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MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000  
DIRECT DIALLING 01-218 2111/3

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PRIME MINISTER

DEFENCE CASH LIMIT 1979-80

You will have seen my minute of 20th June and John Biffen's reply of 26th June about the effect of the Budget increases in VAT and petroleum duty on the current year's defence programme. I am afraid this presents us with a serious problem.

2. These increases will cost the defence budget an additional £180m or so in the current year, including the defence works programme for which the Property Services Agency is responsible. No other Department faces a comparable cost; I understand that the Department of Health and Social Security come closest, with some £50m.

3. The cash limit fixed by our predecessors was inadequate to finance the programme; when we took office we found that because of rising inflation we were heading for a squeeze of over £200m on defence equipment, stores and supplies. The Cabinet accordingly agreed to an increase of £100m in the defence budget. The rest of the squeeze - over £100m - I have to absorb through administrative savings. I also have to cope with the 3% cut in manpower costs which applies to all Government Departments.

4. These challenges I have willingly accepted. But the new increases are in a different category. John Biffen is in effect saying that I must bite the bullet and live within the cash limit agreed before the Budget. If this line is maintained the result would be a real reduction in purchases

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of goods and services and would amount to a deliberate decision to dishonour our undertaking to our NATO Allies. Since defence is the programme most affected such a decision would discriminate against defence and would be seen to do so, contrary to our policy and pledges.

5. This would put the Government in a thoroughly invidious position. Our supporters would not understand why, after all we have said about strengthening defence, the defence programme for the current year should be cut to a level well below that publicly announced by our predecessors. I had to give a stalling answer to Winston Churchill's Written Question last Thursday. Our opponents also stand ready to exploit the situation. John Gilbert, the Minister of State here in the last Administration who took a personal interest in VAT, has a Question down for today. NATO too would realise what is going on - they monitor the performance of all Alliance members against the 3% undertaking.

6. The United States' Embassy were also on to the point a few days after the Budget.

7. To sum up: the Treasury line, if maintained, will effectively cut this year's defence budget by some £180m, contrary to our pledges. It will far more than counter the £100m increase for which we have taken credit, which would in reality be no more than a partial offset for inflation, and would in no way have enhanced the programme. The position will be plain to our supporters and critics alike.

8. I recognise the Treasury's difficulties and do not seek an increase in the cash limit now. I do however ask that, if it becomes clear later in the year that further funds are necessary to prevent further cuts in the defence programme which would otherwise have resulted from the tax increases, additional funds will be provided; and that meanwhile we should state publicly, as and when occasion

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requires, that the tax increases will not lead to cuts in the defence programme.

9. I am copying this minute to the Chief Secretary, OD colleagues, the Lord President and Sir John Hunt.

2nd July 1979

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