies, PAYE has not generally been operated. This was one of the main points discussed at your previous meeting. But Mr Channon now apparently accepts that PAYE must be applied in these circumstances, and you may therefore not wish to reopen that question. He appears to be more concerned now to mitigate the effects of the change. We understand that he may concentrate on three points:

- i. the Revenue should not seek to collect back tax from the companies. It is possible that the Revenue may be content to agree to this;
- ii. the Revenue should simplify the administration of Foreign Earning Reduction, so that they do not collect tax under PAYE from crews which are likely to be 100% exempt in any event. We understand that the Revenue will be willing to discuss ways of achieving this with individual shipping companies. This should satisfy Mr Channon;
- iii. the Revenue or other parts of Government (as appropriate) should provide definitive guidance on the wider implications for the companies of having to operate PAYE. For example, does it mean that crews employed through agencies will have a direct relationship with the shipping companies again, entitling them to employment protection? This point (which is not in Mr Channon's paper) will be more difficult for the Chancellor, but an understanding might be attainable.

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Announcement

13. This may be the most controversial part of the discussion. Mr Channon will wish to announce that a scheme to offer contracts to owners of vessels in short supply is being worked up in order to try and prevent substantial re-registration to flags of convenience in response to the decision on PAYE. He will also know that such an announcement would effectively commit the Treasury to the introduction of some form of scheme. He will point out that, if there is substantial reflagging, the subsequent announcement of a scheme will be viewed as reacting to a horse which has already bolted, and that any such scheme is likely to be more expensive to operate if vessels have to be tempted back from foreign flags than if they had remained registered in Britain and the IoM.

14. The Chancellor is likely to counter this by arguing that any announcement at this stage could only be in general terms, and would lead to pressure for a more comprehensive and expensive scheme than was contemplated; that it is contrary to normal good practice to announce any Government policy before it has been fully worked up and considered; that the cost of the scheme would be an extra call on the Reserve; and that the timing of such an announcement would be particularly unfortunate given both the recent decisions that have led to calls on the Reserve and the possibility of further early announcements on British Ship-builders.

15. The problem would disappear if the Revenue could be persuaded to hold off from writing to the shipping companies about their decision on PAYE until the review of the proposed subsidy is complete. You may wish to ask the Chancellor if this is possible. He may say that postponement would put the Revenue's Accounting Officer at risk.

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Arrangements for a further meeting

16. If you ask for a contractual scheme to be worked up as a basis for further discussion, it would be appropriate for this group of Ministers to meet again to consider<sup>it</sup> perhaps just before the Summer Recess. You could also commission papers for that meeting on:

- i. the industry's response to the PAYE decision (assuming the companies have been informed by then); and
- ii. progress in pursuing the measures in paragraph 5 for improving the availability of vessels in an emergency.

**HANDLING**

17. You will wish to begin by inviting the Secretary of State for Transport to introduce his papers. The Secretary of State for Defence and the Chancellor of the Exchequer have also contributed papers, and could be invited to speak next. The Foreign and Commonwealth Secretary, the Secretary of State for Trade and Industry, the Chancellor of the Duchy of Lancaster, and the PUSS/DHSS (Mr Portillo) may wish to contribute to the discussion.

RJW.

R T J WILSON

Cabinet Office  
29 April 1988

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PRIME MINISTER

29 April 1988

MERCHANT SHIPPING AND DEFENCE NEEDS

This note discusses the conflict that exists between the government's wartime requirements and the government's peacetime requirements for a merchant shipping fleet.

It draws on information from various departments and information gained at a recent conference entitled "A Future for Merchant Shipping".

Recommendations are made for Government action.

Introduction

The responsibility for being adequately prepared for wartime rests with the government.

Primarily the Ministry of Defence determine not only the direct support required for the armed forces but also (by their choice of hypothetical war) the transatlantic sea-lift and civil resupply requirements. At one end of the spectrum, global nuclear war implies that very few ships will be required. A protracted conventional war in Europe however implies a need for many more ships of various types.

The responsibility of the shipping companies is to their shareholders.

Their aim is to make a return to their shareholders and if this means moving out of the shipping business into other more profitable enterprises they will and should do so.

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Market forces are inexorably moving the size and diversity of the merchant shipping fleet away from the wartime requirements.

There is a conflict between government wartime requirements and government peacetime requirements.

Only the government can choose what level of "war insurance" they are prepared to pay for during peacetime.

#### The shipping lobbies

The various shipping organisations have not particularly helped themselves.

Their arguments for subsidies (by whatever name) have often been founded on fuzzy logic, liberally tempered with nostalgia. The hard businessmen amongst them on the one hand have been getting on with the business of getting out of shipping or finding profitable niches. On the other hand they have looked to see if there are "free hand outs" about. (Both strong and weak businessmen know the value of a free handout, the former just make better use of them).

Arguments put forward by the shipping lobbies about the defence needs are qualitatively if not quantitatively valid. They are cries from the hearts of many who participated in World War II. They recall the lack of preparedness then and compare it with what they see as the present day situation. Unfortunately the defence argument has been used as a means to gain an extremely beneficial end - a subsidised industry!

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Ministry of Defence/Department of Transport

The MOD see their prime responsibility as identifying the types of merchant ships they directly need for military support. They expect first call on the merchant fleet and they expect DTP to be responsible for the indirect requirements of transatlantic sea-lift and civil resupply. In fact as all requirements depend on whatever hypothetical war the MOD chooses for its planning purposes. Current estimates by MOD/DTP show that, with the exception of product tankers, the direct requirements for the UK armed forces can be met at present almost entirely from ships on the UK mainland, Isle of Man, Channel Islands and Bermuda registers.

The situation for transatlantic sea-lift and civil resupply is much less healthy with deficits in general cargo ships approaching 500. Other types of vessel, are also in deficit.

The future for British shipping

Inexorably, market forces are driving the UK shipping companies to dispose of ships, flag out and leave the business altogether. Niche markets exist where there is comparative advantage but these will not match defence requirements.

It is wrong to say that the UK shipping industry is not healthy. Parts of it are very healthy indeed. However it should be remembered that UK shipping companies do not need to own, operate or crew the ships they require for their shipping business. Ships are only a means to an end and that end is the efficient and economical carriage of cargo. Leasing and chartering are often the most economical way of carrying out the transportation business. The UK shipping

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industry can survive - but not in the form the government might wish for in times of hostilities.

#### The Government's Role

The only important question for government is: How to guarantee access to sufficient numbers of the right types of ships with crews sympathetic to the government's aims in time of war?

Again I come back to the MOD's responsibility. Only they can define what level of allegiance is required. The spectrum ranges from

- (a) UK-owned, officered and crewed ships, to
- (b) UK-owned, UK officered and foreign crewed ships, to
- (c) impounded foreign-owned, officered and crewed ships.

The shipping industry is moving towards the lower cost end of the spectrum of chartering in foreign-owned, officered and crewed ships. If the government wishes greater UK involvement there will be extra costs to the account of the government.

The costs to the government increase with the level of UK participation they wish and also with the amount of mis-match between economic, peacetime fleet shape and strategic wartime requirement. In order to ensure accountability the MOD should be responsible for those extra costs.

#### How to pay a subsidy

Over the past three years various suggestions have been put forward by DTp as to how to ensure the merchant shipping

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needs can be met in time of war. These have included special front-ended depreciation allowances, roll-over relief of balancing charges, an investment grant targeted to short sea vessels, an emergency availability premium for deep sea vessels, tax relief and national insurance contributions relief for seafarers.

The great difficulty is ensuring that any subsidy is properly targeted.

If it is aimed at shipping companies in general there is a danger of cross-subsidising another part of its business.

Targeting seamen might be setting a precedent for other industries who believe they also fulfill a strategic requirement during times of war.

Finally, is it possible to target selectively in accordance with the type of vessel the MOD require? How is this targeting handled if the MOD change their requirements? Would targeting have to be so broad as to imply a large amount of deadweight?

#### The way forward

Perhaps the best way forward is to build on the proposals in the Merchant Shipping Bill.

The two most useful areas of the Bill relate to:

- (1) Financial assistance to merchant shipping via assistance in respect of training and crew relief costs.
- (2) The formation of a merchant navy reserve.

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One of the most important factors for the future of the British shipping industry, both direct and indirect (financial institutions, maritime insurance etc) is the continued provision of good well-trained officers and ships engineers. It is essential to provide a rewarding career for these officers or they will choose to go into other businesses. It is particularly important to remember that if we are going to have a highly technological shipping industry in the future, efficiently and economically run, the shipping companies are going to need to compete for candidates at A level or university level with all of the other businesses of our expanding economy. At the moment the shipping industry is not seen as an attractive career for the bright graduate. A new improved training programme together with a strong career path will help revive interest.

The merchant navy reserve provisions could well be strengthened by judicious selection of the qualifications required for entry. There is no need to limit the reserve to former seafarers. Indeed "former seafarers" imply that we will have an ageing and declining body of men. Rather perhaps the reserve should be open to all seamen with carefully defined qualifications. Reserve pay could be tailored to strategic need. Effectively, via the Merchant Shipping Bill, the Ministry of Defence and the Department of Transport could top up salaries of strategically required officers and engineers.

Finally, and unfortunately, outwith the scope of the Merchant Shipping Bill, we need some means of ensuring an adequate supply of ships which do not figure in the economic business of the UK shipping companies. The only way forward that I can see is for the MOD/DTP to call for competitive tenders for the provision of those ships. The competitive tendering would contain restrictions on the basis of flag,

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minimum UK equity ownership and of the percentage of UK officers required. The conditions should not however be so restrictive as to require UK registration which would imply 100% UK crews.

#### Government action

It is essential that the government act now by making a statement as to its intentions with regard to the British merchant fleet. The statement should essentially say:

The government remains committed to ensuring that the UK has access to sufficient merchant shipping during times of hostilities. During peacetime the government will continue to fight against protectionism and unfair practices internationally but where necessary to protect its wartime strategic requirements, the government will provide means of assistance commensurate with the level of those requirements.

#### Conclusions

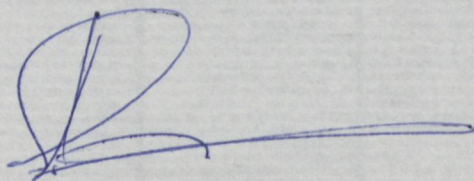
- (a) There is conflict between the government's wartime requirements and the government's peacetime requirements.
- (b) Only the government can choose what level of "war insurance" they are prepared to pay for during peacetime.
- (c) The shipping industry can be healthy, but not in the form the government might wish it to be in times of hostilities.

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- (d) Only the MOD can define what type of war they are planning for. This decides all of the wartime merchant shipping requirements.
- (i) direct military support
  - (ii) transatlantic sealift
  - (iii) civil resupply.
- (e) Only the MOD can define the level of "allegiance" they require from the merchant fleet.
- (f) The MOD should be responsible for any additional costs in ensuring the merchant fleet in peacetime matches their demands in wartime.
- (g) Building on the provisions of the Merchant Shipping Bill provides a good way forward.
- (h) The government must make a statement as to its intentions with regard to the Merchant Shipping Fleet.



GREG BOURNE

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PRIME MINISTER

29 April 1988

MERCHANT SHIPPING AND DEFENCE NEEDS

The Secretary of State for Transport has submitted a minute dated 19 April on Merchant Shipping and Defence. He has argued, quite rightly I believe, that urgent action is required. The trigger for that action is the imminent announcement by the Inland Revenue that they intend to ensure that the employers of British seamen employed through offshore agencies, are required to collect PAYE.

In a note by the Chancellor on Taxation of Seafarers dated 30th of March, he explains why he believes the Inland Revenue cannot make concessions to seamen. He however believes that the shipping companies should be "indifferent" to whether or not they collect PAYE.

The shipping companies are not indifferent to whether or not they collect PAYE. Even though they actively counsel their employees, they know that wide scale tax evasion takes place. It is the seamen themselves who will eventually move to ships with flags of convenience in order to keep net pay at a significantly higher figure than if they work through an agency or company that operates PAYE. The shipping companies will take one of two actions. Some will commence flagging out immediately, others will fight the ruling and if they lose will then commence flagging out. The PAYE issue is the catalyst.

In the attached note I have argued that urgent action is required to resolve the conflict between the government's wartime requirements and the government's peacetime requirements.

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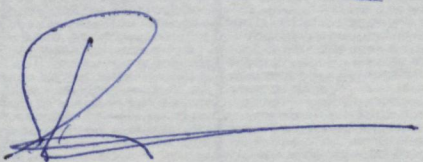
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Only the government can choose what level of "war insurance" they are prepared to pay for during peacetime.

Recommendations

At your meeting with colleagues I believe you should:

- (a) Support the Chancellor's view that PAYE relief for seamen would not be sufficiently well targeted and would be a dangerous precedent.
- (b) Ask the Chancellor if the Treasury have any constructive suggestions to make with regard to balancing the peacetime needs with the wartime requirements!
- (c) Support Paul Channon's recommendations that:
  - (i) urgent action is required by
  - (ii) reinforcing the measures adopted in the Merchant Shipping Bill and that:
  - (iii) DTp should work up a scheme for contracting with owners for supply of certain types of ships, initially product tankers.
  - (iv) DTp should keep the position of other types of ships under review.
  - (v) the communication by the Inland Revenue be delayed until an appropriate statement by DTp can be made as to the government's intentions regarding the British Merchant Fleet.

  
GREG BOURNE

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PRIME MINISTER

MEETING ON MERCHANT SHIPPING AND DEFENCE: 4 MAY

At your meeting on 23 February you commissioned further work on the problems arising from the substantial fall in the size of the British Merchant Fleet. This meeting is to discuss the range of further papers now prepared.

The enclosed papers are:

Flag A - a summary paper by Mr Channon

Flag B - a set of five specific papers; I-IV by Messrs Channon and Younger and V by the Chancellor

Flag C - a brief by the Cabinet Office. I suggest you use this as your handling brief for the meeting.

Flag D - two notes by the Policy Unit.

*Recd.*

Paul Gray

29 April 1988

*The P.A.Y.E. trigger  
is in Ted's  
immediate hands  
not*



File



BSG

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

28 April 1988

MERCHANT SHIPPING AND DEFENCE

This is to confirm that the Prime Minister will be holding a meeting on this subject at 0930 hours on Wednesday 4 May, to which the Home Secretary is welcome to attend. I enclose copies of the papers for this meeting.

Paul Gray

Philip Mawer, Esq.,  
Home Office.

Covering CONFIDENTIAL



B.R.

Chaler  
Thanks. Done.

~~M. GRAY~~

Rec'd 22/4

MEETING ON MERCHANT SHIPPING AND DEFENCE

John Moore's office have been in touch to say surely they should be present at the meeting since a good deal of it touches on social security matters. It sounds sensible to me. Could you invite them if you have no objection?

C.D.P.

CHARLES POWELL

26 April 1988





Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

6 April 1988

Paul Gray, Esq  
No.10 Downing Street  
London SW1

Dear Paul

**SHIPPING: TAXATION OF SEAFARERS**

At the Prime Minister's meeting on 23 February the Chancellor was asked to provide advice on the PAYE/Isle of Man problem and on the personal taxation of seafarers.

... I attach a note by the Chancellor on these matters.

I am copying this letter and enclosure to Tony Galsworthy (Foreign and Commonwealth Office), Brian Hawtin (Ministry of Defence), Alison Brimelow (DTI), Geoffrey Podger (DHSS), Roy Griffins (Department of Transport), Peter Smith (Chancellor of the Duchy of Lancaster's office), Richard Wilson and George Monger (Cabinet Office).

Yours,

Moira

MOIRA WALLACE  
Private Secretary





CC BA  
(minute only)

Prime Minister

MERCHANT SHIPPING AND DEFENCE

Following our meeting on 23<sup>1</sup> February about the potential demand for merchant shipping in an emergency and war, five papers have been prepared:

- Apap. PT3
- (I) George Younger and I have analysed specific merchant shipping requirements;
  - (II) I have drawn up a note on offshore manning contracts;
  - (III) I have contributed a paper on the response of other countries to the decline of their fleets, and
  - (IV) another on access to merchant ships in crisis and war;
  - (V) Nigel Lawson has provided a paper on the taxation of seafarers and the PAYE problem.

Nigel Lawson's paper (V) was circulated on 6 April. I am enclosing the remaining papers (I)-(IV) with this minute.

2. It may help to focus our next discussion, on 4 May, if I now attempt to draw the threads together.

Strategic Needs

3. Enough ships are available at present to provide direct support for the Royal Navy and the Army, though the supply of product tankers may become critical if shipowners move away from





offshore registers (a threat because of the PAYE problem - see para 9) or if the vessels are not replaced as they are scrapped. If war broke out, however, there are likely to be shortages for other purposes in at least three categories of vessel - product tankers, container ships and larger general cargo vessels (Annex D to the paper (I) on Merchant Shipping Requirements in Emergency and War). The NATO pool is most unlikely to be able to supply enough product tankers to enable our essential fuel demands to be met in wartime. The shortfall in container and break-bulk general cargo vessels for transatlantic reinforcement is due in part to the shrinking of the UK fleet. In wartime there would also be a shortage of vessels for the importation of foodstuffs and other essential commodities not shipped in bulk, and this would be exacerbated if hostilities broke out before transatlantic reinforcement was complete. If hostile action resulted in the loss of container facilities at the major ports, there would be a requirement for larger numbers of general cargo vessels which could certainly not be met from either our own or NATO resources.

4. These calculations take fully into account all the opportunities for getting hold of UK-owned vessels operating on foreign registers. We are examining the possibility of obtaining further ships on the assumption that foreign owners would be tempted by the prospect of profits, backed up by the UK's War Risks Reinsurance Agreements, to charter their ships to the UK. But it would be unwise to rely on much assistance from this source, since these ships would be in neither British nor NATO countries' beneficial ownership; and the foreign owners concerned might, for geopolitical reasons, be unwilling or unable to commit themselves to the UK at an early stage of a war.

5. I have reviewed what others have done. The Americans have been giving general operating subsidies to liner companies for





40 years in order to maintain a minimum fleet for strategic purposes. They also maintain a substantial mothballed fleet. In 1986 the cost to the US Government of operating subsidies was \$288 million, while the cost of the Ready Reserve fleet was \$363 million including \$217 million for acquisitions. Elsewhere, the strategic role of the merchant marine tends not to be recognised overtly, but many countries assist their fleets for a variety of reasons, usually to maintain employment in a traditional industry or as a by-product of help to shipbuilding. Investment grants or tax allowances are probably still the most important method of assistance.

#### Assistance with Crew Costs

6. Although at present there is a problem over re-investment, the largest single factor in the competitiveness of British shipping and that of all the traditional maritime countries, is the cost of crewing. Increasingly, Western European countries are turning to offshore registries to help their owners stay in shipping while avoiding the high costs associated with the employment of their own nationals. The strategic implications of this increasing dependence on foreign crews are only just now beginning to be appreciated. In some European countries the trend - likely to be reflected in proposals from the Commission - is towards relieving owners of at least some of the extra cost of employing EEC nationals, probably through tax or social security concessions. Norway, Sweden, Denmark, Netherlands and Greece have all moved very firmly in this direction; though primarily, we believe, for commercial rather than defence reasons.

7. Our own policy, in the absence of any significant investment incentives or special concessions for UK seafarers, has been to work for open shipping markets and to rely on the freedom of owners to flag out to convenient British (Crown Dependency and





Dependent Territory) offshore registers, in the hope that the attractions of British flag registers will be sufficient to keep the necessary ships available. By moving from the UK register owners have managed to make significant savings by negotiating new contracts of employment with their existing employees. When the Merchant Shipping Bill receives Royal Assent we shall be able to give our shipowners some modest help with training and crew travel costs, but the budget for these is limited to £8.5m in the first full year.

8. Doubts about the longer-term effectiveness of this policy flow from:

- (i) the possibility that the application of PAYE (and in some cases employers' NICs) to UK resident seafarers employed by overseas manning agencies will, by seriously reducing the attractiveness of these arrangements, lead to ships being reflagged further away with non-British crews;
- (ii) the fact that, regardless of the flag under which they operate or the crew which they use, British shipowners, except those in the passenger sector, have not since 1984 found the business sufficiently profitable to renew more than a negligible part of their investment.

9. What can we do about these threats? When the Revenue give their decision to require PAYE deductions, there may of course be an appeal which could delay the reaction. The Revenue may be able to offer an administrative simplification in respect of those seafarers entitled to Foreign Earnings Deduction. But there must be a risk that several owners may switch - particularly away from the Isle of Man - to more attractive foreign registers. This is potentially serious since, to take





product tankers which is one of the categories where we foresee a shortage, there are 73 vessels on the Isle of Man/Dependent Territories Registers out of a British flag total of 140.

10. In my view, the most effective ways of reducing the risk of this flight from our offshore registers would be first, for the Revenue not to seek retrospective collection of tax prior to the start of this financial year; secondly, to announce that we are studying ways of reducing the impact of personal tax and social security obligations on UK seafarers employed by British shipping companies in certain trades at least.

11. Just as we cannot insulate ourselves from world-wide trends in personal taxation generally, so we cannot ignore what other countries are doing in this field if a UK-manned fleet is to remain competitive. Tax and NIC payments can amount to as much as 19% of total crew costs - about 4% of total costs - on a product tanker, though the foreign earnings deduction will reduce the tax liability for some seamen.

12. I recognise that Nigel Lawson and John Moore will find it difficult to accept concessions of this sort and also that to announce such a review would raise expectations which might in the end have to be disappointed. I also understand that the Revenue feel that with the new tax year now starting they must very shortly contact the shipping companies about PAYE, and that the shipping companies also are anxious for an early decision. Whatever decision may be made on a review I do hope that, at the very least, the Revenue will not seek retrospective reduction of tax from previous tax years.

#### Investment

13. At our previous meeting it was agreed that we should try to target any assistance to the vessels that were likely to be in





particularly short supply. I therefore consider the three areas of shortage - product tankers, container ships and larger general cargo vessels - separately.

14. On container ships, since I first drew attention to the lack of investment two months ago, P & O have ordered one large container vessel for operation on the UK register. While this is an encouraging development, it is too early to say whether it signals a general improvement in the climate for investment, and will not of itself make much of an impact on the problem of transatlantic seafight. I propose keeping developments in this sector under close review. The arrangements I propose below for product tankers will need to take account of the possible need to apply them to container ships later.

15. Break-bulk (general cargo) ships are steadily disappearing as more modern, efficient container ships take over. But shipping patterns will change in wartime for a number of reasons. Present indications are that we would have a shortage of 600-800 general cargo ships and we can never hope to have enough of these in British ownership to satisfy the war-time demand. This will inevitably be a difficult area to deal with, because of the large number of vessels involved and because they are now more common in the Third World than in the North Atlantic. There is no single answer and I do not suggest trying to secure more of these ships in peace-time. I am, therefore, looking at other ways of helping meet the demand. For example, there may be a certain limited scope for making arrangements with friendly states to charter them quickly in emergency or war, or for paying owners of the smaller container ships to install special gear. It would also be helpful if the containerisation of military supplies could be increased.

16. The third area, which I believe does demand immediate action, is product tankers. Here we expect to be between 40 and





80 ships short of meeting a potential demand for nearly 200 in the range 10,000 - 40,000 dwt. These estimates do not fully reflect the reductions in demand that might result from rationing, but neither do they take account of possible losses through enemy action. On the best evidence we have available, this is a vessel category in which a serious general shortage is likely to emerge in wartime. The consultant advising the NATO Study has said that there is no likelihood of the NATO pool being able to supply sufficient product tankers to enable UK essential fuel demand in wartime to be met since there are only just enough tankers to meet Europe's peacetime requirements. More tankers would be needed in wartime to ship crude oil and product to compensate for the capacity reduction which would result from the loss of North Sea oil and loss of production from European refineries because of enemy action.

17. I believe that we need to take action to ensure the availability of this type of vessel, and I propose that we devise a scheme for this purpose. This could take the form of compensation payments for operation under the British flag of between £50,000 and £250,000 annually per vessel, depending mainly on how many of the crew were British. However, I propose to minimise the cost by a competitive tendering arrangement under which UK owners would contract with us to retain a given number of specified tanker types under the British flag with suitable crews (perhaps a full complement of British officers). This would in effect reflect the extra crewing costs beyond what was commercially justifiable but the element of competition would make the costs payable by Government as low as possible. The scheme would have to apply to all vessels that we need in the specified categories, not merely to the number by which we fall short of the target. If we have to pay an average cost of say £100,000 per vessel the annual cost for 200 product tankers would be £20m, but the actual cost would depend on the results of the competition. Further work will need to be done by officials on such a scheme and primary legislation will be





required. I believe that a scheme of this sort would guarantee the product tankers needed in wartime and that it could, if necessary, be extended to other types of vessels later.

#### CONCLUSION

18. Over the last three years, we have considered collectively or bilaterally with the Treasury a number of options for helping the British shipping industry to compete more effectively and thereby help to meet our strategic needs. These have included

- special front-ended depreciation allowances
- roll-over relief of balancing charges
- an investment grant targetted to short-sea vessels
- an 'Emergency Availability Premium' for deep-sea vessels, designed to encourage the use of Dependent Territory Registers.

None of these schemes has found favour with colleagues. We cannot go on rejecting ideas for dealing with the problem for ever.

#### RECOMMENDATIONS

19. I hope that we can agree that:-

- (i) urgent action is needed to ensure that we can meet the wartime shipping requirements as set out in the paper prepared by George Younger and me;
- (ii) reinforcing the measures we are adopting in the Merchant Shipping Bill, we should take every opport-





unity we can of reducing the extra cost to owners of employing British crews;

- (iii) the Inland Revenue should not seek retrospection beyond the start of this financial year and should look for administrative means of reducing the impact of PAYE;
- (iv) the case for alleviating the personal tax and social security burden on the industry should be further examined;
- (v) I should work up a scheme for a contract with owners of vessels in short supply to secure their availability in war;
- (vi) I should be prepared to announce that we are considering these further measures, to mitigate the likely reaction to the communication by the Inland Revenue of their decision on PAYE;
- (vii) the position on other types of ship should be kept under review and that I should continue to examine alternative ways of satisfying the wartime demand for break-bulk ships, including the containerisation of NATO's Transatlantic reinforcement requirements.

20. I am copying this minute and the papers to Nigel Lawson, Geoffrey Howe, Douglas Hurd, George Younger, John Moore, David Young and Sir Robin Butler.

PC

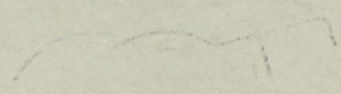
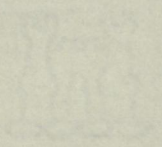
PAUL CHANNON  
19 April 1988



DEFENCE : Policy  
PT 3



COMPTROLLER







MINISTRY OF DEFENCE  
MAIN BUILDING WHITEHALL LONDON SW1A 2HB

Telephone 01-218 2111/3

MO 21/2/33L

5th April 1988

Prime Minister

I think that these changes adequately meet the points made at OD. Cdr

Dear Carol,

DEFENCE WHITE PAPER

minutes attached

The Cabinet draft of Volume 1 of this year's Defence White Paper is to be circulated on 7th April. You may wish to know, in advance of that, how we have taken account of the comments made at the OD meeting of 17th March:

a. A new paragraph has been included in Chapter 1 to bring out the intimidatory use to which Soviet military power might be put for political ends. It reads as follows:

" 108. There is no reason to believe that Soviet leaders want war in Europe. But the Soviet Union has not in the past been reluctant to exploit the threat or use of force to achieve its political ends. And its avowed aim of removing all nuclear weapons from Europe would expose the countries of Western Europe to the intimidating power of Soviet superiority in conventional and chemical forces, which could be used in attempts to impose Soviet will."

b. Lord Carrington's staff have been consulted about our figures for the conventional balance in Chapter 6, and they have reaffirmed that these would give NATO no cause for concern. Their reasoning is that there are, at present, no agreed NATO figures and none are expected to emerge (even on a classified level) until the summer at the earliest. If NATO figures are subsequently published (and this would be much later), and if there were any significant differences, their feeling is that the footnotes against the figures in the White Paper provide sufficient caveats to enable us to explain how these occurred.

c. A new paragraph has been added to Chapter 2, to strengthen the argument about the Warsaw Pact's superiority in conventional forces, drawing on the summit Statement on conventional arms control:

Charles Powell Esq  
10 Downing Street



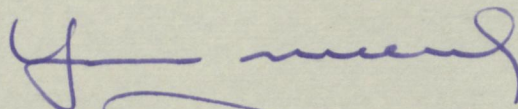
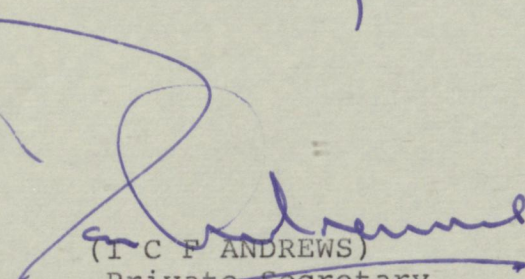


" 215. As the NATO summit concluded, the major problem is the Warsaw Pact's superiority in key conventional weapon systems. But other asymmetries are also important, including the Pact's capability for surprise attack and large-scale offensive action, based on forward-deployed Soviet forces (see page [ ]), and the geographical advantages enjoyed by the Pact with consequent benefits for its reinforcement capability (see pages [ ] and [ ]). These asymmetries are compounded by the dominant presence of Soviet conventional forces, which comprise two-thirds of all active Warsaw Pact divisions in Europe west of the Urals."

In addition, we have made some further changes that will appear in the Cabinet draft:

- a. A recasting of the opening three paragraphs of Chapter 1. This is essentially a rearrangement of existing material to improve its presentation and impact without affecting the content. A copy of these paragraphs is attached.
- b. Adjustments to the essay on 'Soviet Military Doctrine', to take account of the wider publicity recently given to alleged changes in Soviet thinking. The effect of these is to recognise more fully than in the original draft that there has recently been further debate in the Soviet Union about the conduct of any war with NATO and, in particular, the playing-down by Soviet strategists of the concept that the Socialist countries could only be defended by adopting an operationally offensive posture. But the essay continues to emphasise that the Soviet Union still has a force that is structured, equipped and trained for offence and surprise; there has thus been no change in the thrust of the argument.

I am sending copies of this letter to the Private Secretaries of other members of OD, the Secretary of State for Northern Ireland, the Chancellor of the Duchy of Lancaster and the Chief Secretary; and to Trevor Woolley in the Cabinet Office.

  
  
(I. C. F. ANDREWS)  
Private Secretary



## CHAPTER ONE: MAINTAINING SECURITY IN A CHANGING WORLD

## THE DUAL APPROACH

101. The last year has seen continued improvement in the atmosphere of East-West relations and important achievements for NATO's strategy for peace. At the end of 1987, the two elements of the Alliance's balanced security policy - strength in defence and readiness for dialogue - brought about the first ever negotiated reduction in nuclear weapons. At their summit meeting in Brussels in March this year, NATO Heads of State and Government reaffirmed the validity of this dual approach, and reasserted the vital importance of the Alliance's strategy of deterrence, as the guarantee of our collective security. It was thus a successful year for NATO and for British defence policy, confirming our policies on the course that we and our allies must follow to maintain security in a changing world.

102. A year of unprecedented progress in arms control discussions between the United States and Soviet Union culminated in the signature, in December 1987 at the Washington summit between President Reagan and Mr Gorbachev, of the historic treaty eliminating US and Soviet ground-launched intermediate-range nuclear (INF) missiles. As the NATO summit agreed, this is a milestone in the Alliance's efforts to achieve a more secure peace, and the result of the political courage, realism and unity of its members. Soviet leaders were brought to the conference table because NATO deployed, in the face of much opposition, limited numbers of INF missile systems comparable to those already deployed by the Soviet Union. Unilateral gestures could never have achieved the same result. Indeed, had such gestures been made, we would face today the increased threat from Soviet missiles, with no countervailing force on the Western side.

103. The last year also saw the successful introduction of the confidence- and security-building measures agreed at the Stockholm Conference of 1986. And there was encouraging progress in other areas of arms control including, particularly, US-Soviet negotiations on strategic nuclear weapons, where there is now the prospect of agreement on a treaty reducing superpower armouries by 50%. Further details are given in Chapter 2.





## **TAXATION OF SEAFARERS**

### Note by the Chancellor of the Exchequer

At our meeting on 23 February I was asked for papers on the PAYE/Isle of Man problem and on the personal taxation of seafarers.

This note looks at the present position, and possible changes to assist with crewing costs. My conclusion is that tax changes would not offer a sensible solution to the problem of uncompetitive British crewing costs on ships which we wish to retain on the British register for defence reasons.

#### PAYE and the Isle of Man agencies

Until a few years ago, most shipping companies employed their crews directly and operated PAYE like other UK employers. Over the last few years many have stopped employing the crews on their ships and instead engaged them through overseas agencies. The crew then have their contracts of employment with the agencies and are paid by them. The shipping companies are not operating PAYE for crews engaged in this way.

The point at issue between the Revenue and the shipping companies is whether they are still required to operate PAYE when they engage their crews through offshore agencies. The law makes special provision for circumstances in which an employee of one person works for another. Where that second person has "general control and management" of the work done, he is liable to operate PAYE, even though the worker concerned is not his own employee and is not paid by him.





So the question the Inland Revenue have been considering is whether the shipping companies have the "general control and management" of the work done by the crews of their ships. The circumstances vary in detail, and, of course, the Revenue have not yet obtained information on every case. But the general picture emerging is that the shipping companies do have the control and management of the work of the crews on their ships, and the Revenue's legal advice is that the shipping companies should be operating PAYE.

Because of our discussions, the Revenue have not yet given their views to the shipping companies. The shipping companies would, of course, have an opportunity to persuade the Revenue that their views are mistaken, initially through discussions and, if they wished, through appeals to the Appeal Commissioners and, ultimately, to the Courts.

The question of whether or not the shipping companies should be operating PAYE ought not to be a big issue for them. PAYE is an administrative arrangement for collecting the crew's UK income tax liability. It does not affect the amount of the tax for which they are liable, and the tax paid to the Revenue is not an additional cost for the shipping company. There are, of course, some administrative costs; but the system has been much simplified recently, and the cash flow benefits of retaining the tax before paying it over to the Revenue mean that there is often little or no financial cost for the employer.

While the operation of PAYE should thus be a matter of relative indifference to the shipping companies, it is important for the Revenue. Deduction at source is self-evidently a more efficient and effective way of collecting tax than looking to each individual seaman to settle his own tax liability. And the Revenue cannot collect the liability directly from the seamen if the shipping companies ought to be operating PAYE. In any event, the Revenue





has to apply the law to the shipping companies in the same way as it is applied to all other employers.

I can see no conceivable basis on which I would be justified in picking out shipping companies for a special exemption from PAYE obligations. Everyone would know that that would be little help to them, unless the assumption was that they would be able to negotiate lower wages on the footing that their crews would, in one way or another, avoid paying any UK income tax on their pay. We would thus implicitly be encouraging and condoning that situation. In any event, it would make no sense to maintain the tax charge on UK seamen while depriving the Revenue of the administrative arrangements necessary for collecting the liability. And since PAYE is simply a collection mechanism, it would be impossible to justify exempting shipping companies from its requirements and not others in similar situations. Many UK companies, particularly those operating in such areas as financial services, oil and computers, are currently operating PAYE in respect of individuals working for them in the UK but still employed and paid by their foreign employers. And it would not be particularly difficult for other employers to transfer their employment function to an offshore company and to seek, by analogy with the shipping industry, to remove any PAYE obligation. Even if we abandoned PAYE and the seamen thus achieved a de facto exemption, that might not be sufficient, particularly in the longer term, to bridge the gap between UK wage levels and those of competent third world crews.

But while I believe the PAYE position must be maintained, I recognise that starting tax deductions again could in certain circumstances increase the shipping companies' difficulties. The fact of the matter is that some seafarers - perhaps the majority of those concerned - have recently been receiving their earnings tax free. To the extent that shipping companies have already negotiated wage rates on this basis which are lower than they would





otherwise have been, starting PAYE again would put upward pressure on pay costs. I have, therefore, considered whether there is any solution in reducing the tax liabilities of UK seafarers.

### Taxation of Seafarers

The taxation of seafarers, like other people, turns mainly on two considerations

- whether the seafarer is resident in the UK for tax purposes
- whether he performs his duties in the United Kingdom or overseas.

A non-resident seaman is only liable for tax on earnings in the United Kingdom. But if the seafarer is resident in the UK - and most UK seamen will be because they have their homes here and spend a fair amount of time in this country - he will be liable to UK tax on all his earnings, whether the duties are performed in the UK or overseas.

There is, however, a special tax relief which, although it was not introduced with seamen in mind, can provide a substantial benefit for UK resident seamen who work overseas for long periods. The 100% foreign earnings deduction is given where a seaman spends a period of 365 or more days overseas with not more than 62 consecutive days in the UK.

Because of the diverse and quickly changing pattern of shipping - and the cessation of PAYE in many cases - the Revenue do not have a clear picture of the aggregate tax liabilities of UK seamen employed in the deep sea trades which are most exposed to foreign competition. The GCBS have recently quoted a figure of £70 million for the tax liabilities of British seamen on UK





registered ships. Of those employed in the deep sea trades, some will be exempt because they are non-resident and some - possibly an increasing number because the shipping companies are said to be planning seamen's work in that way - will qualify for the 100% foreign earnings deduction. But under the present rules it is probably the case that at least as many are due to pay tax in the UK as are exempt.

### Possible Changes

I have considered two possible ways in which the liabilities of seafarers might be reduced with a view to reducing, indirectly, the crew costs of British ships - an exemption for particular classes of seafarers, or an extension of the present reliefs for people working predominantly abroad, either through the residence rules or the 100% foreign earnings deduction.

### An Exemption for Seamen

This looks extremely unattractive as a matter of tax policy.

We would need to define the particular types of seamen - or rather particular types of voyage whose earnings would be exempt. There is clearly no point in exempting people - such as seamen on ferries - for whom there is no defence problem.

Such an exemption would be unique. It could not be justified on the grounds that a seafarer's taxable capacity was less than that of someone else with the same income. It would thus be considered unfair, both by those seamen who did not qualify (and whose importance in defence terms might be just as great) and by other taxpayers generally. It would lie very awkwardly with the taxation of Royal Navy personnel, who are chargeable on all their pay however long they serve abroad.





It would also be clearly contrary to the general thrust of our tax policy which has been to reduce tax rates while broadening the tax base by removing or restricting special exemptions and reliefs wherever possible.

Nor, in any event, do I think this would be effective in tackling the problem of crew costs.

- Some of the relief would inevitably go to UK seamen serving on foreign-registered ships which might not be available, or available only to a limited extent, to the UK in an emergency.
- Of the relief going to the ships we wish to help, almost certainly the full cost of the tax relief would not be reflected in reduced crewing costs because that would be a matter of negotiation between ship owners and seamen. (The GCBS have pointed to the amount of income tax seamen pay, but they have not argued for an exemption as such apparently because they recognise that some mechanism would be needed to ensure that the benefit accrued to the shipping companies if it were to be of any help in reducing their costs. They have not suggested any such mechanism).
- You cannot easily vary the amount of a tax exemption to give the amount of assistance required; and as tax rates fall an exemption becomes less valuable (as the charities are always telling us).

My conclusion is that a tax exemption for seamen would not only be unattractive but would be inefficient as a method of assisting shipping companies with crewing costs.





### Residence rules and the 100% foreign earnings deduction

The argument for easing these rules would be that more seamen would benefit from them and their increased net pay would enable the shipping companies to pay lower wages.

In terms of tax policy and general effectiveness this approach seems to suffer from much the same disadvantages as a special exemption. It would in fact represent a reversal of previous policy, since in 1984 we were able to withdraw some highly unsatisfactory special reliefs for people working overseas in the light of the tax reductions previously made. It would look extremely odd to be increasing the scope of tax shelters shortly after a Budget containing large tax reductions.

The residence rules and the 100% foreign earnings deduction apply to everyone, so if they were changed the benefit would go far wider than the seamen we want to help. But if relaxations were targeted on seamen, that would be seen as unfair by the others who at present qualify.

This approach would probably be even less effective than a direct exemption for seamen because we would simply be redrawing the boundaries of a tax relief and - even with generous relaxations - some seamen would continue to fall the wrong side of the dividing line. Another big disadvantage is that no-one can be sure he is entitled to relief until he has spent the necessary time abroad. For both these reasons it would be very unlikely that the possibility of increased tax reliefs for the seamen would be fully reflected in reduced wages.





Conclusion

My clear conclusion is that there are very strong arguments against either changing the PAYE rules or granting seafarers special tax reliefs. Moreover, since they operate very indirectly on crew costs, and could not be confined precisely to the type of vessel we want to help, they would be likely to be bad value for money. I thus see no sensible role for taxation changes in achieving our objectives.

*N.L.*

[N.L.]  
30 March 1988



DEFENCE

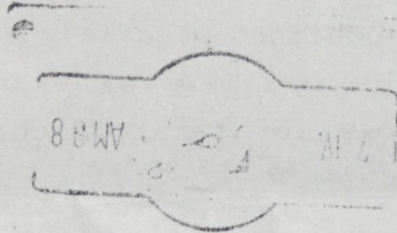
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PRIME MINISTER

OD: DEFENCE WHITE PAPER

OD tomorrow morning is to discuss the Defence White Paper. You saw the first draft over the weekend and asked for some changes to be made. A new version of Chapter 1 has now been produced which is certainly an improvement, although I am not sure that the first sentence will necessarily strike the tone you want. A number of other changes have been made elsewhere in the text which I hope you will find generally satisfactory.

The Cabinet Office brief attached of course refers to the earlier version but still has some useful material in it.

C.D.?

CHARLES POWELL

16 March 1988





MINISTRY OF DEFENCE  
 MAIN BUILDING WHITEHALL LONDON SW1  
 Telephone 01-930 7022 ~~xxxxxxx~~ 01-218 2111/3

cc Blet  
 cc PE

MO 21/2/33L

16 March 1988

MF

Dear Charles,

DEFENCE WHITE PAPER *afflee*

Thank you for your letter of 14th March, recording the Prime Minister's preliminary comments on the OD draft of the Defence White Paper (OD(88)3).

In the light of your letter, my Secretary of State has decided to issue the attached revised version of Chapter 1 of the White Paper for discussion at the OD meeting tomorrow. The major change from the original draft is the greater prominence given to the NATO Summit at the beginning of this month. In addition to a brief reference in paragraph 101, there is now a substantive section, in paragraphs 108-110, recording the conclusions reached at the Summit and in particular the need to keep the Alliance's nuclear and conventional forces up to date.

The 'box' dealing with 'Nuclear Forces in Europe', which will include Figure 1 setting out the land-based theatre nuclear systems remaining in Europe after implementation of the INF Treaty will, of course, give prominence to the issues of post-INF force adjustments and modernisation. As requested, we have given further thought to the possibility of foreshadowing NATO decisions on this. As yet, it is not clear how far the Nuclear Planning Group will be able to take matters at its meeting at the end of April (and after SDE goes to press). But it is unlikely that Ministers will be in a position to decide on the deployment of specific aircraft to specific locations, including the possibility of deploying additional Flls to the UK. We would, therefore, caution against greater specificity in the SDE but you will note that we have added a new sentence at the end of paragraph 3 of the 'box' which makes it clear that the United Kingdom will play its full part in the adjustment process.

Other changes to Chapter 1 to meet the Prime Minister's wishes include:

Charles Powell Esq  
 10 Downing Street





a. a revised paragraph 107 on the Soviet threat, which places more emphasis on the continuing Soviet modernisation programme. There is a cross reference to Chapter 6 which deals with the Soviet threat in considerable detail;

b. a reference in paragraph 116 to the ideas we have put to the French for greater practical co-operation in the defence field;

c. an overall reduction in length of about one-fifth to make it more punchy. This has been achieved by concentrating on current issues and deleting sections that were discursive or contained material that is covered in other chapters (eg the previous paragraphs 105, 106, 111-113, 115 and 116).

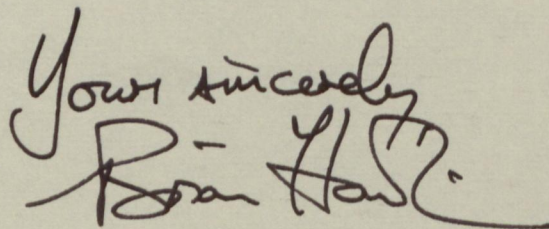
On the remainder of the Prime Minister's points:

a. The reference to arms control priorities in Chapter 2 will be strengthened by adding to paragraph 222 the sentence: 'The United Kingdom believes that there should be no negotiations about further reductions of nuclear weapons in Europe until the imbalance of conventional forces in Europe has been redressed and a ban on chemical weapons achieved.'

b. The reference to EFA in paragraph 414 is in square brackets because it will need to be looked at again nearer to publication date;

c. We are, of course, currently seeking to counter criticism on the procurement issues cited in your penultimate paragraph. But, on balance, we consider that it would be preferable not to draw attention to them in the SDE as this might risk reviving rather than countering press and public criticism in May.

I am sending copies of this letter to the Private Secretaries to members of OD, to the Secretary of State for Northern Ireland, the Chancellor of the Duchy of Lancaster and the Chief Secretary and to Trevor Woolley in the Cabinet Office.

Your sincerely  


(B R HAWTIN)  
 Private Secretary



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**CHAPTER ONE: MAINTAINING SECURITY IN A CHANGING WORLD**

101. The last year has seen continued improvement in the atmosphere of East-West relations. On a wide range of issues, both sides are now able to deal with each other more constructively than has been possible for many years. It also saw, this March, the summit meeting of NATO Heads of State and Government in Brussels, at which they reaffirmed the importance of the Alliance and the validity of its strategy of deterrence to guarantee our collective security. It was thus a successful year for NATO and for British defence policy. We and our allies must continue to ensure that our policies maintain security in a changing world.

**NATO's SECURITY POLICY****The Dual Approach**

102. The year was dominated by the arms control discussions between the United States and the Soviet Union, culminating in the signature, in December 1987 at the Washington summit between President Reagan and Mr Gorbachev, of the treaty eliminating US and Soviet ground-launched intermediate-range nuclear (INF) missiles. 1987 also saw the successful introduction of the confidence- and security-building measures agreed at the Stockholm Conference of 1986. And there was encouraging progress in other areas of arms control including, particularly, US-Soviet negotiations on strategic nuclear weapons, where there is now the prospect of agreement on a treaty reducing superpower armouries by 50%. Further details are given in Chapter 2.

103. 1987 was also, appropriately, the twentieth anniversary of the dual approach set out for NATO by the Belgian Foreign Minister, Pierre Harmel, in his report on the Future Tasks of the Alliance. For two decades, strength in our own defence and readiness for dialogue and cooperation with the East have together formed the basis of the Western approach. Nowhere has the success of this approach been better demonstrated than in the historic INF Treaty. As the NATO summit agreed, this is a milestone in the Alliance's efforts to achieve a more secure peace, and the result of the political courage, realism and unity of its members. Soviet leaders were brought to the conference table because NATO deployed, in the face of much opposition, limited numbers of INF missile systems comparable to those already deployed by the Soviet

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Union. Unilateral gestures could never have achieved the same result. Indeed, had such gestures been made, we would face today the increased threat from Soviet missiles, with no countervailing force on the Western side.

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'There is such a horror of war in the great nations who passed through Armageddon that any declaration or public speech against armaments, although it consisted only of platitudes and unrealities, has always been applauded; and any speech or assertion that set forth the blunt truth has been incontinently relegated to the category of 'war monger' .... The cause of disarmament will not be obtained by Mush, Slush and Gush. It will be advanced steadily by the harassing expense of fleets and armies, and by the growth in confidence in a long peace.'

Winston Churchill,  
1932

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#### Developments in the Soviet Union

104. These events have taken place as we now at last begin to see signs of change in the Soviet Union, reflected elsewhere in Eastern Europe. At home, Mr Gorbachev has set in train a series of wide-ranging reforms. Abroad, he has argued the need for 'new political thinking' in the nuclear and space age, and has laid stress on the growing interdependence of the countries of the world community. This 'new thinking' acknowledges that there is more to security than military might and that Soviet security cannot be maintained on terms that inevitably mean insecurity for others.

105. The British Government has welcomed the reforms that are taking place in the Soviet Union. More open internal policies, which bring the Soviet people more information about their own country and the world outside, are self-evidently desirable. And more pragmatic, less aggressive, external policies ought to make the Soviet Union a less uncomfortable neighbour. Certainly, as the Prime Minister's meeting with Mr Gorbachev at RAF Brize Norton in December 1987 again showed, we are now able to pursue our bilateral dealings with the Soviet Union in an atmosphere that is more open and constructive than before.

106. Although it would be imprudent to rely on a sustained change in Soviet attitudes, the prospect of its taking place is a challenge that the West must accept. The willingness of the present Soviet leadership to take part in the mutual concessions necessary to achieve an INF agreement is a good sign. But these are early days and we

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shall be looking for hard evidence, in the form of actions rather than words, that the 'new thinking' represents a genuine and lasting shift in Soviet policy towards the West, and not merely a new approach to the presentation and execution of old policies. Progress in arms control has not yet been matched by comparable steps over issues such as [regional conflicts and] human rights, equally important for the creation of lasting confidence between East and West.

107. Nor has there been any let-up in the Soviet Union's military modernisation programmes, described in Chapter 6. By the mid-1990s virtually the entire Soviet strategic nuclear force in place in the mid-1980s will have been replaced by new or modernised systems. And the Soviet Union is continuing to modernise its theatre nuclear forces in Europe, where even after the INF Treaty is implemented it will continue to enjoy a huge numerical advantage; improvements include the introduction of more accurate shorter-range nuclear missiles and the deployment of more advanced nuclear-capable aircraft, which will soon carry new nuclear-capable stand-off missiles. The Soviet Union continues to enjoy very substantial advantages in conventional forces, and is updating them so effectively that in key areas, such as aircraft and armour, the West's technological lead is being eroded (see page [ ]). Soviet capabilities for chemical warfare (see page [ ]) far outstrip those of the West and cannot be justified by any comparable threat from NATO. These Soviet forces are all deployed and structured in accordance with a military doctrine (see page [ ]) that has as a key element the principle of defending the Soviet homeland by taking the offensive.

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'Reflecting upon almost four decades of common endeavour and sacrifice and upon the results achieved, we are confident that the principles and purposes of our Alliance remain valid today and for the future. We are united in our efforts to ensure a world of more secure peace and greater freedom. We will meet the opportunities and challenges ahead with imagination and hope, as well as with firmness and vigilance. We owe no less to our peoples.'

The Declaration of the Heads of State and Government participating in the meeting of the North Atlantic Council, Brussels, 3 March 1988

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### **The NATO Response**

108. It was against this background that NATO leaders met in Brussels in March to take stock of the situation facing the Alliance and to set guidelines for future action. At that meeting they reaffirmed that:

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- The link between the European and North American allies was vital to the security of each (see paragraph [111]).
- NATO defences should remain strong, recognising the crucial role of the nuclear deterrence provided not just by the United States' strategic deterrent but also by the presence of effective and up-to-date nuclear weapons in Europe (see [below] [reference to 'box' on 'Nuclear Forces in Europe']).
- They were willing to seek dialogue with the countries of the Warsaw Pact and further arms control agreements (see Chapter 2), based on their confidence in a sure defence.

In particular, all the NATO leaders agreed that, for the foreseeable future, there was no alternative to the Alliance's policy of deterrence based on an appropriate mix of adequate and effective nuclear and conventional forces, and expressed their resolve to keep them up to date where necessary.

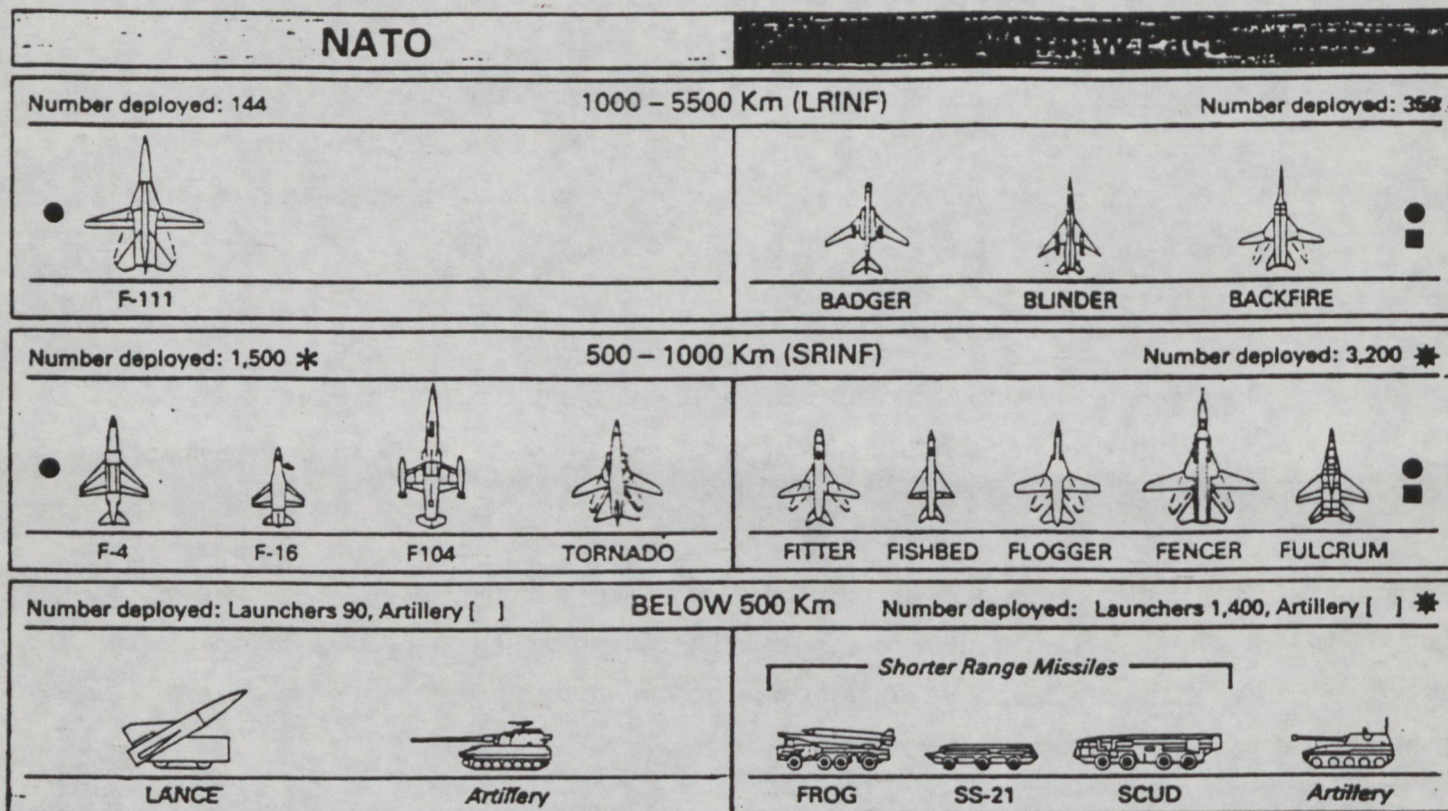
109. NATO's deterrent policy is carried out through the strategy of forward defence (see page [ ] and flexible <sup>s</sup>response. Effective conventional forces will remain an important element in this strategy; but, however strong, they cannot achieve deterrence alone. So long as the West faces an adversary armed with nuclear weapons, it is self-evident that we must retain a similar capability to deter him from using or threatening to use them. More fundamentally, the need for the nuclear element in deterrence rests on the imperative to avoid any further war in Europe, conventional or otherwise; for even conventional weapons, of the power now available, would bring destruction on an unprecedented scale. The achievement of conventional parity would make an important contribution to enhancing international security. But even if an equal balance of conventional forces were to be reached, it could not be relied on to prevent aggression. History offers many examples of attacks launched against the odds; for example, when Hitler invaded the Soviet Union in 1941 his forces were substantially outnumbered. For the foreseeable future, only nuclear weapons will be able to confront a potential aggressor with risks so unacceptable that aggression is no longer a rational option.

110. This reality is recognised in the arms control priorities endorsed at the NATO summit, and in particular in the reaffirmation by NATO leaders that further reductions in nuclear weapons, after the reduction in US and Soviet strategic arms now under

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Fig 1 - Land-Based Theatre Nuclear Systems Remaining in Europe  
after Implementation of the INF Treaty ♦



- ♦ - French systems are not included. They comprise about 80 Mirage IIIE and Jaguar aircraft and 30 Pluton short-range missiles.
- - All capable of delivering tactical nuclear bombs.
- \* - Total Aircraft and Artillery, numbers assigned nuclear role not known.
- - Air-To-Surface Missiles available for use.
- \* - Of which 700 are assigned a nuclear role.



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negotiation, would come about only in conjunction with the establishment of conventional balance and the global elimination of chemical weapons.

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## NUCLEAR FORCES IN EUROPE

1. The INF Agreement will remove NATO's Pershing II and ground-launched cruise missiles, but will not affect the validity or credibility of the strategy of flexible response. Even after the agreement, substantial numbers of nuclear-capable delivery systems will still be assigned to NATO's Supreme Allied Commander Europe (SACEUR).
2. These remaining systems will have to be structured effectively to ensure that they remain a balanced and survivable force. There will also continue to be a need, articulated in the decisions of the NATO Nuclear Planning Group meeting in Montebello in 1983 and reaffirmed at the NATO summit in March 1988, to keep these forces up to date, so that the West can maintain deterrence with the minimum number of warheads.
3. There is nothing new in all this; it circumvents neither the letter nor the spirit of the INF Agreement - a fact clearly recognised by the Soviet Union in its own modernisation programme (see Chapter 6); nor is it inconsistent with reducing the number of nuclear weapons in Europe, which is already 2,400 less than in 1979. It is rather part of the normal, continuing process of review and, if necessary, adjustment to ensure that NATO's forces remain effective and credible. As in the past the United Kingdom will play its full part in this process.

[Figure 1 will appear here]

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## THE EUROPEAN PILLAR

111. A strong and stable partnership between the two sides of the Atlantic, resting on shared values and interests, lies at the heart of our security. As we explained in last year's Statement, neither North America nor Western Europe could carry the full burden alone. The presence in Europe of the conventional and nuclear forces of the United States plays an irreplaceable part in the defence of Europe and provides the essential linkage with the US strategic deterrent. Conversely the credibility of Allied defence cannot be maintained without a major European contribution.

112. That European contribution is substantial. The defence expenditure of European NATO countries has steadily increased, and is now around one-third higher in real terms than it was in the early 1970s, enabling Europe to improve the quality of its forces. The European nations provide some 90% of the manpower, 85% of the tanks, 95% of the artillery, and 80% of the combat aircraft stationed in Europe, as well as 70% of the major warships readily available in the event of a conflict. European standing forces

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currently comprise over 3.5 million men and women, compared with US forces totalling 350,000 in Europe and 2.3 million worldwide. The active duty reserves of the European countries total 3.2 million men, compared with a US total of 1.7 million. Europe's aim is to make better use of the substantial resources it already devotes to the Alliance by more effective cooperation in defence and security matters; a more cohesive European effort can make a greater contribution to the Alliance than the sum total of our individual national efforts.

113. There has been extensive activity in the field of European security cooperation during the last year. The potential of the revitalised **Western European Union (WEU)** was demonstrated by a series of meetings, under its auspices, which helped to concert contributions by member states to mine-clearance operations in the Gulf (see page [ ]). Although it has no role in either operational deployments or force planning, the WEU can provide a valuable forum for coordinating policy on such out-of-area issues.

114. The WEU also met twice in 1987 at Ministerial level, in Luxembourg in April and in The Hague in October. These opportunities for both Defence and Foreign Ministers jointly to discuss European security issues are a unique feature of the WEU. The meeting in October was marked by the publication of the Platform on European Security Interests, which set out how the seven member states intend to contribute to NATO's future security. It included their commitment to maintain credible and effective deterrence, based on both nuclear and conventional defences, and to pursue an active arms control policy aimed at enhancing security and fostering stability and cooperation in the whole of Europe. The platform will provide a basis for the development of the WEU as a forum for harmonising Western Europe's defence effort in support of the Alliance. The United Kingdom will continue to contribute constructively to this work when we take on the Presidency of the WEU in July this year.

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'We are each determined to carry our share of the common defence in both the conventional and the nuclear field, in accordance with the principles of risk- and burden-sharing, which are fundamental to allied cohesion..... We remain determined to pursue European integration including security and defence and to make a more effective contribution to the common defence of the West.'

The Common Platform on European Security Interests,  
WEU Ministerial Council,  
27 October 1987.

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115. The two meetings of Eurogroup Ministers in 1987 provided an opportunity for informal discussion of defence planning issues from a European perspective. The progress of the Independent European Programme Group (IEPG) in pursuing European armaments cooperation is described in paragraphs [408] to [411].

116. The European allies continue to strengthen their already close bilateral defence relations. At the Anglo-French summit in January 1988 a number of proposals for greater bilateral military cooperation were discussed, their purpose being to strengthen the collective defence arrangements of the Alliance. These include the further development of existing plans for wartime reinforcement that involve the use of French facilities, and the scope for closer French involvement in the forward defence of the Federal Republic of Germany. In addition, we have reached agreements with France on defence of the Channel fixed link, and on getting better value for money in procurement (see paragraph [415]). The Government welcomes bilateral arrangements that contribute to the collective defence of NATO, and will continue to seek such opportunities wherever they arise.

#### BRITISH DEFENCE POLICY

117. British defence policy remains founded on membership of NATO. We cannot ensure our security other than through the collective strength of the Alliance. Last year the British electorate again endorsed NATO's policy of deterrence based on a mix of nuclear and conventional weapons, and decisively settled the debate about the maintenance of an independent British strategic deterrent. The Trident programme remains on course to provide the necessary updating of that capability from the mid-1990s (see page [ ]).

118. Chapter 5 gives details of our defence budget, which, at £19,215 million in 1988-89, is among the highest in NATO whether measured in absolute terms, as a percentage of gross domestic product or per capita. Chapter 3 describes how this money is spent by our armed forces. Over 95% of the defence budget goes, directly or indirectly, towards carrying out our main defence roles in NATO (see paragraph [302]). The great majority of our forces are committed to one or other of the three main NATO commands, Europe, Atlantic and Channel; and we remain the only European member of the Alliance to contribute to all three elements of NATO's triad of forces: strategic nuclear, theatre nuclear and conventional.

119. We also have important defence commitments outside the NATO area, described in paragraphs [326] to [330]. They include a direct responsibility for the defence of our



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remaining dependent territories. They also include activities such as the protection of our merchant shipping in the Gulf, military assistance to foreign and Commonwealth countries and contributions to international peace-keeping, which help to achieve the Government's foreign policy aim of promoting stability in areas where we have important economic interests. And since our interests coincide closely with those of our allies, these efforts make an important contribution to preserving broader Western interests outside the NATO area. As Figure [13] shows, the cost of these activities is small compared with the benefits they bring. And in a period of tension or war in Europe, the men and equipment concerned could be redeployed on NATO tasks.

120. The considerably increased sums allocated to the defence budget since 1979 have enabled us to set in hand substantial enhancements to our conventional forces (see page [ ]), the benefits of which are now beginning to be seen and will continue to be felt well into the 1990s. At the same time, we are pressing on with our efforts to achieve the best possible value for money in the management of defence resources (see Chapter 5), and in the procurement of equipment for the armed forces (see Chapter 4 and page [ ]).

121. There can be no doubt about the Government's determination to take the measures necessary for our national defence. We have charted a clear and consistent course for the past nine years. The task now is to move ahead steadily on that course, benefiting from the considerable progress that we have already made.



DEFENSE: Policy Pt 3





file

10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

14 March 1988

*Dear Brian,*

DEFENCE WHITE PAPER

You may find it useful to have the Prime Minister's preliminary comments on the draft Defence White Paper (OD(88)3) in case you wish to do some redrafting to take account of them before the OD meeting on 17 March.

The Prime Minister does not feel that Chapter I is adequate. It needs much more substantial references to the recent NATO Summit and to the declarations adopted there, picking out in particular the reference to keeping the Alliance's nuclear weapons up-to-date. In describing the Soviet threat, there should be more emphasis on Soviet modernisation programmes, giving examples. You might consider adopting some of the material used by the Prime Minister in her remarks at the Summit and in her subsequent Statement to the House. In general the Prime Minister thought this opening chapter could benefit from considerable rewriting to make it more punchy and convincing.

In Chapter II, there needs to be a stronger reference to our view that there should be no further reductions in short-range nuclear weapons until there is parity in conventional forces and a ban on chemical weapons.

There should be some detailed reference - possibly in the Essay on The Forward Defence of Europe or in the section on the European Pillar - to the ideas which we have put to the French for greater practical co-operation.

We need to give more thought to how we should foreshadow the decisions which NATO will need to take on adjustments to the deployment of its nuclear forces following the INF, including the possibility of deploying additional F-111s to the UK.

Nearer the time of publication, we shall need to decide what to say about EFA.



In dealing with defence procurement, there should be some counter to the recent criticisms by the Public Accounts Committee and to the problems which have arisen at Aldermaston.

I am copying this letter to Tony Galsworthy (Foreign and Commonwealth Office) and to Trevor Woolley (Cabinet Office).

Yours sincerely,  
Charles Powell

Charles Powell

Brian Hawtin, Esq.,  
Ministry of Defence.



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PRIME MINISTER

c Sir Robin Butler

STATEMENT ON THE DEFENCE ESTIMATES 1988  
OD MEETING AT 9.30 AM ON THURSDAY 17 MARCH  
OD(88)3 AND 4

attended

CONCLUSION


Subject to discussion, the Committee might be guided to agree that the draft Statement on the Defence Estimates, amended to take account of any points agreed in discussion, should be circulated to the Cabinet for consideration on 14 April and, subject to Cabinet agreement, be published on 17 or 18 May.

BACKGROUND

2. The draft Statement is similar in structure to previous editions. It again comprises six chapters. The first sets out the broad lines of our defence policy, laying especial stress on the need for an effective nuclear element, and the second is devoted to arms control. The remaining chapters describe the role and equipment of the armed forces and their activities over the past year, defence procurement (including research and development), the management of defence resources and the East-West military balance (previously contained in an Annex). As in previous years, the chapters of the draft are interspersed with essays, which will be printed in colour to stand out in the text, dealing in greater depth with topics of current interest: Soviet military doctrine (at the end of Chapter 1), NATO's forward defence strategy

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(Chapter 2), defence procurement policy (Chapter 4) and the conventional East-West balance (Chapter 5). There will be more photographs than before; for the first time these will be in colour, including one on the outer cover. There are a number of shorter notes, also to be highlighted in colour, on detailed aspects of defence policy and operations. The second volume of the Statement, covering statistics, has been circulated separately as OD(88)4.

**ATTENDANCE**

3. All members of the Committee will be present except the Chancellor of the Exchequer, who will be represented by the Chief Secretary, Treasury, and the Secretary of State for Trade and Industry, who will be represented by the Chancellor of the Duchy of Lancaster. The Secretary of State for Northern Ireland and the Chief of the Defence Staff have been invited to attend.

**HANDLING**

4. You should invite the Defence Secretary to introduce the draft Statement and then invite general comments, particularly from the Foreign and Commonwealth Secretary and the Chief Secretary. Thereafter, discussion should cover the following major aspects:

A. Presentation

The Statement is an important public relations opportunity. Its layout has been transformed over recent years, with the introduction of essays on specific topics, printed in colour, and photographs. Has this been well received? (Defence Secretary) The order in which the various subjects are





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covered and the balance among them seem on the whole to be right. Do they present the Government's defence policy to best advantage? (Lord President, Chief Secretary). The Defence Secretary again plans to issue a shorter, popular version (Volume I only) simultaneously with the Statement, free of charge. Did the decision to do so last year provoke any accusations that Government resources were being used in a party interest? (Defence Secretary)

[yes, but so what?]

B. The Threat

It is important to depict in a convincing manner the scale and nature of the Soviet threat, which are the real reasons for our defence effort. Particularly at a time when Gorbachev's attempts at reform are catching the popular imagination, the formidable Soviet military capability needs to be set out squarely in language which avoids charges of exaggeration. The treatment of the Soviet Union in paragraphs 107 to 112, together with the essay on Soviet military doctrine and the assessment of the East-West conventional balance in Chapter 6, seem to strike the right note. Does the Foreign and Commonwealth Secretary agree?

?

C. Nuclear deterrence

Chapter I stresses the need (paragraphs 113 to 115) for the nuclear deterrent and the accompanying box on "Nuclear Forces in Europe" stresses the importance of keeping shorter range systems up to date, in the language agreed at the recent NATO summit.





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Last year's paper contained two essays on the deterrent. Is the case this year sufficiently persuasively argued? (Lord President, Chief, Chief Secretary).

D. Arms Control

This chapter covers in detail the various arms control negotiations, nuclear, conventional and chemical, now in progress and sets out the Alliance's future aims; a detailed box recounts the history of the INF negotiations and refers, in particular, to the arrangements for inspection of Greenham Common and Molesworth under the US-Soviet treaty. Is the Foreign and Commonwealth Secretary content with this chapter? Does the section on future aims (paragraph 220 following) adequately reflect the Government's insistence on the need to reduce the Warsaw Pact superiority in conventional and chemical forces as a first priority?


F. Merchant Shipping

Only two paragraphs (319 and 320) are devoted this year to the Merchant Fleet. The Transport Secretary, who cannot be present, may comment in writing. Does the wording of this section strike the right note? Will it satisfy the shipping lobby? (Defence Secretary)

G. Defence Procurement

Chapter 4, together with its concluding essay, explains the steps that have been taken to improve defence procurement procedures, through the introduction of

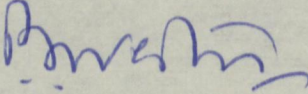


  
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greater competition and a tighter contractual approach. Does the material need to be revised to deal with recent criticisms by the Public Accounts Committee? The box on the Trident programme (between paragraph 415 and 416) reports encouraging progress, but makes no mention of Aldermaston. Is this because the problems there are not yet solved? And is the omission of any reference to Aldermaston not likely to invite questions? Are the Chancellor of the Duchy and Chief Secretary content with the reference to defence research and development expenditure (paragraphs 416 and 417)?

H. Defence Budget

The paragraphs (510-513) on future defence expenditure will be scrutinised carefully, not least by our NATO partners, especially in the wake of the NATO summit. Paragraph 501 suggests that defence expenditure in 1988/89 and 1989/90 is up on the provision shown in the 1987 Public Expenditure White Paper. Is this an increase in real terms? What is the force of the statement in paragraph 503 that "the defence budget will now benefit from a broadly level provision between 1988/89 and .... 1990/91"? Has the decline in the defence budget now come to an end? Last year it was not expected to level out until 1989/90. (Chief Secretary, Defence Secretary)



P J Weston

11 March 1988



## PRIME MINISTER

## DEFENCE WHITE PAPER

The Defence White Paper will be taken in OD next Thursday. You may like to look at it over the weekend. || BF

Generally it is comprehensive and thorough, but rather boring.

*very laconic and light-weight.*  
Chapter I is a general statement of our defence policy and the international context. It needs a much more substantial reference to the recent NATO Summit and the declarations issued there. In particular there should be a reference to the commitment to keep nuclear weapons up to date. In describing the Soviet threat, there should be more emphasis on their continuing modernisation programmes. Indeed the section as a whole would benefit from drawing more on your speaking note at the NATO Summit.

Chapter II deals with arms control in familiar terms. But we need a stronger reference to our view that there should be no further reductions in short-range nuclear weapons until there is conventional parity and a chemical weapons ban.

One would like to see somewhere - perhaps in the Essay on the Forward Defence of Europe - reference to the proposals which you put to President Mitterrand for closer French cooperation with the NATO military structure.

We need to consider how far to foreshadow the decisions which will be needed on re-adjustment of NATO's nuclear forces after an INF agreement e.g. the possibility of additional F111s in the UK. I do not think that the White Paper can credibly ignore the issue.

Nearer the time of publication, we shall need to decide what to say about EFA.



Chapter IV deals with procurement and seems to me a good statement of the improvements which the Government has made, particularly the essay which I have flagged.

Defence Spending is dealt with in Chapter V. It predicts broadly level provision between now and 1991. But it rather skates over some of the very difficult choices implicit in the long-term costings and is likely to be attacked for this. There is quite a good section on improved financial management, rather on the lines of the recent Value for Money seminar.

Finally I draw your attention to the essay on the Conventional Balance which is a thorough piece of work.

C.D.P.

(C. D. POWELL)

11 March 1988



# Keeping the gleam on deterrence



Europe needn't flutter about something that makes it safer

**M**OST Europeans know they need it. Most Europeans suspect it is no longer in working order. Most Europeans resist ideas for putting it back in shape. The object of this curious confusion? The American nuclear umbrella: to be precise, the ability of America's long-range nuclear weapons, whether they sit in silos on the Great Plains or in Trident missile submarines, to go on being relevant to the protection of Western Europe. Some confusion is understandable, "deterrence theory" being just big words for A guessing how B might react if A did X in response to B's having just done Y or Z. A lot of Europeans are nevertheless getting into a mistaken tizzy over the latest American attempt to put a little more precision into this nuclear algebra.

Why is more precision needed? Because Western Europe cannot be defended by non-nuclear weapons alone, partly because Russia has more of them—plus a nuclear arsenal. Short-range nuclear arms are necessary but not enough, Russia having the lead here too (and, being short-range, the western ones would leave Russia itself unscathed). The French and

British deterrents, opinion polls say, provide no deterrent comfort for Germans, Italians and other non-nuclear breeds.

Pretty well everybody in Europe, except the far left and the pacifists, now agrees that the American long-range nuclear force is an indispensable component of the guarding of Europe. The trouble, as has been apparent for years, is that for America to say it will blow Russia's head off if it steps across the line in Europe may not impress the Russians—or the Europeans—if Russia can then do the same to America's head. The indispensable component has to be subtler.

The search for something subtler has been going on at least since 1974, when Mr James Schlesinger as secretary of defence gave new targets to some of America's missiles. The latest suggestion has come in a report from such good American names as Iklé, Wohlstetter, Brzezinski and Kissinger. The report says that the first aim of the long-range American missiles, if the Russian army started an attack in Europe, should be to slow down or stop the attack by hitting the sort of targets the attackers depend on—airfields, troop concentra-

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tions, places where supply lines run together. A trio of European defence luminaries promptly attacked the report, and a European chorus now accuses it of being a sell-out to Russia, an attempt to confine a nuclear war to Europe, even a cunning first step towards an American abandonment of Europe. These Europeans are wrong, because they have not thought their way through what makes deterrence deter.

Threaten a general nuclear assault on Russia if it moves across the European dividing line, and Russia is liable to remain unperturbed, because it knows the Americans know it can reply with a general nuclear assault on them. Threaten Russia with an attack on specific targets of the sort the new American report suggests—so long as these include some targets in the Soviet Union itself—and the Russians face three unpleasant possibilities. Their army's move into Western Europe will probably fail if mushroom clouds erupt along its supply lines. If these mushroom clouds include Minsk and Pinsk, the Soviet Union will itself have paid an immediate price for crossing the line. Most important, it will be Russia, not America, which has to decide whether or not to make that mind-boggling next move, the jump to the general holocaust.

This is likelier to give Russia pause. It is likelier, in other words, to prevent anything violent happening at all: which is what "deterrence" means. The credibility of the long-range American nuclear force would have been reinforced. Nothing can restore the absolute authority it wielded in the 1950s.

That began to fade as soon as Russia built missiles which could hit America. Since then, the realists' task has been to make the commitment of the long-range American arsenal to the defence of Europe more believable than fearful Europeans, or hopeful Russians, were increasingly inclined to think it was. To repeat, that commitment is indispensable.

## One thing that hasn't changed

Has all this become academic, because Mr Gorbachev has made Russia a place Europe no longer needs protection against? No. Even the most amiable Russia, if it saw a chance of using armed strength to achieve something it thought desirable at minimal risk to itself, would be tempted to do so. Test that proposition by putting it the other way round. If the West, at minimal risk to itself, could help the democratisation of Poland and Hungary, would it not be tempted to do so—unless Russia raised the risk? The risk-raising precaution, on the West's side, means both arguing for the removal of Russia's non-nuclear superiority in Europe and preserving Western Europe's link to America's nuclear power.

The odd thing about Mr Gorbachev is that, for all the changes he is trying to make in Russia itself, the sheer physical dominance of the Russian military presence in central Europe remains unchanged. Until and unless that gets restructured by *perestroika*, West Europeans had better make sure their insurance policy is in good order.



SECRET



10 DOWNING STREET  
LONDON SW1A 2AA

*file*  
SUBJECT *ECC*  
*CC MASTER*

*cc G. BOUENS.*

From the Private Secretary

23 February 1988

*Dear Roy,*

*Meeting record.*

SHIPPING

The Prime Minister this morning held a meeting to discuss merchant shipping. The main paper before the meeting was the minute dated 5 February from your Secretary of State. Those present were the Secretary of State for Foreign and Commonwealth Affairs, the Chancellor of the Exchequer, the Secretary of State for Defence, the Secretary of State for Trade and Industry, the Chancellor of the Duchy of Lancaster, the Secretary of State for Transport and Mr. Richard Wilson and Mr. George Monger (Cabinet Office).

The Secretary of State for Transport said that over the past few years there had been a substantial fall in the size of the British merchant fleet, the number of its ships and the number of officers and crew, so that our defence needs were now threatened. To take the main classes of need:

- We probably had just enough ships at present to support direct military operations but the position on product tankers would be tight.
- For civil supply in wartime, we would be short of product tankers and, by a substantial margin, general cargo vessels. We had just enough container ships, but were dependent on 23 Hong Kong vessels. Some ships would be available from the NATO pool, but not enough to offset our shortfall.
- For transatlantic reinforcement, the Pentagon now calculated that 600 ships needed to be earmarked to enable 400 to be delivered promptly to the US eastern seaboard. They were reviewing their requirements, and were likely to increase those figures, with the latter rising to 450. But only 448 ships were at present earmarked for this purpose. Although this was a problem for the alliance as a whole, at least our partners were taking steps to slow down the decline of their fleets.

In every case, if investment continued to be very low the situation would worsen. Your Secretary of State was concerned about the strategic implications of these shortages. He therefore proposed the reintroduction for a limited period of roll-over relief for taxation of balancing charges for ship

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assets. He also hoped that the Inland Revenue would not proceed with their plans to require the operation of PAYE by companies providing crews for ships registered in the Isle of Man through Manx crewing agencies. If they did, many such companies would reflag abroad, thus worsening the problem. There was a similar question over the payment of National Insurance Contributions (NICs) in respect of such crews, although that was less serious since the Isle of Man fleet was not affected. Finally, he believed that further studies were needed of the scope for measures of help focussing on particular types of vessel.

In discussion the following were the main points made:

- (a) The biggest problem on the defence side was that if hostilities began, ships would be required simultaneously for our direct military operations, for providing civil supplies, and for transatlantic reinforcement. Our allies would also require ships for their own use at the same time. Moreover, the figures which had been circulated overstated what would be available for our defence needs, since experience showed that civil vessels were often unsuited for military purposes.
- (b) It was important before considering special measures of help to find out what contribution could be made to our defence needs from the NATO pool and from British-owned but foreign-flagged vessels. On the other hand, the importance of these sources should not be exaggerated. The NATO studies were likely on past form to take a long time to complete and the number of British-owned ships registered abroad was not large.
- (c) It was desirable to avoid indiscriminate measures of support. The roll-over relief which had been proposed risked unravelling the 1984 reform of Corporation Tax, and any such tax concession risked provoking demands for similar treatment from other industries. Another alternative would be a direct subsidy for building ships which would be suitable for defence purposes, although the effect of such a step on shipbuilding policy would need to be considered.
- (d) Personal taxation of seafarers required further study. Operation of PAYE made no difference to their liability to tax and was probably being opposed by the industry in the Isle of Man case because it made evasion harder. Evasion could not be condoned. On the other hand, it had to be remembered that those working in the industry were unusually mobile and that action which led to reflagging from the Isle of Man to foreign countries could substantially worsen our problems while a long term solution was sought. More generally, more information was needed about the tax treatment of people employed on ships and aircraft.
- (e) One option worth further study was to arrange by agreement for ships not flagged in the UK to be made



available to us in time of war. War risks reinsurance could be offered in such cases. The United States Government had exploited such offers with some success in similar negotiations in which they had been involved, and we should see if we could profit by their example. We should also find out how far we could proceed by compulsory chartering, through the use of the Royal Prerogative, in time of war.

The Prime Minister, summing up the meeting, said that the group accepted that the Secretary of State for Transport had raised a problem which could not be ignored. But it needed more information, and further work on the available options for closely targeted action. A number of papers should now be prepared. The Secretary of State for Defence should consider further which particular types of ship raised the most acute problems, and whether urgent action was required in respect of them. The Secretary of State for Transport and the Chancellor of the Exchequer should consult further about the proposed operation of PAYE in the Isle of Man case, although it might well have to be accepted that the Inland Revenue had no option but to apply the law as it stood. They should also consider what arrangements other countries in a similar situation had made to deal with the shortage of shipping for defence needs. The Secretary of State for Transport should consider further the scope for compulsory chartering, and for making vessels not registered in the UK available to us, in time of war. The Chancellor of the Exchequer should set out the position on the personal taxation of seafarers. All those papers should be circulated to those attending the meeting by mid-March.

I am copying this letter to Tony Galsworthy (Foreign and Commonwealth Office), Alex Allan (H.M. Treasury), Brian Hawtin (Ministry of Defence), Alison Brimelow (Department of Trade and Industry), Peter Smith (Chancellor of the Duchy of Lancaster's Office), Richard Wilson and George Monger (Cabinet Office).

Yours,  
Paul

(PAUL GRAY)

Roy Griffins, Esq.,  
Department of Transport.



PRIME MINISTER

MEETING ON UK MERCHANT SHIPPING

When you discussed this briefly with the Chancellor last week you decided to go ahead with a meeting with a wider group of Ministers tomorrow.

You have already seen the main papers. The central one is Mr. Channon's paper of 5 February at Flag A. The Cabinet Office have now produced a brief, at Flag B, which you may like to glance at and use in steering the discussion. Also attached is the Chancellor's minute of 12 February, Flag C. You do not need to trouble with the other papers mentioned at the beginning of the Cabinet Office brief.

You suggested last week that the Chancellor should not bother to attend, and that the Chief Secretary might deputise for him. But I gather the Chancellor may well decide to come himself.

RCG.

(PAUL GRAY)

22 February 1988

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P 03025

PRIME MINISTER

UK MERCHANT SHIPPING

(Meeting of Ministers at 11 am on 23 February)

Relevant Papers

(Main document: minute from Mr Channon of 5 February. Other papers: letter from Mr Channon to the Chancellor of 18 January; letter from your office to Mr Channon's office of 18 January; letter from Mr Younger to Mr Channon of 28 January; letter from the Chancellor to Mr Channon of 12 February; letter from Sir Geoffrey Howe's Office to Mr Channon's Office of 15 February).

DECISIONS

Mr Channon's minute of 5 February describes his concerns about the recent decline in the UK Merchant Shipping Fleet. At present the UK has access to virtually all the ships which it would need immediately for its armed forces in a time of war, but with the current lack of re-investment in UK shipping this is unlikely to continue. There are already not enough vessels to provide the UK's civil supply needs in time of war, and it is unlikely that the rest of NATO could cover the gaps. There is also a growing shortfall against the number of ships required for the US military reinforcement of Europe.

2. Mr Channon suggests that measures to stop the decline should now be considered. You may wish to consider the issues in the following order:

- a. whether more can be done to inject urgency into the proposed NATO studies and to persuade our NATO Allies to do more in ensuring they can requisition ships in times of emergency;

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- b. whether an immediate fiscal change on roll-over relief for reinvestment in shipping should be considered, as proposed by the General Council for British Shipping (GCBS) and supported by Mr Channon and Mr Younger;
- c. whether Mr Channon should be asked to develop his ideas for other measures of help to the shipping industry; and
- d. whether shipping companies with vessels on the Isle of Man register should be required to operate PAYE in respect of UK seafarers employed on those vessels through local crewing agencies.

#### BACKGROUND

3. Ministers have discussed the decline of the UK merchant fleet several times. In December 1986 E(A) endorsed a modest package to assist the UK shipping industry. This comprised assistance towards the travel costs of UK deep-sea crews and financial help with training, at a cost of £5 million in 1988-89 and £8.5 million per annum thereafter. The Merchant Shipping Bill now before Parliament provides the powers for these schemes and establishes a Merchant Navy Reserve of former merchant seafarers.

4. Since this package was agreed the UK and Isle of Man merchant fleet has declined from 13.9 million tonnes in July 1986 to 10.2 million tonnes in November 1987. There is little re-investment by UK shipping companies and prospects are uncertain. The General Council of British Shipping (GCBS) has now recognised that the Government is not going to reverse its 1984 Budget decisions and re-introduce 100 per cent First Year Allowances for capital investment in shipping. Instead it is now proposing a more limited fiscal change which would give shipping companies rollover relief on balancing charges provided that they re-invest the proceeds from the sale of any vessel into further shipping assets within three years (an explanation is in Annex A to this brief). Mr Channon and Mr Younger support this proposal.

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## ISSUES

Strategic implications of the decline in the UK merchant fleet

5. There is a disagreement between the Chancellor and Mr Channon about the size of the problem. Mr Channon says (his letter of 18 January) that since E(A) considered the matter in 1986 the UK and Isle of Man fleet has fallen further from 13.9 to 10.2 m tons. The Chancellor says (his letter of 12 February) that according to the GCBS the size of the British-owned and controlled fleet has been stabilised at least for the time being. The difference between the two may be that the Chancellor includes vessels which are British-owned but not British flagged. You may wish to probe the difference and in particular ask how far such vessels would be available to us in time of war.

6. Mr Channon's paper describes the UK's three requirements for shipping in times of crisis and war:

- a. UK contribution to NATO transatlantic reinforcement;
- b. direct support for the UK armed forces; and
- c. civil supply to the UK from overseas.

7. There appears to be a substantial shortfall of the NATO Alliance's needs under (a) above. The number of dry cargo vessels for the whole of NATO has steadily declined to 448 in 1987, against an estimated requirement of at least 600. However, this is clearly a matter for NATO as a whole, and individual action by the UK at this stage would seem premature. We have pressed NATO to carry out a comprehensive study of Alliance merchant shipping, but Mr Channon's paper refers to difficulties in getting this started. Other NATO members are being encouraged to take similar steps to ours in reaching agreements with their shipping companies, who have ships registered under foreign flags of convenience, so that such vessels can be requisitioned if required. You may wish to ask Mr

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Channon and Mr Younger whether any further action can be taken to clear any blockages to early action by NATO itself and by other NATO members.

8. Direct support for UK armed forces ((b) above) can be met from British and Dependent Territories registered ships, with the exception of one heavy-lift vessel (MOD are making arrangements with the Netherlands to cover this).

9. The UK has insufficient general cargo vessels and large product tankers to meet its civil supply needs under (c) above, even in the early days of war, and the situation would worsen over time as ships were lost. Mr Channon says that these shortfalls could not be wholly offset by ships made available by other NATO members into the NATO pool, although Annex C shows that the pool is greater than our shortfall. The detailed position will only be known accurately when the detailed NATO studies are available, which will not be for at least a year and possibly much longer. Mr Channon believes that the trend of a shortfall is clear and that action should be taken relatively quickly; the Chancellor will wish any action to be deferred until the NATO studies are available. You will wish to probe Mr Channon and Mr Younger about how certain they are that any shortages in vessels needed for civil supply cannot be met by surpluses of other NATO countries.

10. All the discussion in the papers concerns our needs as members of NATO. You may wish to ask whether there are any implications for our ability to conduct independent operations, such as the recovery of the Falklands.

#### Roll-over relief

11. The GCBS maintain that the introduction of roll-over relief on balancing charges would be "the most useful single early measure" that could be introduced to assist re-investment in UK shipping. Mr Channon endorses their suggestion that this relief should be included in the Budget. The GCBS estimate that this concession could cost up to £77 million per annum. Estimates from the Inland Revenue (in confidence) suggest the cost might be £35 million in

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1989/90, £55 million in the following two years, and declining thereafter to an eventual £10 million per annum.

12. The Chancellor will resist this suggestion strongly. He will argue that a general relief for the entire shipping industry - as proposed it would extend, for example, to the fishing industry - would be far too generalised to tackle shortages in certain particular types of vessel. He may also argue that a fiscal concession along these lines would reverse the policy introduced by his 1984 Budget, and lead to substantial pressure from other industries for similar roll-over relief or a return to 100 per cent First Year Allowances for capital expenditure. It is also difficult to demonstrate that the fiscal change GCBS are proposing would have the effect of reducing the decline in UK shipping. It could make little difference and simply result in higher profits for shipping companies and substantially lower tax receipts.

#### Other work

13. Mr Channon also says (his minute of 5 February) that 'we need to develop further proposals focusing on shortages of particular types of vessel'. He does not say what he has in mind. You may wish to ask him and if necessary invite him to circulate a paper for further consideration. An alternative would be to wait for the NATO studies.

#### PAYE and National Insurance

14. The point at issue on PAYE is not clear. Mr Channon says that some shipping companies with vessels on the Isle of Man register have contracted with Manx clearing agencies for the crews. They have not so far had to operate PAYE for UK seafarers recruited in this way, but the Inland Revenue have now decided that the law requires them to do so. Mr Channon is afraid that this will drive them to re-flag abroad.

15. You may want to ask exactly what the problem is. The UK seafarers concerned are subject to UK tax anyway and including them within PAYE does not affect the amount they are liable to pay.

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There are three possible points which Mr Channon may be making:

- a. Present arrangements allow tax evasion by the seafarers and therefore lower wages by the employers. The Chancellor hints that this is the real issue.
- b. Administering PAYE imposes costs on the employers. The Chancellor says these are very small.
- c. The seafarers should not have to pay UK tax. But this would be a major and remarkable change: they are UK citizens and must be subject to the same responsibilities as other citizens.

The best solution might be to ask the Chancellor and Mr Channon to study the problems and put in a further paper, preferably a joint one.

16. The other issue is whether DHSS are obliged to collect employees' national insurance contributions (NIC) from UK shipping companies in respect of UK seafarers working on foreign flagged vessels. This is not of concern to Isle of Man flagged vessels: the Manx Government operate similar NIC schemes to our own. But if DHSS decide that UK shipping companies have to collect NIC, this will discourage the use of UK crews in UK-owned ships flagged abroad. The legal position is not yet clear and DHSS are taking further advice. A second NIC issue raised in Mr Channon's paper - whether contributions from seafarers should be increased in April - has been settled: Mr Channon has reluctantly agreed to DHSS's proposals.

#### HANDLING

17. You will wish to begin by inviting the Secretary of State for Transport to introduce his paper. You may wish to invite the Secretary of State for Defence and the Chancellor of the Exchequer for their views. The Secretary of State for Trade and Industry may wish to comment on the implications for decisions for shipbuilding.

*R.T.W.*  
R T J WILSON  
Cabinet Office  
19 February 1988

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ANNEX A

Roll-over of balancing charges

1. The purpose of this annex is to explain the effect of granting roll-over relief on balancing charges.
  
2. A balancing charge would arise when a ship is disposed of for more than its tax written down value. Most ships in the UK merchant fleet will have been acquired before Budget Day 1984 and will therefore have attracted 100 per cent First Year Allowances, thus giving them a tax written down value of zero. Ships now attract 25 per cent Writing Down Allowances each year, and so ships purchased after Budget Day 1984 will have some residual tax written down value. The amount of the balancing charge is the disposal price less the tax written down value. Normally, Corporation Tax (currently at 35 per cent) would be charged on a balancing charge in the year of the disposal.
  
3. If, however, a replacement ship (new or secondhand) is bought in the same tax year as a previous ship is disposed of, then the balancing charge would not arise. Instead, the amount of tax capital allowances which could be claimed for the new ship would be reduced by the amount of the averted balancing charge. Thus if a ship was bought in 1983 for £100 million and sold in 1988 for £80 million then the potential balancing charge would be £80 million. If a replacement ship were bought in 1988 for £120 million, the balancing charge would be averted and Writing Down Allowances of £40 million would be available in respect of the new ship. This is advantageous for the shipping company, because effectively it receives the old valuable 100 per cent First Year Allowances on the £80 million of disposal proceeds when the replacement ship is bought.
  
4. The GCBS want UK shipping companies to be able to avoid any balancing charge not only if the sale and replacement occur in the same tax year but also if the replacement ship is bought up to three years after the disposal. Tax on the balancing charge would then only need to be paid if no replacement had been purchased

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after 3 years. This would give the shipping companies greater flexibility to buy replacement ships when it was commercially advantageous for them to do so. It would also give them a three year cash flow benefit, although Mr Channon has suggested that this might be clawed back through an interest charge if no vessel was eventually bought.

conqueror

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DEPARTMENT OF TRANSPORT  
2 MARSHAM STREET LONDON SW1P 3EB

My ref:

Your ref:

Robert Culshaw Esq  
Private Secretary to the  
Secretary of State for Foreign  
& Commonwealth Affairs  
Downing Street  
LONDON  
SW1A 2AH

17 FEB 1988

*cc PC*  
*PAB*  
*Can we please*  
*FCS (but with a*  
*substitute) to be*  
*meeting*  
*✓ Tg*  
*15/2*  
*will request if*  
*required*

Dear Robert

UK SHIPPING POLICY

We spoke this morning.

You wrote to Roy Griffins here on 15 February, suggesting that the FCO should be involved in any future exchanges on the decline of the UK merchant shipping fleet, and that you should see a copy of the paper which my Secretary of State sent to the Prime Minister on 5 February.

As you say, there are very good reasons why you should see the papers; and I apologise for not having ensured that you were copied into the correspondence before. I think it is simply a matter of the whole thing gradually evolving from a group of fiscal proposals, and the copy list not expanding accordingly!

I am therefore sending you copies of my Secretary of State's paper and of a related letter from the Chief Secretary of 12 February.

It must, of course, be for No.10 to consider whether the Foreign Secretary should be invited to next week's meeting. But my Secretary of State would have no objection whatsoever to that.

I am copying this letter to Charles Powell, to the Private Secretaries to the Chancellor, the Chief Secretary, the Home Secretary, the Defence Secretary, the Health and Social Services Secretary and the Trade and Industry Secretary, and to Trevor Woolley.

Yours

*Neil Hoyle*

N T E HOYLE  
Private Secretary



Defence - future UK needs

Pr 3

SECRET  
DEFENCE SECRETARIAT  
LONDON SW1A 2JG

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SECRET  
DEFENCE SECRETARIAT  
LONDON SW1A 2JG

SECRET

17-11  
PM88





CCBG  
CCB/UP

Treasury Chambers, Parliament Street, SW1P 3AG  
01-270 3000

12 February 1988

The Rt Hon Paul Channon MP  
Secretary of State for Transport  
2 Marsham Street  
London SW1P 3EB

JG in cell  
be admit a meeting  
CCB  
15/2

*Paul Channon*

**MERCHANT SHIPPING AND DEFENCE**

Thank you for your letter of 18 January about UK merchant shipping. I have also seen a copy of your minute of 5 February to the Prime Minister and the accompanying paper.

I note what you say about the further decline of the UK and Isle of Man fleet since July 1986, but I am also aware of the statement in the GCBS's recent policy document, "The Future of the British Merchant Fleet", that the size of the British owned and controlled fleet has been stabilised, at least for the time being. Your paper indicates that good progress has been made on clearing away any difficulties in requisitioning in war UK-owned ships on the registries of Liberia, Panama and the Bahamas.

I recognise that this still leaves two types of ship for which the UK itself does not appear to have enough vessels to meet its civil resupply needs in war. You doubt whether the NATO pool would be able to fill the gaps but until we have the results of the NATO study of supply and demand for merchant shipping, this judgement is inevitably speculative. As you say, we still have enough merchant shipping to meet the needs of the UK armed forces. I question, therefore, whether circumstances have changed materially since December 1986 when E(A) concluded that it would not be right to introduce fiscal incentives for new investment in shipping, or personal tax concessions for seafarers.

On the PAYE question I can assure you that the Inland Revenue have given very careful consideration to the meaning of the Regulation to which you refer; but, in the light of the information the shipping companies have given and the legal advice the Revenue have received, they have concluded that it is not possible to adopt the interpretation you suggest. In any event, I find it difficult to understand the companies' reported reaction to what they expect will be the Revenue's conclusions. This question concerns the mechanics by which shipping crews pay their tax; it does not affect the amount of tax for which they are liable. Given that the same





amount of tax is legally due - whether collected by PAYE or otherwise - there is no legitimate reason for shipping companies to increase their costs by compensating the seamen for applying PAYE. I imagine that the companies will not wish to argue that they are able to pay lower wages now because the assumption is that the non-operation of PAYE will enable their employees to evade their tax liabilities. And the actual compliance costs of operating PAYE, for larger employers in particular, are generally recognised to be very small.

I am glad that the question of the reduction of the National Insurance Contribution rebate for seafarers has now been settled.

As for roll-over relief, it is really, in substance, just another form of accelerated capital allowances which we largely abolished in 1984. You have recognised the importance which I place on the 1984 reforms. The introduction of any capital allowance incentives for shipping would look like the first stage in the unravelling of these reforms, which have brought substantial benefit to the economy as a whole, and could make it difficult to sustain them in the long term. Moreover the evidence does not support the proposition that the reintroduction of accelerated capital allowances - either generally or in the form of a roll-over relief - would do much to promote greater investment in shipping. The UK fleet declined sharply in the decade prior to the 1984 Budget despite the existence of full 100 per cent first year allowances.

I am copying this letter to the Prime Minister, the Home Secretary, the Defence Secretary, the Secretary of State for Health and Social Security and the Secretary of State for Trade and Industry, and to Sir Robin Butler.

A handwritten signature in black ink, appearing to read 'Nigel Lawson', written in a cursive style.

**NIGEL LAWSON**





DEFENCE: UK defence policy pt 3.





DEPARTMENT OF HEALTH AND SOCIAL SECURITY

Richmond House, 79 Whitehall, London SW1A 2NS

Telephone 01-210 3000

*From the Parliamentary Under Secretary of State for Social Security*

The Rt Hon Paul Channon MP  
Secretary of State  
Department of Transport  
2 Marsham Street  
London  
SW1P 3EB

NBDM

REC  
9/2

9 February 1988.

Dear Paul!

Paper with PG/PM

I have read your letter of 8 February to John Major.

I note that you now agree that the Redundancy Fund rebate currently enjoyed by the mariners should be abolished with effect from next April. I will therefore go ahead and order the printing of the contributions tables this afternoon. Since this is a NIC matter, I feel that I should write to the GCBS, but my officials will be in touch with yours, and with the Treasury, about the terms of the letter.

I am copying this letter to the Prime Minister, Nigel Lawson, Patrick Nicholls, Roger Freeman and Richard Needham.

I am grateful to you for your agreement.

Yours ever

Michael

MICHAEL PORTILLO





Parliamentary Under  
Secretary of State

Department of Employment  
Caxton House Tothill Street London SW1H 9NF  
Telephone Direct Line 01- 273-5808  
Switchboard 01-213 3000

cc/c

PATRICK NICHOLLS MP

The Lord Brabazon of Tara  
Parliamentary Under Secretary of State  
for Shipping and Aviation  
Department of Transport  
2 Marsham Street  
London SW1P 3EB

NBPA to this date.

filed  
15/2

9 February 1988

*John Major*

**NATIONAL INSURANCE CONTRIBUTIONS OF REGISTERED DOCKWORKERS AND MARINERS**

WITH COP?

Thank you for sending me a copy of your letter of 14 January to Michael Portillo about National Insurance Contributions. This letter also covers the one of the 2 February from Paul Channon to John Major.

You asked for my view on the possibility of the shipping industry joining the Redundancy Fund. As you will be aware the Redundancy Payments (Merchant Seaman Exclusion) Order 1973 currently excludes merchant seamen (as defined in the Order) from the statutory redundancy scheme. For the industry to rejoin the state scheme, and become eligible for payments from the Redundancy Fund, it would be necessary to revoke this Order and amend the originating legislation. I understand that there may be difficulties about this because of the contractual arrangements applying to the employment of merchant seamen and we would need to consider very carefully the legal and policy implications before I could give a firm view.

I have some doubts that the benefits that the shipping industry would gain from eligibility to draw on the Fund (over the current arrangements) would be that great but, of course, this is a matter for you. The payments available from the Redundancy Fund are limited to redundancy rebates to employers (which since August 1986 have been restricted to employers employing under ten employees), direct redundancy payments, which are made to employees when their employer is unable by reason of financial difficulty to meet his responsibilities, and insolvency payments ie payments arising from an insolvency such as arrears of pay, holiday pay and notice pay. However, if there is a positive wish to pursue the matter further I shall, of course, be happy to arrange for my officials to discuss the subject with yours.



As far as registered dockworkers are concerned, you are right in saying in paragraph 4 that amendment of primary legislation would be necessary. At the present stage, we would certainly not wish to contemplate this, nor of taking any action affecting registered dockworkers.

I am copying this letter to the Prime Minister, Paul Channon, John Major, Roger Freeman, Richard Needham and Michael Portillo.

Tom W.  
pk

---



PRIME MINISTER

**UK SHIPPING INDUSTRY: NATIONAL INSURANCE CONTRIBUTIONS 1988/89**

Charles showed you over the weekend the paper the Secretary of State for Transport has now prepared on the strategic implications of the decline of the UK merchant fleet. We will now be fixing up a private word with the Chancellor followed by a small meeting with other colleagues.

But you should also be aware of the immediate position on one minor issue affecting the shipping industry which has been causing Mr. Channon concern, and where he has proposed action should be suspended. This is a proposal to abolish the Redundancy Fund rebate on national insurance contributions. This will have the effect that a mariner may have to pay up to an extra 76p per week in NICs.

Following exchanges in recent weeks, the Department of Health and Social Security are now proposing this week to go ahead with this proposal. I think the case for doing so is strong, and any action taken to "protect" the shipping industry from the change would be very difficult to present. But you may like to glance through the recent papers to check that you are content for the DHSS to proceed as set out in Mr. Portillo's latest letter of today.

PG

8 February, 1988.

JD81

*I fear DHSS will  
have to go ahead. But it makes  
consideration of the main point even  
more urgent.*





DEPARTMENT OF HEALTH AND SOCIAL SECURITY

Richmond House, 79 Whitehall, London SW1A 2NS

Telephone 01-210 3000

From the Parliamentary Under Secretary of State for Social Security

Rt Hon Paul Channon MP  
 Secretary of State for Transport  
 Department of Transport  
 2 Marsham Street  
 LONDON  
 SW1P 3EB

*cc BG*  
*Mr Paul*  
*to see X*  
~~PA - [unclear]~~  
*R26*  
*SL*

8 February 1988

*Dear Paul*

UK SHIPPING INDUSTRY : NATIONAL INSURANCE CONTRIBUTIONS 1988-89

I have read your letter to John Major of 2 February, and his reply of 5 February. My belief is that the abolition of the Redundancy Fund rebate must go ahead in 1988-89. It would be illogical to continue to reduce mariners NIC's in respect of an Employment Protection Allocation which will no longer exist. To keep the rebate in force after abolishing the EPA on which it is based would mean that these Mariners would pay 0.25 per cent less than everybody else into the National Insurance fund for no good reason. I cannot, therefore, contemplate any further delay: otherwise the employers will not receive the appropriate contributions tables by the start of the financial year. The effect of this change on the industry has been exaggerated. The extra yield in National Insurance contributions is just £1 million - £600,000 extra paid by mariners, and £400,000 extra from employers. The maximum extra amount that a mariner would have to pay in NIC would be 76 pence per week. Mariners have benefited from the rebate since 1982, and I should remind you that when the Employment Protection Allocation was cut in 1983 from 0.35 per cent to 0.25 per cent, the mariners' rebate was subsequently cut by the same amount. I should also add that employers of foreign-going mariners are entitled to a rebate of 0.5 per cent on employers' contributions, for which I have proposed no change in 1988-89.

*with request of reqd.*

I have now also had a chance to see your paper "Strategic Implications of the Decline of the Merchant Fleet". In paragraph 22(ii) you refer to the joint investigation by the Inland Revenue and DHSS into how employment practices in the shipping industry affect liability for National Insurance Contributions. This is an entirely separate issue from that of the Redundancy Fund Rebate. Officials are still collecting the evidence with regard to NIC liability and there is no prospect of an early decision on this.

*X*



C.R.

I regret having to take action on this matter in the absence of agreement between us: but we have now run out of time. Computer software houses must be told the rates this week. The mariners' contribution tables have to be printed by the middle of this month.

I propose therefore to announce the decisions by written PQ as quickly as is convenient; to authorise printing of the contribution tables on the afternoon of February 9 and to inform the computer software houses on February 11, when they have an important meeting.

I am copying this letter to the Prime Minister, Nigel Lawson, John Major, Patrick Nicholls, Roger Freeman and Richard Needham.

Yours ever

Michael.

MICHAEL PORTILLO





DEPARTMENT OF TRANSPORT  
2 MARSHAM STREET LONDON SW1P 3EB

My ref

Your ref

The Rt Hon John Major MP  
Chief Secretary to the Treasury  
HM Treasury  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

8 FEB 1988

Dear John,

UK SHIPPING: NATIONAL INSURANCE CONTRIBUTIONS

Thank you for your further letter of 5 February. I have considered carefully what you have said as well as the letters from Michael Portillo of 28 January and 8 February. *file with PG*

Your point about perspective is well made. The removal of the rebate will result in the shipping industry's contribution being increased by about £1 million in 1988/89. This may seem a modest enough sum but then so is the financial assistance which is being provided to the industry through the Merchant Shipping Bill. This comes to only £5 million in 1988/89, so we shall be seen to have devalued that support by 20% even before the Act is on the Statute Book.

If we are to proceed with your proposal, therefore, we shall need to take these effects into account in considering other measures to help ensure that the merchant fleet meets our strategic requirements. There is in addition the important presentational point which Ivon Brabazon made and which still does not appear to have been answered. The increase for shipping will have to be explained and defended to the industry. This can only be done by telling them that it is our policy to hold overall NIC rates constant, even when there are changes within the mix of particular NIC contributions. In this case, the other NIC contributions are being increased so that the overall level is maintained. Consequently, before Michael Portillo makes his announcement, I will need to write in these terms to the General Council of British Shipping, to minimise the adverse reaction.



I am copying this letter to the Prime Minister, Nigel Lawson, Patrick Nicholls, Roger Freeman, Richard Needham and Michael Portillo.

*Xmas,*

*Paul*

PAUL CHANNON



DEFENCE: Future UK Defence  
Policy Pt 3

PAUL CHURTON





10 DOWNING STREET

~~PE~~  
~~PAB~~

11.00 on  
Tues. 23rd Feb  
1 hr.

Shipping

Please see my note  
attached. We need:

- to put on the  
agenda for the PM's  
bilateral with the  
Chancellor on 14 February  
(since this is not one hour).
- fix a meeting  
a.s.a.p. after 14 February



for Transport fee,  
Chancellor, Deputu  
Secretary, Trade & Industry  
fee. no discuss this.

Circle of PAB  
could fix the meeting.

CAP  
- 2/2



PRIME MINISTER

MERCHANT SHIPPING AND DEFENCE

You expressed alarm at the figures given by the Transport Secretary for the decline in the UK merchant fleet (from 27 million tonnes in 1980 to 17 million in 1986 to 12 million by the end of last year).

At your request, the Transport Secretary has now produced the attached minute and paper. Its conclusions are:

- the ships which we and other European members of NATO could make available to meet the USA's requirements for moving defence equipment to Europe in time of tension are now inadequate;
- for two types of ship, the UK already does not have enough to meet its foreseen civil supply needs in war;
- while we still have enough to meet the needs of the UK armed forces, we soon shall not unless there is new investment (at present there is none);
- since stimulating investment is the key, the Chancellor should consider including in the budget a measure of roll-over relief for investment in shipping;
- we should not pursue the proposal to extend PAYE and NIC obligations to UK shipowners for the crews of ships registered outside the UK.

When E(A) last considered this in 1986, you concluded that "it was of crucial importance that there should be an adequate merchant marine to meet the nation's needs for defence and for civil resupply at time of tension and war." Equally you also concluded that "the Sub-Committee did not believe that it



would be right to introduce fiscal incentives for new investment ... or personal tax concessions for sea-farers."

The upshot is that:

- the problem has got worse since 1986;
- the remedies agreed then have not been effective;
- but the remedies suggested now are those which (or very similar to those which) E(A) rejected in 1986.

*Yes - urgent*  
It does not seem to me worth putting this back to E(A) as it is. It would probably be better to get a smaller group of Ministers - Transport, Defence, Chancellor, Trade - to look at in the first instance. The question is whether you have time to chair it, or prefer to delegate it to a neutral Minister. The latter is difficult since solutions are likely to mean over-ruling the Treasury.

Agree to chair a small meeting when time can be found? *Yes*

Or prefer to have a private word with the Chancellor first? *and Yes*

*C.D.P.*

*not*

CHARLES POWELL

5 February 1988

VC3AVZ





CC: B/UP

Prime Minister

MERCHANT SHIPPING AND DEFENCE

1. I am deeply concerned about the strategic implications of the decline of the UK merchant fleet. I set out the position in greater detail in the attached paper.

2. The ships we and other European members of NATO could make available to meet the USA's requirements for moving defence equipment to Europe in time of tension are now inadequate. For two types of ship, the UK does not have enough to meet its foreseen civil supply needs in war; and I do not think the rest of NATO would be able to cover the gaps. We still have enough British ships to meet the particular needs of UK armed forces in time of tension and war. But that will not continue unless there is UK investment in merchant ships in the future. At present there is virtually none. The prospects of adequate availability of British shipping are not good.

3. In the Merchant Shipping Bill I am doing something about possible shortages of UK seafarers. In the UK and in NATO I am taking all possible steps to get the members of the Alliance able to use all the shipping owned by their nationals. In the UK we are benefiting from the increased use being made of British registers such as the Isle of Man and Bermuda.

4. But none of these steps and developments will make good a continuing lack of investment. I have therefore pressed the Chancellor as a first step to give favourable consideration to including in the Budget a measure of





roll-over relief for investment in shipping. Beyond that, we need to develop further proposals focussing on shortages of particular types of vessel.

5. I must also make it clear that I am extremely perturbed by possible PAYE and NIC moves which would be harmful to our strategic interests in shipping. The Inland Revenue are proposing to impose PAYE obligations on UK shipowners for the crews of their ships registered outside the UK and manned by seafarers employed by manning agencies established outside the UK. The effect on UK-owned ships on Isle of Man and Bermuda registers could be disastrous: owners might either move to foreign registers and give up all UK crewing, or sell out altogether.

6. The DHSS are moving the same way on NICs. They also propose to increase NIC contributions of all UK seafarers.

7. I think these damaging proposals should be suspended.

8. I am copying this minute to the Chancellor, the Home Secretary, the Defence Secretary, the Health and Social Services Secretary, the Trade and Industry Secretary and Sir Robin Butler.

P.C.

PAUL CHANNON

5 February 1988



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STRATEGIC IMPLICATIONS OF THE DECLINE OF THE MERCHANT FLEET

Note by the Secretary of State for Transport

INTRODUCTION

1. The total fleet of ships registered in the United Kingdom and Crown Dependencies shrank from 27 million tonnes - 6% of the world fleet - in 1980 to less than 12 million tonnes (2%) at the end of last year. The number of trading vessels on the UK register has halved in the last five years. Although other vessels such as those registered in overseas Dependent Territories and those owned in the UK but registered in foreign countries can be claimed as part of our overall shipping assets, the picture remains one of steep decline, without parallel in any other country of maritime importance.

2. Our needs for shipping in crisis and war would comprise:

the UK contribution to transatlantic reinforcement;

direct support for the armed forces;

civil supply for the UK from overseas.

THE POSITION TODAY

Transatlantic Reinforcement

3. The US merchant fleet is insufficient to bring US military stores and equipment across the Atlantic in a crisis to reinforce Europe. NATO has agreed under the Rapid Reinforcement Plan (annex A) that European countries will supplement US shipping resources. Taking account of geographic dispersement and the need for rapid availability the Pentagon has estimated that some 600 dry cargo ships need to be earmarked for this task in order to enable 400 ships to be delivered promptly to the US Eastern seaboard. Following a US review now coming to an end the requirement for 400 ships is likely to increase this summer to about 450. The requirement, which could well extend into a period of war, makes no allowance for attrition.

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4. The availability of ships for this plan is monitored every six months. The number of suitable ships has declined substantially over the past five years. Last September only 448 dry cargo ships were earmarked, of which 94 were British. The equivalent figures only 2 years before were 574 and 124. There is therefore already a substantial shortfall, even disregarding any losses which might occur.

**UK Military Requirements**

5. The Ministry of Defence would need ships for support of naval operations, reinforcement of central Europe and the flanks, outload to Europe of US stores and depots in the UK, and bringing back forces from overseas bases. The majority of this shipping will be needed at an early stage of crisis and for a relatively short period.

6. Annex B shows that at present these requirements can be met with British-registered ships (including those from Dependent Territories) with the exception of one heavy-lift vessel. The position on ro-ro ferries could be strained if different reinforcement movements were compressed. Whilst we should be able to offset substantial shortages of British ro-ro ferries by use of ships owned by our NATO allies, the consequences of post-Zeebrugge safety standard changes have yet to be seen.<sup>(1)</sup> The supply of British product tankers should cover our naval requirements but the position would be tight, and here in particular we are increasingly dependent on vessels registered in the Isle of Man and Bermuda.

**Civil Supply**

7. Assessing the shipping required for sustaining the civil economy is difficult, and the supply departments do not have precise wartime import plans. Nonetheless my Department has estimated our important civil requirements in war. The results, summarised in annex C, indicate that even in the early days of a war there would be shortages of general cargo vessels and product tankers. As the war progressed the shipping situation would deteriorate as ship attrition and port damage took their toll.

8. In war NATO would pool its ocean-going ships for employment in the best overall interests of the Alliance. The pool has however contracted significantly in recent years (annex D) and, although there has as yet been no overall assessment of NATO wartime supply and demand for merchant shipping (see paragraph 14(a)), it is clear from the the overall supply figures (annex C) that we cannot expect UK shortfalls of shipping for civil supply to be wholly offset by surpluses of other countries.

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1. The Sheen report recommended that ferries built to pre-1980 standards should be scrapped if they could not be suitably modified.



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**Overall Supply and Demand Position**

9. The main features are:

- a. **Tankers.** UK requirements can still be met using British registered and flagged-out ships (for the latter see paragraph 15), except for product tankers (10,000 - 40,000 dwt). The NATO pool is unlikely to be able to make up this shortfall.
- b. **Bulk Carriers.** UK requirements can still be met using British registered and flagged-out tonnage.
- c. **Small General Cargo Ships.** There would be a shortage if all UK working anchorages (paragraph 14(c)) had to be activated. The NATO pool would not make up the shortfall - the NATO pooling arrangements do not cover most of this type of ship - but bilateral arrangements with Norway, Denmark and Netherlands should enable us to fill the gap (see paragraphs 16 and 17).
- d. **Large General Cargo Ships.** Even allowing for access to dependent territory and flagged-out shipping, we would not have enough large general cargo ships. These difficulties are likely to be aggravated by the commitment to assist the US with transatlantic reinforcement. The NATO pool is unlikely to be able to make up the UK shortfall.
- e. **Container Ships.** If transatlantic reinforcement was not completed by the outbreak of war our container ships would still be in use for it, and our own requirements for container ships would not be met.
- f. **Other Ships.** UK requirements can be met from UK registered ships except a single heavy-lift ship. (MOD are making arrangements with the Netherlands for one.)

**PROSPECTS**

10. In overall terms UK merchant shipping is now deeply into the second phase of an extensive adjustment to difficult trading conditions world-wide. In the first phase UK owned tonnage contracted massively, down to some 17 millions dwt as owners cut their losses and sold ships; this process has now slowed down. In the second phase many owners, in an attempt to find an acceptable basis for remaining in the most sharply competitive areas of shipping business, are seeking out lower costs by moving vessels from the UK mainland register to the Isle of Man; to dependent territories - Bermuda, Gibraltar, Hong Kong etc; and to open registers such as Liberia or Panama. This process, which has reduced the UK register to 5 million dwt, has further scope to run and this will involve some further reduction in UK crews.



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11. Within this overall pattern, prospects for UK shipping vary considerably between sectors:

- Our container-ship sector, although profitable, has been stagnant for some years and looks unlikely to expand significantly. Extensive fleet renewal will be needed within five years to maintain our present position.
- Our deep sea tankers and dry bulk sectors have borne the brunt both of contraction and the search for lower cost registers. Although these markets are improving, significant expansion by UK owners looks out of the question, and further flagging-out is likely.
- The market for small bulk vessels is severely overtonnaged, rates are low and some further contraction by UK owners can be expected.
- Conventional break bulk ships have no future in UK operations. They have been effectively displaced by container ships in most Western European fleets.
- Both our ferry and cruise shipping sectors are robust and profitable, and they have made new investment during the last few years. This capacity is secure but expansion is unlikely - because of the Channel Tunnel and a surge of new cruise ship building by Norwegian and other owners.

**STRATEGIC IMPLICATIONS**

12. These prospects provide no basis for expecting recovery either in the overall size of the UK owned fleet or in that proportion of it which is held in the mainland register. The unpalatable but quite critical conclusion is that the size and composition of UK shipping that will be commercially sustainable in world conditions over the next few years will become increasingly inadequate to meet our strategic needs.

**Deterrence and Crisis Management**

13. The UK reinforcement of the Continent is still viable. The ability of the US to reinforce Europe in a crisis is looking less credible, in spite of substantial efforts being made by the US to strengthen their Ready Reserve Fleet. This is an issue of major importance in defence planning, and its significance is likely to increase with the successful negotiations of strategic arms limitations.



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War

14. There are two outstanding areas of concern:

- i. product tankers, where the tight supply position would weaken naval operations if there were significant attrition, and would reduce the availability of fuel for the armed forces and the civil economy;
- ii. the initial shortage of general cargo vessels and the development of shortages of other vessels as attrition took place could have the most serious implications for our ability to sustain the nation in war.

And these assessments make no allowance for any difficulty in requisitioning or crewing ships on registries outside the UK.

**ACTION IN HAND**

**In NATO**

15. UK pressure in NATO led to a communique in October 1986 to the North Atlantic Council highlighting our concern at the decline in the number of Alliance ships, and then to a number of initiatives:

- a. NATO has agreed (on the basis of UK proposals) to carry out a comprehensive supply and demand study of Alliance merchant shipping. The feasibility study has recently been completed, but the main study is being held up because of difficulties over of NATO's military budget. If it starts soon, first results can be expected in 1989.
- b. We have encouraged our NATO partners to take measures that would enable them to get control of their flagged-out ships. Several, including Germany and Norway, are responding.
- c. The Alliance has been trying to ensure that all available ships would be used as efficiently as possible. To that end, plans have been made to modify container ships to enable them to carry non-containerised military equipment. (We have for some time had plans for setting up emergency port facilities - working anchorages - and equipment to enable container, bulk and other ships to continue to off load to the UK even if our major ports have been damaged).



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**Flagged-Out Shipping**

16. We have long taken the view that shipping beneficially owned by UK companies but registered in foreign states is a resource that we should plan to secure in war. We have therefore for the last three years used commercial sources to monitor what such ships there are. Draft emergency legislation has been extended to include their requisitioning in crisis. To avoid the possibility of legal conflicts with the states of registry we have been negotiating appropriate agreements to ensure that they will not stand in our way if British controlled ships are requisitioned. The current state of play in these negotiations is:

Bahamas has agreed to sign a memorandum of understanding under which they will undertake not to oppose any attempt by the UK to requisition ships owned by British companies currently on their register.

Liberia has indicated no opposition in principle provided the prior agreement of the owner is obtained, and we are putting final proposals to them.

Panama has indicated that its sovereignty requires reflagging back to the UK before requisitioning takes place; but Panama will undertake not to oppose this reflagging provided the owners are up to date on their dues. An agreement on these lines is being finalised.

Vanuatu has approached us for an agreement; proposals are on their way to them.

Arising from these negotiations we have prepared draft contracts of commitment whereby UK shipowners guarantee to make their foreign registered ships available in a crisis on the understanding that HMG will provide war risks reinsurance in the event of hostilities involving the UK. The agreements between HMG and the UK War Risks Associations have also been recently revised to enable foreign-registered ships to be covered.

**Bilateral Agreements with Allies**

17. We have had agreements for many years with Denmark and Norway whereby we reinsure their merchant ships in war against a common enemy in return for a first refusal on the ships that they did not require. This provides a particularly useful source of coastal vessels. We have recently initiated discussions with the Netherlands to secure a similar arrangement, which would give us access to a further 400 coasters.

18. We already have arrangements with Denmark, and are completing some with Norway, for these countries to make certain specialised ships available to the UK for military use in specified circumstances.



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**Crews**

19. There has been increasing concern about the decline in the number of trained seafarers to man the merchant ships we should use in time of war. Availability of crews is also recognised within NATO as being of prime importance, and the Alliance is working on the problem. Draft UK emergency legislation provides for the direction of labour. In addition, the current Merchant Shipping Bill includes three initiatives which will provide some help towards increasing the supply of British seafarers in wartime. They are:

- assistance for travel costs of crews in deep sea changeovers;
- assistance towards the cost of training seafarers;
- the establishment of a Merchant Navy Reserve.

**IMMEDIATE MEASURES**

20. I now come to the further steps we should take. The restructuring of capital allowances in 1984 unquestionably reduced the attractiveness of this country as a place in which to invest in shipping, and I have urged the Chancellor to help stimulate some new investment by introducing for a limited period roll-over relief for taxation of balancing charges on ship assets. I believe that the special strategic importance of shipping, the uniquely mobile nature of the assets, and the dramatic drying-up of investment since 1984 together justify making an exception for this industry.

21. As is clear from the experience of other European countries, this is not necessarily the most effective fiscal measure that could be adopted; the restoration of substantial first-year depreciation allowances of a general exemption of deep-sea seafarers from personal tax and/or security liability could have a more profound impact, but both would involve a more distinct reversion to policies which the Chancellor abandoned in 1984.

22. There are however other areas where we need to act now to avoid the decline getting worse:

i. PAYE

Several large UK shipping companies with deep sea tonnage - notably Shell Tankers, Canadian Pacific and Maersk (UK) - have transferred vessels to the Isle of Man register. By not going further afield - to Panama or Liberia, for instance - they have prevented the decline of the fleet assuming catastrophic proportions. One of the features of



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the transfer was that in the process they have relieved themselves of direct employment responsibilities and costs by contracting Manx crewing agencies to provide crews for their vessels. The Inland Revenue have been looking into these arrangements, and intend to require at least some of the companies concerned to operate PAYE arrangements for UK seafarers on their vessels. Some of the companies concerned have said that if this happens and to save themselves the trouble of further re-negotiation with the seafarers' unions, they will instruct the agencies not to place UK seafarers on their vessels. This will mean re-registering the vessels abroad, since Isle of Man regulations require certain officer posts to be filled by holders of the UK certificates or equivalent. There are now at least 90 deep sea vessels totalling 3.5 million deadweight tons on the Isle of Man register, possibly employing in total around 6000 seafarers. Not all these vessels would be re-registered, and not all the seafarers employed on them are UK citizens, but the departure of one large owner could start a run, with severe implications for the availability of these vessels and seafarers in time of emergency (and for the Manx economy).

ii. National Insurance Contributions

The DHSS is considering making a similar decision on the obligation of UK shipping companies to pay employees' NICs in respect of UK seafarers employed by crewing agencies to man their vessels. Whilst this would not alter the current position in respect of Manx agencies (because the Isle of Man operates a national insurance scheme similar to ours) it would discourage foreign agencies from including UK seafarers in the crews they provide for UK-owned vessels registered abroad. Finally, proposals to increase NICs for seafarers while leaving all other employees (apart from dockworkers) where they are will take a further £1m out of the industry and have a bad psychological impact at a critical time.

*now agreed  
and announced.  
R266 n/2*

**LONGER-TERM MEASURES**

23. Both the shortage of vessels for transatlantic Sealift and the shrinking of the NATO pool are issues which the Alliance must address. But we must expect that at the end of the day it will be the Member States that will have to do whatever is necessary. We ought now to be thinking about further ways of tackling the shortages that will inevitably develop.



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24. Many of the troubles that have affected world shipping recently have arisen from an excess of shipyard capacity. We should therefore avoid if possible the kind of generalised subsidy that will lead to new buildings regardless of demand. But the British fleet is ageing, and help should be targetted towards desirable new investment in areas of strategic importance. There is also the problem of competing with cheap crews from the third world with negligible tax or social security commitments. Our measures in the Merchant Shipping Bill will not be enough to bridge that gap.

25. In 1986 E(A) considered proposals from my predecessor to tackle both problems. Since then the situation has deteriorated. We ought now to look again at ways of assisting the industry but concentrating as closely as possible on the vessels that will be in particularly short supply.

**RECOMMENDATIONS**

26. I invite colleagues to:

- i. note the importance of an adjustment this year in the capital allowances regime for ships, to give owners more flexibility over their re-investment decisions and so to encourage them to stay in shipping.
- ii. endorse my request that the Inland Revenue and the DHSS should avoid taking actions which seriously detract from the advantages of the Isle of Man and other dependent territory registers; and that the DHSS should suspend its proposal to increase NICs for seafarers;
- iii. agree that further work should be set in hand on a scheme or schemes to encourage British shipping companies to acquire and operate vessels of particular importance to our strategic interests.



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Annex A

**TRANSATLANTIC REINFORCEMENT AND SUPPLY**

1. The Major NATO Commanders plan to move reinforcements to Europe prior to the outbreak of war. Reinforcement movement would be initiated on short notice and would have to be completed as quickly as possible. The major task would be the deployment of US reinforcements to Europe

2. Some ships from the US National Defence Reserve Force can be activated rapidly and would be employed in the opening phases of the Reinforcement Sealift, but most of the reinforcement shipping would consist of liners taken from trade. The United States would requisition its liner fleet immediately under standby legislative authority. For fastest possible delivery of reinforcements, the US fleet would be augmented by European NATO liners. NATO has identified the ships in the European NATO fleets that are most suitable for Reinforcement Sealift. Governments up-date the lists every six months.

3. Current estimates of the amounts of munitions and freight to be moved from the US to Europe under NATO's Sealift Reinforcement plan are 8.5 million tons of dry cargo and 15 million tons of POL reinforcement cargo, followed by 7.2 million tons of dry cargo and 9.6 million tons of POL as re-supply, all within the first 180 days of tension and war. Of this, the equipment for the first 30 days active duty brigades should be in Europe within the first 30 days. To take account of geographic dispersion and the need for rapid availability it has been estimated that 600 dry cargo ships need to be earmarked to meet a requirement of 400 ships, though a current review by the US indicates that this requirement is likely to increase to around 450 ships. At the last count (September 87) 448 European vessels were earmarked for Sealift. There is therefore a substantial shortage of ships for this critical role. Table 1 to this annex shows the decline in vessels earmarked for Sealift from 1982 to 1987.

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Table 1 to Annex A

NATO SEALIFT: DRY CARGO VESSELS

	Apr 82	Apr 83	Apr 84	Sept 85	Sept 86	Sept 87
Belgium	18	16	15	15	13	13
Denmark	59	61	56	45	41	51
Germany	102	103	101	101	98	99
Greece	85	72	119	106	84	75
Italy	35	35	33	28	28	28
Netherlands	85	84	80	76	73	62
Norway	69	53	57	50	39	9
Portugal	14	14	14	14	7	3
Turkey	15	15	15	15	15	14
United Kingdom	138	115	117	124	100	94
<b>Total</b>	<b>620</b>	<b>568</b>	<b>607</b>	<b>574</b>	<b>498</b>	<b>448</b>

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## UK ARMED FORCES SHIPPING REQUIREMENTS

TYPE OF VESSEL	NUMBERS AVAILABLE WITHIN REQUIRED TIMESCALES		REQUIREMENT
	UK REGISTERED	DEPENDENT TERRITORY REG'D INCLUDING IOM & CHANNEL IS.	
LARGE STERN TRAWLERS	4	0	20 SEE NOTE 1
OTHER FISHING VESSELS AND OFFSHORE SUPPORT VESSELS	317	8	88
PRODUCT TANKERS 2,000-4,000 DWT	17	9	11
4,000-15,000 DWT	0	9	4
15,000-60,000 DWT	6 (8)	43 (58) SEE NOTE 2	24 SEE NOTE 3
BREAK BULK-GENERAL CARGO VESSELS 1,000-10,000 DWT SEE NOTE 4	88	27	) ) ) ) 43
SMALL CARGO VESSELS OVER 300 GRT UP TO 1,000 DWT	58	20	) ) )
LARGE PASSENGER LINERS	3	0	2
RO/RO FERRIES PASSENGER & FREIGHT	63	9	63
HEAVY LIFT SHIPS	0	0	1
TUGS	96	2	12

1. The Shortfall in supply would be made up by adapting offshore support vessels.
2. The Unbracketed availability figures are for vessels assessed as being available within 14 days; the bracketed figures refer to the total numbers available within 30 days.
3. 12 are required within 14 days.
4. Sealift listed vessels are assumed to be unavailable.



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**UK WARTIME SHIPPING  
OVERALL SUPPLY AND DEMAND**

Annex C

	A: SUPPLY						B: DEMAND					A-B	
	UNITED KINGDOM REGISTER	ISLE OF MAN AND CHANNEL ISLANDS REGISTERS	DEPENDENT TERRITORIES REGISTERS (EXC HONG KONG)	HONG KONG REGISTER	UK BENEFICIALLY OWNED BUT REGISTERED OVERSEAS	TOTAL	UK MILITARY	UK ESSENTIAL IMPORTS (SEE NOTES)	DEPENDENT TERRITORIES (INC HONG KONG) ESSENTIAL IMPORTS	UK ANCHORAGES AND OFFSHORE	TOTAL	BALANCE	NATO POOL
TANKERS 1,000 - 10,000 DWT )	60	18	15	11	14	118	11		1	14	26	+ 92	232
10,000- 40,000 DWT ) <b>product tankers</b>	57	35	24	22	20	158	18	164	8	7	197	- 39	473
40,000- 80,000 DWT )	10	8	6	2	1	27	10	5	4		19	+ 8	229
80,000-150,000 DWT	6		4	5	14	29		7	4		11	+ 18	211
OVER 150,000 DWT	4	5	16	4	2	31		27		2	29	+ 2	195
DRY BULK CARRIERS													
5,000 - 40,000 DWT	30	1	29	53	8	121		67			67	+ 54	659
40,000 - 80,000 DWT	5		7	53	12	77		9	2		11	+ 66	317
80,000 - 150,000 DWT	4	2	3	28	4	41		16	12		28	+ 13	97
OVER 150,000 DWT	2	2	2	12	2	20		4			4	+ 16	38
GENERAL CARGO (CONVENTIONAL, SPECIALISED, CONTAINERS, DRY BULK) BELOW 5,000 DWT	111	10	76	22	68	287	31		7	397	435	-148	368
GENERAL CARGO (CONVENTIONAL & SPECIALISED) 5,000 DWT AND OVER	24		30	27	29	110	12	505	31		548	-438	800
CONTAINERSHIPS 5,000 DWT AND OVER	44	8	5	23	6	86		63	16		79	+ 7	483
RO-RO	116	8	25	15	9	173	63	8	4	35	110	+ 63	276
TUGS	241	1	22	22	32	318	12			43	55	+263	-
LARGE PASSENGER LINERS	8			1	3	13	2				2	+ 11	119
HEAVY LIFT VESSELS	0					0	1				1	- 1	
OTHER (INCLUDING MOORING BOATS, STERN TRAWLERS, FISHING VESSELS, OFFSHORE SUPPORT ETC)	465	18	93	10	62	648	92			110	202	+446	-



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Table 1 to Appendix D

VESSELS IN NATO POOL: 1983-1987

The main figures in the table below show the total numbers in the NATO pool; the bracketed figure show the UK contribution. The categories of vessels differ from those in table 1 to Annex C.

VESSEL TYPE	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Tankers (all types)	1486	1402 (290)	1285 (232)	1246 (227)	1106 (186)
Dry Bulk Carriers	1490	1501 (249)	1398 (243)	1306 (243)	1188 (227)
General Cargo	1697	1579 (176)	1451 (132)	1324 (146)	1082 (115)
Containership	330	415 (77)	438 (73)	432 (74)	420 (62)
Ro-Ro	262	239 (40)	283 (38)	297 (46)	289 (38)
Large Passenger	303	227 (16)	190 (16)	188 (13)	183 (12)
Other (inc helicopter carriers, salvage vessels etc)	-	47 (5)	147 (4)	160 (29)	124 (21)
	—	—	—	—	—
	5568	5410 (853)	5045 (738)	4953 (778)	4392 (661)
	—	—	—	—	—

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Annex D

THE NATO POOL

1. The NATO pool would comprise all ocean-going merchant ships (broadly 1600 grt and above) brought under national control by member governments (by requisition or otherwise) except limited categories that could be excluded (see paragraph 5 below). The pool would in addition to Alliance-flag shipping include flagged out shipping brought under national control by member governments as well as possibly neutral tonnage on long-term charters. The pool would also include ships controlled by those non-nato countries participating directly in the allied effort.

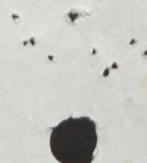
2. The users of shipping in the NATO pool would be member governments of the Alliance, who would determine their national priorities for shipping for military and civil purposes. In a period of crisis the North Atlantic Council would be responsible for deciding policy guidelines for overall priorities within the Alliance. These policy guidelines would be used in the allocation of shipping to member governments.

3. Table 1 shows how the numbers of vessels in the NATO pool has declined from 1983 to 1987 and how the composition of the pool has changed during this period.

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DSF6NCG : UK Policy PT3





5.2.88



Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP  
 Secretary of State for Transport  
 Department of Transport  
 2 Marsham Street  
 London  
 SW1P 3EB

NBM

RCCG

5/2

5 February 1988

Sea Secretary of State,

**UK SHIPPING: NATIONAL INSURANCE CONTRIBUTIONS**

Thank you for your letter of 2 February.

I think I should emphasise that seamen will not be buying less in the way of benefit entitlement for the same contribution. Entitlement to Redundancy Fund benefits is not 'bought'; it is acquired as a result of being employed, subject to certain exceptions.

All National Insurance contributions (NICs) paid by mariners from April 1988 will go into the National Insurance Fund (NIF) (with the exception of the NHS allocation). The same is true of non-mariners. This money will then go exclusively to fund NIF benefits, to which mariners are entitled - not Redundancy Fund benefits. Any Redundancy Fund benefits distributed after April 1988 will be paid for out of the Redundancy Fund surplus, which has built up over some years from the contributions of employees entitled to Redundancy Fund benefits. The money in the Redundancy Fund has been paid in by workers other than mariners; it will be paid out to workers other than mariners.

As far as any presentational problems are concerned, I think that the NICs change has to be kept in perspective. As you say, the Merchant Shipping Bill will give substantial help to the shipping industry; the change to NICs will cost the employers of a mariner earning £12,500 a year about 36 pence a week.



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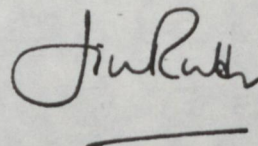
DEFENCE UK Defence Policy 3

You also ask whether it would be possible to bring the shipping industry within the scope of the Redundancy Fund. This is of course a matter for Patrick Nicholls and the Department of Employment in the first instance. But I understand that it would require primary legislation, would be administratively complex, and in any case be unlikely to be of much benefit to the industry.

I understand that the timetable for consultation, which began with Michael Portillo's letter of 16 December, has now virtually run out. In view of Michael's letter of 28 January, I hope he will now proceed to lay the regulations on the basis proposed.

I am copying this letter to the Prime Minister, Nigel Lawson, Ivon Brabazon, Patrick Nicholls, Roger Freeman, Richard Needham and Michael Portillo.

Yours sincerely,



pp JOHN MAJOR

(Approved by the Chief Secretary +  
signed in his absence).

88/11/17



GC80



DEPARTMENT OF TRANSPORT  
2 MARSHAM STREET LONDON SW1P 3EB

My ref: C/PSO/836/88

Your ref:

The Rt Hon John Major MP  
Chief Secretary to the Treasury  
HM Treasury  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

*NBSM  
RCC  
hr*

*Dear John,*

**12 FEB 1988**

**UK SHIPPING: NATIONAL INSURANCE CONTRIBUTIONS**

Thank you for your letter of 25 January. *got flap.*

You say that the defence of Michael Portillo's proposal is quite straightforward: employees and employers in the shipping and ports industries should not be able to buy entitlement to the same benefits for less than any other employee with the same earnings. But they would not be buying the same entitlement, because they do not have access to the National Redundancy Fund. The fact that the employment protection allocation would for the time being be suspended does not alter the fact that seamen and registered dockworkers and their employers would be having to pay increased NICs for no improvement in entitlements.

The argument seems to be that the earlier contributions and rebates for employment protection have been too high, and that the proposed imbalance would rectify the situation. If so, it does not reflect well on the way contributions have been assessed in the past, nor would it appear to everyone as really quite straightforward. The defence would have to be that everyone's NHS contribution was going up. Ivon Brabazon said in his earlier letter that he was not clear whether Michael Portillo intended to say this, and the point still does not seem to be clear. If you and he are not prepared for this, I think you should think again about the rebate.

Even if you are, I am disappointed that you do not feel able to accept Ivon's request that we withhold implementation of the proposed increase in the contributions paid by the shipping (and ports) industry until we have



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considered the presentational aspect. Implementation could not take place at a less opportune time than the present. For the Government to give to the industry with one hand (through the Merchant Shipping Bill) but take with the other (through requiring increases in NICs of both seamen and their employers) would do us no credit.

In any case I should like to know the views of Patrick Nicholls on the question of bringing both the shipping industry and registered dockworkers within the scope of the National Redundancy Fund.

I am copying this letter to the Prime Minister, Patrick Nicholls, Roger Freeman, Richard Needham and Michael Portillo.

*Yours,  
Paul*

PAUL CHANNON

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DEFENCE: UK Defence

Policy 173







DEPARTMENT OF HEALTH AND SOCIAL SECURITY

Richmond House, 79 Whitehall, London SW1A 2NS

Telephone 01-210 3000

*From the Parliamentary Under Secretary of State for Social Security*

The Rt Hon Paul Channon MP  
Secretary of State  
Department of Transport  
2 Marsham Street  
London  
SW1P 3EB

*1. Mr Paul - to see*

*2. PA - NBPM*

*PR16  
1/2*

*28 January 1988*

*Dear Paul*

UK SHIPPING INDUSTRY: NATIONAL INSURANCE CONTRIBUTIONS 1988-89

*at flap*  
In your letter to Nigel Lawson you raised the question of the rebated National Insurance Contributions (NICs) which some mariners currently pay. The GCBS proposal that employers' NICs in the shipping industry should be halved would cause me severe difficulties: such a concession would lead to other hardpressed industries demanding similar treatment.

As for the Redundancy Fund rebate itself, it would be illogical to continue to reduce mariners' NICs in respect of a non-existent Employment Protection Allocation. To keep the rebate in force, after the EPA, on which the rebate is based, is abolished, would imply that these mariners would pay 0.25 per cent less than everybody else into the National Insurance Fund. This would hardly be fair to the minority of mariners who currently do not enjoy the rebate as well as to everybody else.

Further delay in reaching agreement about the proposals for mariners' and registered dockworkers' NICs for 1988-89 will cause severe difficulties, since computer houses must be told by the end of this month what mariners' NIC rates will be from next April, and that is why I raised the matter as long ago as 16 December. Delay will also disrupt the process of approving the re-rating orders and regulations, which must be in force well before the start of the



**E.R.**

financial year. I very much hope, therefore, that NIC rates for 1988-89 can now be settled and not held back for discussion alongside the GCBS Budget bids. I am therefore hoping that you will now agree that my proposals can be implemented from next April.

I am copying this letter to the Prime Minister, John Major, Patrick Nicholls, Roger Freeman and Richard Needham, and to Ivon Brabazon.

*Yours ever*

*Michael*

MICHAEL PORTILLO



DEFENCE: UK Defence



PL 5  
A3





DEPARTMENT OF TRANSPORT  
2 MARSHAM STREET LONDON SW1P 3EB

My ref: C/PSO/287/88  
Your ref: C/PSO/462/88

The Rt Hon Lord Young of Graffham  
Secretary of State for Trade & Industry  
Department of Trade & Industry  
1-19 Victoria Street  
LONDON  
SW1H 0ET

26 JAN 1988

*Dear David,*

WAR RISKS: REINSURANCE OF SHIPPING

Thank you for your letter of 11 January, commenting on whether the Government Tonnage Replacement Account (GTRA) provisions should be retained in the new Agreements with the UK Mutual War Risks Insurance Associations.

My officials have, as you suggested, again strongly pressed representatives of the shipping industry to agree to the retention of the GTRA in the new Agreements. The industry restated that they could not accept that the GTRA should be retained. They felt strongly that shipowners should be free to decide in the light of the market situation at the time whether, when and where to replace lost tonnage. They emphasised that the hard-pressed British shipping industry should not be placed at a commercial disadvantage compared with its international competitors. They added that the GTRA had been a thorn in their side for many years and they had lived with it in the expectation that this review would see its abandonment. They recognised that the existing provisions included the possibility of waivers, but they stressed that the waivers are at the sole discretion of the Secretary of State and thus the position would remain uncertain.

You will have seen that George Younger and John Major are content for the GTRA to be abandoned in the interest of greater availability of flagged out or foreign merchant shipping during crisis or war.

In view of the continuing hostility of the British shipping industry to the retention of the GTRA, the strategic considerations which you recognise and our need to bring the new Agreements into force without undue delay, I



intend to drop the GTRA provisions in the new Agreements. My officials will be in contact with the Treasury about their implementation.

I am copying this letter to the Prime Minister, Geoffrey Howe, George Younger, John Major and David Waddington.

*ms*  
*Paul*

PAUL CHANNON



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COP  
25/1

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP  
Secretary of State for Transport  
Department of Transport  
2 Marsham Street  
London  
SW1P 3EB

25<sup>th</sup> January 1988

Dear Secretary of State,

**UK SHIPPING/NATIONAL INSURANCE CONTRIBUTIONS**

I have seen a copy of your letter of 18 January to the Chancellor about the UK shipping industry, and of the No. 10 letter of the same date recording that the Prime Minister wishes to hold a meeting on this subject. I would not wish to say anything at this stage about the wider issues you raise in your letter, but I would like to comment on the particular question of National Insurance Contributions (NICs) which I understand needs to be settled quickly so that DHSS can lay their contributions Order.

I am convinced that the proposal in Michael Portillo's letter of 16 December to reduce the NIC rebate for mariners, the Armed Forces and dockworkers is the right one, and that it would be wrong effectively to use the NI system as a means of subsidising a particular industry or group of workers.

We have always held the view that National Insurance Contributions (NICs) are not suited for the task of encouraging employment in specific industries or regions and have rejected Opposition proposals along these lines. Ivan Brabazon's proposal (in his letter to Michael Portillo of 14 January) that NICs should be considered simultaneously with the GCBS Budget bids runs counter to this since it implies that NICs could in some sense be 'traded off' against concessions in other areas. The case for such concessions will be considered on their merits but meanwhile Michael's proposal can and should be discussed in the context of the NI system.

It would be quite wrong to retain a rebate for which there is no longer any rationale or actuarial basis in order to subsidise a specific industry.



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Ivan is concerned as to how Michael's proposal can be defended. This is really quite straightforward. NICs buy entitlement to benefits, and it is entirely reasonable that an employee in the shipping industry should not be able to buy entitlement to the same benefits for less than any other employee with the same earnings. If they could - which is what retention of the rebate would imply - it would constitute a serious erosion of the Contributory principle which is the basis for the whole NIC system.

There is no need for us to say that the NICs of other workers have increased, because it is not true. The Employment Protection Allocation will be reduced from 0.07 per cent for employees and 0.06 per cent for employers to zero, but at the same time the NHS Allocation will increase by 0.1 per cent for both groups, so the NIC percentage going to the National Insurance Fund to pay for the broad range of benefits will actually be reduced. Moreover employers in your industries have benefited over the past few years since the EPA, and consequently the rebate, was set at an unrealistically high level.

And, more generally, Michael will be able to point to the Government's excellent record on employer's NICs, notably the abolition of the National Insurance Surcharge and the NIC restructuring in the 1985 Budget.

I hope therefore you can agree that DHSS should not press ahead with NI contributions regulations (which I understand are now a matter of some urgency) on the basis set out in Michael Portillo's letter.

I am copying this letter to the Prime Minister, Patrick Nicholls, Roger Freeman and Richard Needham, Ian Brabazon and Michael Portillo.

Yours sincerely,

JOHN MAJOR

(Approved by the Chief Secretary  
and signed in his absence)





010

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CCBG?  
(2)



DEPARTMENT OF TRANSPORT  
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

The Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer  
HM Treasury  
Treasury Chambers  
Parliament Street  
LONDON  
SW1P 3AG

*Prime Minister*

*You should be aware of this.*

*We need to have a small meeting*

18 JAN 1988

*COP 15%*

*Dear Nigel's A fall from 13.9 → 10.2 mt in a year and further importation is very serious and we must take some action to reverse that*

**UK SHIPPING**

Since arriving in this post, I have become increasingly concerned about the strategic implications of the decline of the UK merchant fleet. When my predecessor brought the matter to E(A) in July 1986, the UK and Isle of Man fleet stood at 13.9 million tons; by November 1987 it had fallen to 10.2 million tons. Our ability to cope in an emergency is reducing every month.

The overall position on supply and demand for shipping for NATO in war is a complex matter, and one that NATO has agreed should be the subject of a special study. We cannot anticipate the results, but the indications are alarming. Nearly all NATO fleets are declining substantially, and it already appears that the Alliance no longer has all the ships it would need for the rapid US reinforcement of Europe. And while we still have enough ships to meet the particular needs of the UK armed forces, this too will be threatened unless re-investment picks up.

The Merchant Shipping Bill contains schemes to assist the industry with costs of repatriation and training in an effort to stabilise the employment situation. The amounts of money available under these schemes are of course extremely small, but I believe they will help to stem the alarming decline in the numbers of British officers serving on our ships. But they will not help with investment.

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You will recall that our policy for the fleet is based partly on the assumption that some of the ships leaving the UK will be re-registered in Dependent Territories, particularly the Isle of Man, and will therefore be easily requisitionable in times of emergency. This has indeed been happening. The Isle of Man has been particularly attractive to us because the seafarers employed on those ships have generally continued to be British, an important feature in defence terms. It is therefore most disturbing to learn that the Inland Revenue have concluded, after a long and therefore presumably not open-and-shut review, that shipping companies have an obligation to collect PAYE in respect of UK seafarers employed by offshore and foreign crewing agencies to man their deep sea vessels. The companies have expert advice to the contrary, but are not likely to spend time and money testing the issue in the Courts. Companies who have distanced themselves from employment involvement in order to reduce their direct costs will not easily be lured into a fresh round of negotiations with the unions; they will instead instruct the agencies not to employ UK seafarers on the vessels for which the agencies are responsible for crewing. Those companies with vessels registered in the Dependent Territories, and particularly in the Isle of Man crewed through Manx agencies, will flag out to foreign registries so that they can instruct crewing agencies to dispense with British crews entirely. This will nullify the initiative in the Merchant Shipping Bill (and cause difficulties for the Manx government).

I am sure that the matter is an important one for the Revenue, and that they have reached their position with a full understanding of the difficulty it imposes for UK strategic interests. But now I must press you to consider what administrative or legislative way there is to avoid such damage. One way could be for the Revenue to accept an interpretation of Regulation 3 of the 1973 PAYE Regulations that would restrict the obligation to collect to the individual who performs the primary employment function; recruitment, promotion, allocation of ships, imposing discipline and monitoring performance are all carried out by the crewing agencies.

I have to say that the DHSS have at the same time proposed removing the shipping industry's rebate on the Redundancy Fund element in National Insurance contributions. Ivon Brabazon has written to Michael Portillo about this. The increase in the industry's costs this would lead to would be another blow, offering further ammunition to those who say we do not care whether we retain a merchant fleet or not.

This brings me to the recent GCBS paper "The Future of the Merchant Fleet" and the proposals in it for investment assistance. I recognise that these investment proposals are likely to involve an incentive rate of capital allowance, which the

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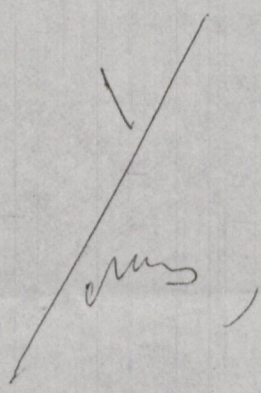
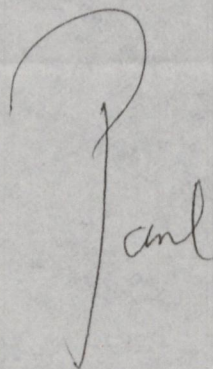


1984 Finance Act sought to remove. We have to remember that during the passage of that Act the then Financial Secretary stated that shipping was a special case because of its economic and strategic importance to the nation. The special provisions of free depreciation he then announced have not secured their aim; investment has virtually dried up. I would not argue that further action is needed now on economic grounds, but as I explained I am deeply concerned about the strategic implication of the dearth of investment. I recognise the importance you place on the reforms you introduced in the 1984 Finance Act, and am not pressing for a ship allowance or investment grants. But I would urge you to give the most favourable consideration to the roll-over relief proposal. This is I think now the most important GCBS policy option, and movement on it would have significant political appeal. There could be a provision that an appropriate rate of interest would be charged on roll-over allowances not in the event used for re-investment in ships, and no doubt the proposal could be refined further.

I would be very surprised if any other sector could produce either the arguments of national strategic interest or the proof of need - in terms of a complete drying-up of investment since the 1984 reforms - that make the shipping industry a genuine special case.

I am at your disposal to discuss any of these issues further.

I am sending copies of this letter to the Prime Minister, the Home Secretary, the Defence Secretary, the Secretary of State for Health and Social Security and the Secretary of State for Trade and Industry and to Sir Robin Butler.

  
  
PAUL CHANNON



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FILE  
Pruce



10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

18 January 1988

*See Roy.*

UK SHIPPING

The Prime Minister has seen a copy of your Secretary of State's letter of 18 January to the Chancellor about the further decline in the UK Merchant Fleet. She is most perturbed by the figures showing that it has fallen by 3.7 million tons in only fifteen months. She would like to hold a meeting to consider the consequences and what, if anything, we can do about it. Mrs. Gaisman will be getting in touch to propose a date in due course.

I am copying this letter to the Private Secretaries to the Chancellor, the Home Secretary, Defence Secretary, the Trade and Industry Secretary, the Secretary of State for Health and Social Security and Sir Robin Butler.

*Yours sincerely,  
C. D. Powell*

C. D. POWELL

Roy Griffins, Esq.,  
Department of Transport.

*dg*

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*copy*

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000  
DIRECT DIALLING 01-218 .....

13 January 1988

MO 26/3/3

*EM 14/1*

*Dear Paul,*

WAR RISKS: REINSURANCE OF SHIPPING

Thank you for sending me a copy of your letter of 21st <sup>1st</sup> December to David Young.

I fully support your proposal that war risks reinsurance should be extended to foreign registered vessels as both logical and necessary now that, although there is sufficient shipping available to meet defence requirements, we can no longer rely wholly upon United Kingdom and dependent territory registered vessels to meet this country's resupply needs in time of war.

It is clearly important to consider the presentational implications of abandoning the Government Tonnage Replacement Account (GTRA), but your letter makes a very strong case for doing so. I am sure you are right that foreign owners would be discouraged from putting their ships under our control in time of war unless they could be assured that they would be fully compensated in the event of loss and allowed to reinvest the settlement as they see fit.

I am sending copies of this letter to the Prime Minister, Geoffrey Howe, David Young, Norman Lamont and David Waddington.

*Yours truly,  
George*

George Younger

The Rt Hon Paul Channon MP



DSFONCG : UC Pouly PT3







Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Paul Channon MP  
Secretary of State for Transport  
Department of Transport  
2 Marsham Street  
London  
SW1P 3EB

*John*  
*11/1*

8 January 1988

*Dear Paul,*

WAR RISKS: REINSURANCE OF SHIPPING

I have seen a copy of your letter of <sup>11/1</sup> 21 January to David Young.

It is clearly in our interest to persuade owners of foreign registered ships to commit their vessels to UK use in time of war, and one important means of doing so will be to offer them war risks reinsurance.

I can quite see, however, that the continued existence of the Government Tonnage Replacement Account (GTRA) would make reinsurance by HMG a good deal less attractive. I judge that the GTRA has now outlined its usefulness and I therefore support your proposal to abolish it.

*Copies to:*

*Prime Minister*  
*Geoffrey Howe*  
*George Younger*  
*David Waddington*

*Yours faithfully,*  
*John*

JOHN MAJOR



DB F6N06: UIC Defence Policy PT3.





*CEPC*



DEPARTMENT OF TRANSPORT  
2 MARSHAM STREET LONDON SW1P 3EB

01-212 3434

The Rt Hon Lord Young of Graffham  
Secretary of State for Trade and Industry  
Department of Trade and Industry  
1-19 Victoria Street  
LONDON  
SW1H 0ET

21. December '87.

*Amat commeth*  
*000*  
*23/12*

Dear Secretary of State

WAR RISKS: REINSURANCE OF SHIPPING

We are in the process of revising with the insurance industry the arrangements for reinsurance by HMG of the UK Mutual War Risks Associations against risk to UK ships arising from wars in which the UK is involved. My officials have been in touch with yours about two aspects of particular concern to your Department - shipbuilding and insurance, and also with the Treasury. I am writing to clear the broad lines on which we are proceeding, and to expose one particular difficulty on the shipbuilding side.

War risks reinsurance of ships by HMG goes back to the First World War. The current arrangements have to be revised to bring them into line with the significant changes in the terms of marine risk cover, on the London market in recent years. We are also taking the opportunity to bring the arrangements more in line with the present strategic reality. When the arrangements were last revised in the 1950s, the UK merchant fleet was large enough to meet all our needs in time of war and the war risk reinsurance arrangements covered UK registered vessels only. Since then, the decline of the merchant fleet has meant that we have had to look at the possibility of using foreign registered vessels. In revising these reinsurance agreements therefore we want to extend them to cover ships registered in foreign states if their owners are prepared to commit their vessels to our use in war.

The extension of war risk reinsurance is important not only to attract foreign owned and foreign registered vessels but also to ensure vessels beneficially owned in the UK but registered abroad are readily available to us. The FCO has been making good progress on clearing away any difficulties there might be in our requisitioning, in emergency and war, UK owned ships on the important open registries of Liberia, Panama and the Bahamas. Agreements with these countries will turn, in part, on



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the shipowners themselves confirming that they would be prepared to see their ships so taken up, and the availability of war risks cover may well be critical here.

The revision and extension of war risk reinsurance arrangements are, in the main, straightforward. But there is one possible point of difficulty. The current agreements contain a provision called the Government Tonnage Replacement Account (GTRA), which was designed to encourage owners of lost vessels to replace them. A ship's value can often rise in time of war. The GTRA gives the Government the right to retain the increase in insured value until the owner has replaced the vessel. If replacement is to be by new build rather than purchase of a secondhand ship, HMG can retain the added value element until a new vessel is ordered from a UK yard. The GTRA also allows Government to require that the replacement vessel is kept on the UK Register for seven years.

The GTRA was originally intended to meet criticism, following the First World War, that shipowners who had received an increased value for their ships had not reinvested in shipping and had thus profited from the war. The position is very different now, and I do not think that similar criticisms would arise. But that apart, the GTRA would be a major disincentive to foreign-owned shipping which we would want to attract in a time of war and might well be an obstacle to getting requisitioning arrangements for UK owned vessels on the Bahamas, Liberia and Panama registries. Shipowners want to know that they have full flexibility in the use of an insurance settlement and are not bound to reinvest in shipping. Many of today's shipping companies are parts of conglomerates with wide interests, and could well have better opportunities for investment. If the limitation of construction of new-build replacements to UK shipyards were retained, this would be another major disincentive. If a shipowner were minded to replace his vessel by building a new one, he would not want to be tied to replacement in a UK yard which, as we know, is almost invariably more expensive than, say, a Far Eastern yard. As the insurance value of vessels is determined by market value not replacement cost, the insurance settlement would not usually be sufficient to cover replacement in any yard. This would increase the financial pressure on owners to build in the cheapest yard.

In any event, I am advised that retention of the restriction of new build replacements to UK yards would be contrary to the EC Treaty and, for that reason alone, I do not think that element of the present GTRA could be included in the revised reinsurance agreements.

Our own shipowners are also in favour of abandoning the GTRA for much the same reasons. As far as we know, the other NATO nations with government war insurance of their merchant shipping are the USA, Canada, France and the FRG. None of them has a provision equivalent to GTRA nor does the equivalent NATO agreement.

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I have looked at a number of halfway houses such as abandoning the GTRA for foreign owners but retaining it for UK owners. None of these, however, would be satisfactory; distinguishing between foreign and UK owners would be difficult to defend to our shipping industry, and we should be accused, and perhaps be guilty of, encouraging UK owners to extend their flagging-out. I am therefore minded, on strategic grounds, to abandon the GTRA. There will, of course, be no actual impact on the UK shipbuilding industry short of a war, but I am conscious that it could cause presentational difficulties. Opponents may well claim now that it is a mark of our lack of concern for the industry and that, in the event of a war, UK taxpayers would be paying for replacement ships to be built in foreign yards.

I think we could mount a robust defence. Although HMG stands behind the reinsurance scheme, premiums have, in past wars, been sufficient to cover claims. It is therefore very unlikely that the UK taxpayer will actually pay for replacement vessels. Moreover, if we are to encourage foreign owners to put their ships under our control in time of war, we should not fetter their compensation. In any event, even the existing GTRA does not allow us to compel owners to build replacements in the UK - it allows us to retain some of the compensation if the owner has a replacement built outside the UK. And as I say that provision is inconsistent with the EEC Treaty and could not be retained. An owner could choose to forsake any increased value element or to buy a secondhand ship. Most important, I think we can represent the GTRA as an anachronism and point to other nations which do not have similar requirements.

All this assumes that the decision to abandon will attract publicity. That is not certain. The war risk reinsurance agreements have to be laid before Parliament but they are agreements not statutory instruments, though they can be prayed against. Abandoning the GTRA would only be one element of a far reaching revision. I would of course carefully consider whether and in what terms any public announcement should be made.

Given the wider considerations, I should be grateful for your views and those of the colleagues to whom I am copying this letter. It would be very helpful to have a response before 11 January since the target is to agree the Associations' new rules and the reinsurance in time for them to come into effect in February.

I am copying this letter to the Prime Minister, Geoffrey Howe, George Younger, Norman Lamont and David Waddington.

*Yours Sincerely,  
Jon Cunliffe*

*P.P. PAUL CHANNON  
(approved by the Secretary of State and signed  
in his absence)*

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cc PC. 1

MO 13/1/35L

CDP  
12/11PRIME MINISTERNATO MARITIME RULES OF ENGAGEMENT (ROE)

1. In my minute of 30 April, I proposed a solution to outstanding differences between the US and the UK over the amendment of NATO's maritime Rules of Engagement (ROE). This solution involved suggesting to the US that the Emergency Procedure outlined in my minute of 30 July 1986, whereby Major NATO Commanders (MNCs) would be empowered to authorise anticipatory self-defence in advance of DPC approval in the face of overwhelming and compelling evidence of "hostile intent", should be linked to the transfer of "Mission Essential Forces" (aircraft carriers or major amphibious units) to NATO command; NATO operational plans which entailed such a transfer should make the Emergency Procedure available to the relevant MNC. By authorising the plan, the DPC would also authorise the Emergency Procedure.

2. Your Private Secretary's minute of 4 May reported that you were content that this proposal be put to the US. I am pleased to report that Cap Weinberger accepted this safeguard, and a text of the ROE based on our proposal has now been agreed with the Americans. I am satisfied that this text meets our original concern by retaining adequate political control whilst allowing appropriate flexibility to military commanders to protect their forces from attack. The text is now with the MNCs prior to submission to the Military Committee and the DPC for national approval. I hope that this will be forthcoming by next spring.

3. I am sending copies of this minute to other members of OD and to Sir Robert Armstrong.

A.Y.

Ministry of Defence  
10th November 1987



DKHence



UK DKHence

POLICY

PTZ



PART 2 ends:-

SS/MOD TO PM 27.7.47

PART 3 begins:-

SS/MOD TO PM 10.11.47



# Grey Scale #13



**A**

1

2

3

4

5

6

**M**

8

9

10

11

12

13

14

15

**B**

17

18

19

Inches 1 2 3

Centimetres 1 2 3 4 5 6 7 8

## Colour Chart #13

Blue

Cyan

Green

Yellow

