

Ref: A0924

SECRET AND PERSONAL

MR. LANKESTER

1. An Whitman JMW  
2. J.

Prime Minister Defence  
I think you should  
dismiss this with the Chancellor  
before Cabinet on Thursday.  
But you might also discuss  
with Robert Armstrong after  
E tomorrow (see last para).

*attached 1* You asked for advice for the Prime Minister on the Chancellor of the Exchequer's Secret and Personal minute of 11th December about defence expenditure. *R 1/12*

2. The first thing to be said is that the problem is even more difficult than the Chancellor has indicated. His proposals on cash limits for 1980-81 are based on a pay and price increase of 14 per cent. On present prospects the eventual increase in pay and prices seem likely to be higher than that. The defence budget is peculiarly vulnerable on this account. Armed Forces pay is determined by the recommendations of a Review Body; the recommendations of that Body, due to come into effect on 1st April 1980, are unlikely to be below the "going rate", which might well be  $17\frac{1}{2}$  per cent or more, and it will be very difficult for the Government, in view of its previous commitments not to accept whatever is recommended. On the equipment side, defence expenditure is vulnerable to a "sophistication factor" which generally has the effect that price increases are larger than average in that sector. On the basis of reasonably realistic assumptions about these two factors, the Chancellor's proposals on cash limits imply a volume squeeze on defence expenditure in 1980-81 of the order of £150 million.

3. If this is allowed for, the reductions proposed in paragraph 3(a) of the Chancellor's minute - the ones he himself prefers - imply a spend of about £7,675 million in 1980-81, and correspondingly reduced figures for later years; this figure compares with the figure of £8,062 million published in October's White Paper - a reduction of about £400 million or 5 per cent.

4. Even the less drastic reductions in paragraph 3(b) of the Chancellor's paper would be increased, for 1980-81, from about £100 million to about £250 million.

5. There is also the problem of Polaris replacement. This was more or less allowed for in the understanding arrived at earlier - though even then you did not preclude the possibility that some of the cost of the Polaris replacement programme might be found from within the existing levels of the defence budget.

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The run of figures resulting from the understanding is that at the bottom of the first page of the Chancellor's minute. These are the figures for which the Secretary of State for Defence believes he has agreement; and the Chancellor is, in practice, talking about reductions of somewhere between £250 million and £400 million on these figures, when one takes account of the volume squeeze resulting from his proposals on cash limits.

6. Past experience suggests that the Secretary of State for Defence will not readily accept reductions on this scale. On the other hand the Chancellor is pushing his luck in canvassing the possibility of reductions in the defence budget as part of the new review: the figures which he circulated for the Prime Minister's meeting on 7th December suggested ways in which £1 billion could be saved in 1980-81 without any reduction in the defence budget. He would be asking a lot if he went for reductions in the defence budget on top of the volume squeeze implied by his proposals on cash limits.

7. The immediate question is how to handle this problem ahead of Cabinet on Thursday. There does not seem to be any possibility of the Prime Minister holding a meeting with the Chancellor and the Secretary of State for Defence before then, because the Secretary of State for Defence will be in Brussels until late tomorrow evening, and the Prime Minister has to go and wave goodbye to President Tolbert before Cabinet on Thursday morning. In any case, I do not think the Prime Minister ought to involve herself in this with the two Ministers together at this stage. If that is right, we have to find some way of getting through Cabinet on Thursday so that the two Ministers can discuss the problem thereafter, as part of the public expenditure bilaterals which should follow the Cabinet meeting.

8. It may be that the Prime Minister will think that, as the Chancellor was able to produce a package of £1 billion in 1980-81 without including reductions in the defence budget, the right course would be for her to tell him to stick to that, and not to risk a major confrontation with the Secretary of State for Defence by trying to get even more out of the defence budget than is implied by his proposals on cash limits.



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9. If, on the other hand, the Prime Minister agrees with the Chancellor that the defence budget will have to contribute to the £1 billion, I think that she ought herself to have a word with the Secretary of State for Defence, without the Chancellor of the Exchequer, to try and soften him up and, at the very least, of making some judgment of what his reaction is likely to be.

10. However that is to be handled, there remains the problem of getting through Cabinet on Thursday. On present plans, the Chancellor is expected to talk about the total reduction to be sought, but not to give any indication of the way in which he thinks that that total should be made up. In discussion, however, it is almost bound to emerge that he is looking primarily at the social security programme and at housing. There is obviously a considerable likelihood that some Minister or other will suggest that the defence budget should not be excluded from scrutiny. If that happens, the Prime Minister will have, I think, to say that these are all matters to be pursued by the Chancellor of the Exchequer and the Chief Secretary in their bilaterals, and the Cabinet is not asked to and should not take any decision or express any views at this stage.

11. If the Prime Minister is minded to deal with it in this sort of way, she ought, I think, to send the Chancellor of the Exchequer a personal note, or have a word with him, to make sure that he plays it that way and does not rock the boat at the meeting of the Cabinet. I understand that she will have an opportunity to do that early on Thursday morning, when she is due to meet the Chancellor. If, when she has considered the Chancellor's minute and decided what line to take, she would like to have a draft minute or Speaking Note for her meeting with the Chancellor, no doubt you will let me know.

12. We are still left with the problem of the volume squeeze on the defence programme implied by the Chancellor's cash limit proposals. The Secretary of State for Defence can, on past form, be expected to react very strongly against these and their effects on his budget. He will say that the Chancellor is trying to get by the back door reductions in the defence programme which he failed to get at the earlier stage, and he may say that what the Chancellor proposes is not possible for him to tolerate. There are various possibilities of

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mitigating the Chancellor's proposals on the defence budget. One could take the pay of the Armed Forces out into a separate block for cash limit purposes, and deal with that as it is proposed to deal with Civil Service pay, by fixing the cash limit at a later date when the probable outcome of the Review Body's latest inquiry is clearer and it is possible to arrive at a realistic cash limit for Armed Forces pay. But the Prime Minister should be advised, and I should be happy to discuss with her, what steps if any we should take before Cabinet on Thursday, to try to defuse the Secretary of State for Defence's adverse reaction, which could otherwise become the spark which led the Cabinet to reject the Chancellor's proposals as a whole.

*RA*

*PR*

(Robert Armstrong)

11th December 1979