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PRIME MINISTER

Defence Expenditure

We have to consider how to handle this, once you have seen the Chiefs of Staff tomorrow.

2. There are three major questions outstanding:

- (a) The size of the reduction of defence expenditure in 1981-82.
- (b) The treatment of Armed Forces pay for cash limit purposes.
- (c) The application of the prices factor on the cash limit for defence equipment.

3. I now judge that the key to this is the amount: once that is settled it should be possible to resolve the other two questions.

4. I do not believe the amount of the reduction in defence expenditure can be settled except between you, the Chancellor of the Exchequer and the Secretary of State for Defence. It is clear that the Secretary of State for Defence is prepared to move up to £188 million and the Chancellor of the Exchequer is prepared to come down to £250 million. The objective in any meeting between you, the Chancellor and the Secretary of State would be to get the Secretary of State as near as possible to £250 million. I would judge that he might be persuadable to £225 million, subject to a satisfactory agreement on the other two factors.

5. If agreement can be reached on the amount, it would be worth having a preliminary discussion on the other two factors, as a guide to officials to work out some kind of formulation. There will be a trade-off between the two: the Secretary of State for Defence and the Chiefs of Staff would attach more importance to satisfaction on the pay factor than to the prices factor. If the Chancellor were prepared to agree that the cash limit for Armed Forces pay should be adjusted to take account of the Government's decisions following the report of the Armed Forces Pay Review Body, the Secretary of State for Defence would probably be prepared to accept the 11 per cent prices factor, perhaps with some repetition of the general formula - which is already in force in respect of cash limits as a whole - that the cash limit can be looked at again in the event of some major unforeseen change in the relevant considerations.



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6. If your discussions with the Chancellor and the Secretary of State lead to agreement on the figure and, if possible, some general agreement on the approach to these two issues, officials can be sent away to tie up the words. I should of course be happy to act as a broker in this, if that is what you would like; but it may be your discussions will make that unnecessary and it can be left to the Treasury and the Ministry of Defence to sort it out between them.

7. As to timing, it would obviously be convenient to have the defence figure agreed before Cabinet on Thursday, 13th November, so that you can inform the Cabinet of the outcome. Whatever the outcome was might have a bearing on the reactions of other Ministers on their programmes. But it seems unlikely that the Cabinet will be able to dispose of all the outstanding issues on Thursday, and, if it has not been possible to reach agreement before Thursday, this could probably stand over for further discussions between now and the meeting of the Cabinet scheduled for Wednesday 19th November.

(Robert Armstrong)

10th November 1980