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10 DOWNING STREET

From the Private Secretary

1 August 1980

*sub*  
*BF for mby Monday*  
*10*  
Dear Mr.

The Prime Minister held a meeting this morning with the Chancellor and the Chief Secretary to discuss the defence budget and the problem of this year's overspend. Sir Anthony Rawlinson, Mr. Hansford and Mr. Kerr were also present. They had before them the Chief Secretary's minute of 30 July and the further note which you enclosed with your letter of 31 July.

The Chancellor explained that defence expenditure in 1980/81 was projected to exceed the cash limit by £650 million if no countervailing action were taken. £250 million of this was due to volume overspend, the rest due to pay and prices being higher than the assumptions made when cash limits were set. MOD were starting to take action to rein back the £250 million volume overspend but were doing nothing to eliminate the remaining £400 million. The Treasury would like to insist on the £400 million being eliminated too so that spending stayed within the cash limit. In addition, they wanted a deduction of £60 million to compensate for the MOD overspend in 1979/80. Other Departments were having to live within their cash limits and accept a volume squeeze; the MOD had been more favourably treated when cash limits were set and had been allowed to "keep" the cash from their staff savings; and it was crucial for the Government's borrowing plans and for the integrity of the cash limit system that MOD should not be allowed to overspend. The bad banking figures coming out the following week made it all the more important to act quickly and decisively. However, it was clear that to insist on MOD's staying within the cash limit (with the £60 million deduction on top) would be difficult. Annex D of the paper enclosed with the Chief Secretary's minute overstated the difficulties for the defence programme which this would involve; but they were none the less considerable.

The Prime Minister said that she was in full agreement with the Chancellor's objective but she felt an element of compromise would be necessary. After some discussion of the volume figures underlying the cash limits especially in relation to the NATO target, she suggested that the Treasury should be prepared to concede an additional £100 million after deducting the overspend for 1979/80 (i.e. about £150 million gross).

/The Chancellor

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The Chancellor said this could be presented to the Defence Secretary on the following basis:

- (i) a £100 million reduction would ensure that defence expenditure rose 3% in volume terms compared with the 1979/80 out-turn;
- (ii) a further £200 million reduction was justified to bring the volume of spending back to what had originally been implied when the cash limit was set;
- (iii) the £150 million concession in gross terms still meant that MOD were being treated more favourably than other Departments.

It would be important, in addition, to insist that:

- (i) MOD should keep within the revised figure and not overspend as they had done in the last two years;
- (ii) there should be the deduction for last year's overspend;
- (iii) there should be no further review let-out;
- (iv) there should be no concession or commitment in respect of spending for later years (which was the subject of separate discussions between Mr. Biffen and Mr. Pym).

The Prime Minister will now have a meeting with the Chancellor, the Chief Secretary and the Secretary of State for Defence at 2.30 p.m. on Monday with a view to achieving a settlement on the above basis. You will be letting me have speaking notes, and an aide memoire on the figuring, for the Prime Minister's use.

I am sending a copy of this letter to Alastair Pirie (Chief Secretary's Office).

*W. M.*

*Tim Laker.*

John Wiggins, Esq.,  
HM Treasury.

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