

CONFIDENTIAL

*Tray note handed to the by the Chancellor 15/7*

DEFENCE EXPENDITURE

Two objectives of Government policy are now in conflict: adherence to the NATO commitment, as interpreted by MOD, to 3% real increases in defence spending; and the need to hold cash limits, keep the borrowing requirement under control, and restrain future public expenditure plans. Defence accounts for 11 per cent of total public expenditure.

The NATO target

2. The Allies are asked to "aim at average annual increases in defence expenditure in the region of 3% in real terms". Only the UK, US and Italy did so in 1979, and only the UK, US, Germany, Netherlands, Norway and Canada have announced plans to do so over the period to 1983.

The UK interpretation of the target

3. We penalise ourselves by interpreting the target in volume, not cost terms. Few of the Allies do so. We thus take no credit for the major increases in forces' pay made in fulfilment of the commitment in the Manifesto (which was silent on the target). And since their primary concern is with the overall volume total, MOD have insufficient incentive to economise in administrative and support services and concentrate on front-line forces.

Implications for cash limits

4. Defence argue that it is insufficient to aim at the target: we must be able each year to demonstrate retrospectively that we hit it. But this year's cash limits were intended to impose some volume squeeze, and it is important for the CGBR that they be held. Officials are now reviewing MOD's current spending, and Defence are likely to bid for an addition of some £350 million to ensure 3% volume growth over the year (after the deduction - on which we must insist - of some £60 million to compensate for the overspend on the 1979-80 cash limit).

Implications for future expenditure plans

5. Defence expenditure was exempt from detailed scrutiny in the 1979 Survey. In view of the NATO target, it was accepted that we would plan

/ for

for 3% annual growth, and the debate centred on the baseline. The figures eventually agreed, and published in the White Papers, provided for a 3.6% increase in 1980-81, and 3% increases thereafter. (See attached table.) In the 1980 Survey documents the Chief Secretary has not challenged the 3% volume target, but has pointed out that annual average 3% growth over this year and the next three now calls for figures rather lower than those in the White Paper, because the 1979-80 volume outturn was lower than expected. Defence are in fact now asking for some £140 million in each of the three years 1981-82 to 1983-84 over and above what would be required to comply with the target, as they interpret it, and on the basis used in the White Papers. (See attached table.)

#### The case for a review

6. The importance of holding down public expenditure necessitates a review of our attitude to the target. NATO specifically accepted, when it was first adopted, that there would be derogations in difficult economic circumstances: the prospect of a 2½% decline in our GDP this year is highly relevant. The Defence White Paper pointed out that "we shall not feel obliged to adhere slavishly to a particular growth path, nor shall we consider it a failure of policy if we modify our spending plans in either direction from year to year as new information becomes available".

#### Options

7. Savings greater than those proposed by the Chief Secretary could be achieved if we were to come into line with the majority interpretation of the NATO target, or to conclude that our present circumstances necessitate a one-year derogation from it. Various courses are possible, depending on how far we decide to hold the cash limits this year. No increase in them would mean no volume growth, although we might still plan for 3% in future years.

#### Timing

8. It would be wrong to choose between the options until the current review of the MOD 1980-81 cash limit is complete, and bilateral discussions with other spending departments have established the likely feasibility of the Chief Secretary's Survey proposals. The proposal

/ in respect

in respect of defence is seen at this stage only as a marker. But it would be damaging in both the cash limits and Survey contexts, and to the search for economy, if Cabinet were now to accept that the MOD interpretation of the NATO target was sacrosanct. The case for demonstrating, in both plans and outturn, constant 3% volume growth in the defence programme does not necessarily take precedence over the Government's wider policy concerns and commitments.

### Conclusions

- (i) Current financial and economic prospects necessitate a review of our current interpretation of the NATO target, and the re-assertion of the primacy of cash control over expenditure in the current year;
- (ii) public statements should be so framed as to impale us no further on the hook of our current interpretation of the NATO target; and
- (iii) decisions on future levels of defence expenditure should be deferred until later in the Survey.

DEFENCE PROGRAMME†

	1979-80	1980-81	1981-82	1982-83	1983-84
£ million at 1979 Survey prices					
The inherited plans (Cmnd 7439)	7917	8177	8219	8227	8227
(% increase over previous year)	5.9	3.3	0.5	0.1	0.0
June, 1979 Budget	+100	-115			
July Cabinet decision	-193				
Revised estimate of outturn	7824	8062	+21	+263	+513
(% increase over previous year)	4.2	3.0			
Cmnd 7746 (November, 1979)		-65			
(% increase over previous year)					
January 1980 Cabinet decisions	-101				
Revised estimate of outturn	7723	7997	8240	8490	8740
Cmnd 7841 (March, 1980)	2.9	3.6	3.0	3.0	3.0
(% increase over previous year)					
£ million at 1980 Survey prices					
Cmnd 7841 revalued*	9288	9615	9941	10236	10540
(% increase over previous year)	2.9	3.5	3.4	3.0	3.0
Revised estimate/Cash Limits squeeze	-49	-175	+2	+5	+3
Estimating changes					
Survey baseline: Mr Pym's position	9239	9440 <sup>ø</sup>	9943	10241	10543
(% increase over previous year)	2.4	2.2	5.3	3.0	3.0
Chief Secretary's proposals	9239	9440 <sup>ø</sup>	-139	-141	-143
(% increase over previous year)	2.4	2.2	3.9 <sup>ø</sup>	3.0	3.0

+ The Defence Budget figures, to which the 3% strictly applies, are £3 or 4 million more in each year.

\* and with some minor classification changes.

ø The estimate of outturn in 1980-81 is uncertain: the Chief Secretary's proposal ignores the current year and bases 1981-82 on a 3% compound increase over 1979-80.