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SUBJECT



File

10 DOWNING STREET

From the Private Secretary

4 August 1980

Dear Martin,

The Prime Minister held a meeting this afternoon with the Chancellor, the Secretary of State for Defence and the Chief Secretary to discuss the defence budget and the problem of this year's cash limit over-spend. Sir Anthony Rawlinson, Sir Frank Cooper and Sir Robert Armstrong were also present. They had before them as background the Chief Secretary's minute of 30 July and the note by Treasury and Ministry of Defence officials enclosed with it setting out the factual position.

The Prime Minister said that she understood that defence spending in 1980/81 was projected to exceed the cash limit by £650 million. £250 million of this was due to volume over-spend, and the Ministry of Defence were apparently taking steps to eliminate this. The remaining £400 million was due to pay and prices being higher than the assumptions made when cash limits were set. There was no way in which it would be possible to meet this £400 million over-run. Compared with other Departments, the Ministry of Defence had already been favourably treated. They had received a cash limit increase to cover the additional costs of the Armed Forces Pay Review Body's recommendations; they had been allowed to retain the savings from the Civil Service cuts. They had also benefited from the appreciation of sterling. Despite all this, defence spending was running well outside the cash limit while other Departments were expected to stay within theirs. The extent of the over-spend was aggravated by the pay settlement just completed for the Civil Service industrials, which had been extremely generous. If the Ministry of Defence had fought harder to keep this settlement down, they would not be in such difficulty now. Against the background of very heavy Central Government borrowing in the first quarter and the continued pressure on the private sector, she could not see how more than a small adjustment to the existing Ministry of Defence cash limit would be possible.

The Chancellor said that the latest internal forecasts showed the PSBR running at a considerably higher level in 1980/81 compared with the forecast made at the time of the Budget. There were a number of reasons for this, including excess borrowing by the local authorities and by the nationalised industries. But the Ministry of Defence over-spend was also an important factor, and there was growing concern amongst economic commentators and in the City that the Government was losing control. Other Departments were having to accept a volume squeeze through sticking to their cash limits, and he had no option but to ask the Ministry of Defence to do the same.

/The Chief Secretary

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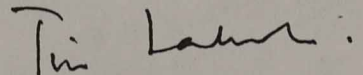
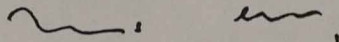
The Chief Secretary added that the Treasury were also looking for a deduction from this year's cash limit for the amount over-spent last year. Sir Anthony Rawlinson explained that, although an over-spend figure of £61 million had been mentioned, it might be possible to reduce the deduction to about £50 million because of additional receipts which had come to light.

The Secretary of State for Defence said that he accepted the principle of a deduction for last year's over-spend, and he also recognised the general economic case for restricting Government borrowing and spending. But the proposition that defence spending should stay within the existing cash limit had very important implications, which he would need to consider carefully. In effect, the Treasury were saying there could be little or no volume growth in defence spending this year. He had tried to be helpful to the Chancellor when the volume figures for this and subsequent years were set, and also when the cash limit was negotiated. But the Chancellor was now asking him to go a great deal further. Because so much of the programme was already committed, staying within the cash limit would require some very drastic measures, and it would be bound to cause trouble with our NATO allies. Moreover, if there was to be little or no growth in real terms for this year, how could he be sure that there would be any growth in future years? A decision to hold back defence spending this year would undermine the planning base for spending in the years ahead.

The Prime Minister suggested that the Treasury should agree an increase in the cash limit of £100 million net, or about £150 million gross including the deduction for last year's over-spend. She very much hoped that Treasury Ministers and the Secretary of State for Defence would be able to agree on this with a view to an announcement later this week. If it could be agreed, then the Chancellor could simply report the matter to Cabinet on Thursday. If no agreement could be reached, then the issue would have to go to Cabinet.

I am sending a copy of this letter to Brian Norbury (Ministry of Defence), Alistair Pirie (Chief Secretary's Office) and David Wright (Cabinet Office).

M. A. Hall, Esq., M.V.O.,
H.M. Treasury.



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