

CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG
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Dear Clive,

DEFENCE CASH LIMITS

Following this morning's meeting, I understand that you asked that a draft speaking note, and some supporting material, should be prepared for the Prime Minister's use at the meeting with the Defence Secretary which has now been ... arranged for Monday afternoon. I attach the required papers.

Yours ever

John Wiggins

A.J. WIGGINS

DRAFT SPEAKING NOTE

1. The essentials of the situation described in the Chief Secretary's minute, and the paper by officials, are simple:-

Defence are on course to overspend their volume programme.

This is clearly unacceptable, and Defence have agreed to prune all excess volume growth.

But Defence maintain that they must achieve the agreed volume programme, whatever its cost.

The cost seems likely to be some £400 million above the cash limit, and Defence have bid for the extra cash, which would give them a 4% increase on last year's outturn.

Meanwhile, as the markets have spotted, they continue to spend at a rate which assumes acceptance of their bid.

But the Treasury reject the bid: hence this meeting.

2. To accommodate the bid would presumably entail:-

An addition to the PSBR, and/or

Cuts in other expenditure programmes, and/or

Increases in taxes.

Realistically, fiscal action is hardly possible. Nor are compensating cuts in other programmes. And the markets are looking for action to keep spending in line with the target for the PSBR, not to increase it. Holding down public

expenditure, and hence the PSBR, is crucial to the achievement of the economic strategy.

3. The Defence bid cannot therefore be accepted. Cash must rule, and be seen to rule. The volume of Defence purchasing must be brought down to what the cash limits will allow; and the sooner the markets see this happening, the better. Some modest increase in the cash limit need not be excluded, although Defence will have to accept a deduction to compensate for their overspend last year. [See Annexes] But an extra £400 million is just not on - nor is it needed to ensure that we maintain a respectable record in relation to the NATO target. Moreover, we interpret the NATO target in terms of outturn on outturn, not outturn on plans, and it specifically recognised that economic circumstances would affect what individual countries could achieve. Ours must affect what we can do this year.

4. Of course it will not be easy to bring spending back in line with the cash limits, perhaps marginally increased. But the MOD Annex to the paper by officials exaggerates the difficulties. Defence benefits from:-

A cash limit increase (£54 million) to cover the additional costs of the Armed Forces Pay Review Body's recommendations.

Retention of savings (£30 million) from Civil Service cuts.

The appreciation of sterling.

Increased receipts from Hong Kong.

- and some reductions in stock and on the works and equipment programmes should be possible without effect on the readiness of units declared to NATO, or their availability for exercises and routine activities. (The Annex is "horror comic stuff".)

5. A settlement must be announced before the House rises.

It must be:-

- In line with Cash Limits policy (ie incorporating the compensating deduction), and
- Consistent with the Government's rule that cash must determine expenditure, not vice versa.

It must also be:-

- Accepted as final (no more reviews), and
- Implemented with determination (no third consecutive overspend).

DEFENCE CASH LIMIT 1980-81

	£ million (cash)
Prospective overspend	650
Of which, volume excess over approved programme (Cmnd 7841) which Defence Secretary has agreed to eliminate:	250
Remainder, ie extra cash requirement arising from the excess of current pay (1) and price forecasts over those assumed in setting the cash limits:	400
A cash limit increase of <u>£400m</u> , restoring the programme in its entirety, would permit 4% real growth over the outturn in 1979-80.	
Amount required for 3% growth	300 ⁽²⁾
Reduction in programme implied by pay and price assumptions at the time of the Budget:	200
Remainder, ie extent of "unforeseen" squeeze	100
In addition, developments on the exchange rate, the contribution from the Government of Hong Kong, and civilian staff savings will make it easier for the MOD to absorb the squeeze.	

(1) Compensation has been agreed for Armed Forces' Pay (£54m) which has therefore been excluded from this calculation.

(2) Rounded.

DEFENCE BUDGET (1)

	1979-80	1980-81
Original cash limit	8005	10125
increases granted	549 ⁽²⁾	218 ⁽³⁾
Total	8554 ⁽⁴⁾	10343
Gross increase over previous year	24.3%	20.9%
Underlying growth ⁽⁵⁾ at constant September 1979 prices	2.4%	4.0%
The price forecasts at the time of the Budget implied that the cash limit would constrain growth to	....	2.2%
Current price forecasts imply that growth will be constrained to	....	0.3%
Growth which would be permitted by an increase in the cash limit of:		
£100m	....	1.25%
£150m	....	1.75%
£200m	....	2.25%

(1) The Defence Budget includes, in addition to the Defence cash limit, Service Pensions and certain other expenditure.

(2) Including £270m for Forces' pay, £100m for equipment and £140m compensation for VAT.

(3) £164m for Civil Service pay, and £54m for Forces' pay (not yet Voted).

(4) The outturn was £8615m.

(5) Defence Budget.