

Prime Minister.  
The background to the  
British Aerospace issue, on  
which Sir Keith Joseph  
wants a word next week.



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MAP 17/X

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ML

Dear Tim,

PUBLIC EXPENDITURE AND THE BAE FLOTATION

As you know, Sir Keith Joseph saw the Chancellor this morning to discuss whether the Defence programme could be made exempt from the current public expenditure reductions, and be maintained at the Cmnd 7841 planned levels, in order at least partially to resolve current uncertainties about future MOD orders for British Aerospace which will otherwise preclude the privatisation of BAE next month. I understand that Sir Keith Joseph may intend to mention the matter to the Prime Minister tomorrow.

Sir Keith is now  
now coming in  
on Saturday. We  
will get him in  
next week.

ML  
17x.

The Chancellor explained to Sir Keith Joseph this morning that the level of cuts in total public expenditure which, in his view and that of the Chief Secretary, are now required necessitates a substantial contribution from Defence. While regretting the delay to the privatisation of BAE, he saw no way in which an exemption for MOD could be contrived. At his request, I have subsequently sent to Sir Keith Joseph's office a copy of the attached note by officials which sets out some of the considerations underlying his view that some reductions on the Cmnd 7841 Defence figures are both essential and defensible within the Alliance.

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It may be helpful to set out for your information some figures relevant to the arrangement which Sir Keith Joseph had in mind. As foreshadowed in the Chancellor's minute of 10 October to the Prime Minister, Treasury Ministers are now seeking a substantial reduction, at present set at £500 million pa, in the Defence PES figures throughout

/the Survey



the Survey period. To forego any Defence reductions might be to concede rather more than this, since it would be difficult to secure Cabinet agreement to the total public expenditure cuts sought if as significant a programme as Defence had been wholly exempted. On the other side of the equation, the proceeds from a sale in November of 50 per cent of the shares in BAE Ltd. are, on the DOI's estimate, likely to amount to rather less than £70 million; and, provided that no new launch aid proposals from the Company were accepted, the PSBR would additionally benefit to the tune of some £100 million in 1981-82 and £75 million in the following two years as a result of the Company's meeting its forecast capital requirements from within the private sector. The imbalance in these figures is obvious: moreover, it is not certain that a sale of shares next month could take place even if MOD were granted exemption from any Survey reduction, since their current cash limit problems would make it difficult for them to give a commitment to no cancellation of existing BAE orders. Various other uncertainties overhanging the plan for November flotation were mentioned in E(DL) on 14 October.

The picture should of course be much clearer in the New Year.

Yours ever,

Richard Tatham

for

A.J. WIGGINS

NEED FOR CUTS IN PUBLIC EXPENDITURE: WHY DEFENCE CANNOT BE EXEMPT

It is vital to the Government's economic strategy that they should adhere to their commitment to contain public expenditure. It is fundamental to their approach that the size of the public sector should be rolled back. And added to this is a financial imperative to hold the PSBR in 1981-82 to a manageable level. It now appears necessary to find further savings of the order of £2 billion in order to achieve the objective, agreed in July, of holding to the Cmnd 7841 totals adjusted for the EC contribution.

2. The scope for savings on other programmes is severely limited: indeed there are some areas where increases are being sought. Defence represents a sixth of all Central Government expenditure. Total public expenditure programmes for 1981-82 were cut last year by £6.5 billion or 8.4%, while Defence was allowed an increase. Total spending was planned to decline by 0.6% in 1980-81 and 1.2% in 1981-82 while defence was to rise by more than 3% a year. The Cmnd 7841 figure for 1981-82 would now represent a 5.8% increase on the volume for 1980-81 which was implicit in the decision on the August cash limit increase. It has become impossible to reconcile this rate of growth with the progressive decline in output. Mr Fym accepted in the discussions on the cash limit that it was necessary to fall short of the NATO target in the short term in the interests of restoring the economic health which will sustain an enhanced defence effort in the future.

3. The UK's performance in relation to the NATO target will still compare favourably with many of our Allies. The target allows for derogation in the event of economic difficulties and many Allies have availed themselves of this with much less justification than the UK's current circumstances provide. (See the Annex attached, which reflects the position so far as we have been able to ascertain it in consultation with MOD.) The UK is still, along with the USA, well clear of the rest of the field in the share of national income it devotes to defence (about 5%) and that share will rise as the economy contracts over the next year or so. This compares with other European countries as follows:

	<u>1979</u>
Germany	3.3%
France	4.0%
Belgium	3.3%
Netherlands	3.3%
Italy	2.3%

4. It is up to NATO as a whole to respond to the threat to the Alliance. The UK is already carrying a disproportionately heavy share of the burden. Mr Fym recognises this, and is indeed understood to be preparing a paper for OD Committee on the possibility of more equitable burden sharing.

5. Politically, too, the success of the overall public expenditure strategy, which will require great sacrifices from other Ministers, demands a substantial contribution this time from the previously protected programmes. Mr Whitelaw has accepted a cut in the provision for law and order. The whole balance of the package would be distorted if there were no contribution from Defence, and it would not be feasible to re-allocate Defence's share to other programmes.

## PERFORMANCE OF OTHER COUNTRIES IN RELATION TO THE NATO TARGET

The NATO target

In 1977 NATO Defence Ministers agreed (and the undertaking was endorsed by Heads of State and Government at the Washington Summit in May 1978) to aim at making available resources which would allow for annual increases in Defence spending in the region of 3% in real terms, recognising that, for some individual countries, economic circumstances would affect what could be achieved. The agreement covered the period 1979-1984. In May 1979 Defence Ministers agreed to extend this objective up to 1986.

2. But it is a target, not a binding commitment, and there are several ways in which countries can justify deviating from it. It speaks of "increases in the region of 3%", and allows for derogation in the event of economic difficulties. In practice compliance has been very patchy, as the following notes show.

Belgium

The Belgians achieved a 4.5% real increase in 1979, but in 1980 their plans provided for a 3.3% fall in real defence spending. In mid-year they announced a package of emergency cuts designed to save 5% of the defence budget in the second half of the calendar year. These measures attracted severe criticism from NATO.

Canada

Canada had negative growth of 2.3% in 1979. The previous Government's plans for 1980 were for an increase of 4.7%, but the restrictive fiscal stance being adopted by the Trudeau Administration makes it likely that the increase will fall well short of 3%; and the prospects for future years are uncertain.

Denmark

Denmark's growth in 1979 was - 0.2% and a further slight decline is planned in 1980. They are now considering a freeze on defence spending at constant prices: the clearest possible departure from the NATO target.

France

France is not a signatory to the target, but in fact French defence spending has been increasing at 3% a year and is likely to continue to do so.

## Germany

The Germans achieved 1.7% growth in 1979. Their initial budget for 1980 provided for real growth of only 1½%, but supplementary provision is likely to bring them near to 3%: the latest estimate is 2.8%.

## Italy

Italy achieved 6.0% growth in 1979, but real defence spending is expected to decline by 2.8% in 1980.

## Netherlands

The Netherlands achieved 3½% growth in 1979. Their plans for 1980 showed a real increase of 2.2% and growth of 1½% in 1981. However the planned 2.2% is unlikely to be achieved because inadequate provision has been made for inflation. The Defence Minister has stated that the country's "difficult financial position" will prevent it meeting the target this year.

## Norway

Norway achieved 1.9% growth in 1979 and plans for 2.6% growth in 1980.

## Portugal, Turkey

It is accepted that these countries, in their particularly difficult circumstances, will be unable to achieve significant real growth of defence spending in the foreseeable future. Portugal is planning 2% growth in 1980 but negative growth after that.

## United States

The USA achieved 3.1% growth in 1979. The budget for fiscal 1980 (ie. the year starting in October 1979) was intended to achieve 3.9% growth, although the President did not exempt the Defence Budget from cuts in supplementary provision in the course of the year, so the outturn may be rather lower. The President's budget for fiscal year 1981 provides for more than a 5% real increase in defence spending, and although this is as usual on a conservative assumption about inflation there seems little doubt that in the current mood the necessary supplementary provision will be granted to achieve most of that growth. The planned minimum growth in 1981 is 2.7%. The plans for future years show increases of more than 4% a year in real terms up to fiscal year 1985. The Presidential candidates are currently outbidding one another on further increases in defence spending - Mr Reagan has mentioned 10%.



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