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From the Private Secretary

2 January 1981

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Dear David,

Defence Estimates 1981/82

As you know, the Prime Minister held a meeting with your Secretary of State, the Foreign and Commonwealth Secretary and the Chancellor of the Exchequer on Wednesday afternoon to discuss the defence estimates for 1981/82. They had before them Mr. Pym's minute of 23 December and your two letters of 30 December.

The Prime Minister said that she was concerned about the unemployment consequences of some of the proposed spending cuts set out in annex B of Mr. Pym's minute. She was particularly concerned about the political implications of closing Deal and cancelling the Sea Eagle project both of which were in marginal constituencies. It also did not seem sensible to cancel projects which were nearing completion or on which a great deal of R and D work had already been done. In addition, she wondered whether the full budgetary consequences of particular spending decisions had been worked out. It seemed to her that all too often a reduction in the defence budget led to increased spending on social security and on other spending such as short time working compensation. In net terms, the effect of spending cuts on defence was likely to be much less than appeared at first sight. It would be far better if, before Ministers reached decisions on spending programmes, the Treasury could work out the full expenditure and PSBR implications of different options.

The Prime Minister went on to say that there was surely a case for allowing MOD to speed up their spending on equipment if this was to be offset by lower spending in later years; for by bringing spending forward this was likely to save on costs. But if the Treasury insisted on MOD finding further programme reductions in 1981/82 to offset the faster spend on equipment than had earlier been anticipated, she hoped that - as far as possible - projects could be deferred rather than cancelled. In addition, she thought that more money

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could be raised for the defence programme from property disposals. Your letter of 30 December on this subject had indicated that about £66m. could be raised from the sale of MOD land and buildings in 1981/82. But her impression was that the institutions would like to buy considerably more property than currently appeared available, and that the figure of £66m. could be increased. She suggested that the MOD disposal programme should be looked at again with the assistance of Mr. David Young. Finally, to the extent that programme reductions had to be met, she did not believe the presentational problems were quite as great as Mr. Pym suggested. She doubted whether it would be necessary to declare all of the reductions in specific terms to our NATO allies - other Governments, she felt sure, would not do so in similar circumstances; and in any case, the Government could take credit for the early completion of defence contracts.

Your Secretary of State said that the defence programme was under very great pressure. He was having to make specific programme reductions of £360m for 1981/82 because of faster than anticipated spending on equipment contracts and £200m. because of the Cabinet's November decisions on public expenditure as a whole. Nine-tenths of the defence programme was already firmly committed, so that his room for manoeuvre was very limited. The problem was made worse by rising real costs. It did not, in his view, make any sense for the Treasury to insist upon the full £360m. claw-back - since this would mean scrapping projects for which, in later years, sufficient money should be available; it would be much more reasonable if the claw-back could be spread over a period of years. If the Treasury were to insist upon additional reductions in 1981/82 to compensate for any cash overspend this year, then the whole position would become absolutely intolerable. More generally it was extremely difficult to plan on a sensible defence programme when it was subject to continued cuts: since the Government came into office, the programme had been cut five times. As regards the specific options put forward in annex B of his minute, he agreed that closing Deal and cancelling Sea Eagle would have serious political repercussions. But in terms of defence policy; item 2 of annex B - namely not forming the third Lightning Squadron or increasing establishments of existing squadrons - was much more serious. When there was a clear need to improve our air defences he was very loath to pursue this option; on the other hand, there was little alternative if savings - especially in the later years - of the magnitude required were to be achieved. The shipbuilding measures under item 5 would probably mean the closure of Cammell Laird, Scott Lithgow and Vosper's with up to 15,000 redundancies.

/The Chancellor

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The Chancellor of the Exchequer, responding to the general point about spending decisions put forward by the Prime Minister, said that the net reduction in total Government spending would be less than the spending reductions in the defence programme. But it was an illusion to think that total spending would be lower if the defence reductions were not made. Total expenditure and the PSBR would certainly be higher in the absence of the MOD reductions. If the Prime Minister's line of argument were to be pursued, this would mean reopening the decisions on defence spending reached in recent months; and it would make it impossible to resist reopening decisions on other spending programmes. As regards the £360m. claw-back, he had to insist on this simply because - in its absence - the defence budget would be overspent by that amount; if this happened, it would add to the overall financing problem and the Government would lose all credibility on public expenditure. In his view, despite the further cuts in specific defence programmes which would now be needed, the defence programme as a whole would remain basically intact. One indication of this was the formidable list of projects contained in the last paragraph of your letter of 30 December which would continue unaffected. On the other hand, the difficulties which MOD seemed to have in fulfilling their commitments within the overall programme figures suggested to him that our defence strategy was not consistent with what we could afford; and the problem was likely to become worse as spending on Trident developed in the mid-1980s. In short, we were over-committed on defence, notwithstanding the increase in spending allowed for. But he also felt that MOD's approach to spending could be improved. In contrast to other Departments, there was a tendency to give priority to the achievement of their volume programme even at the expense of exceeding their cash limits. This, he understood, was because the discussion of priorities within MOD between the three services was conducted entirely in volume terms, and because the cash limit had never been satisfactorily broken down between individual programmes. There was also, in the Treasury's view, not enough flexibility built into defence programming, and staying within the spending ceilings would be easier if MOD's long term costings were prepared on a more conservative basis.

/The Foreign and Commonwealth

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The Foreign and Commonwealth Secretary said that, from a foreign policy standpoint, he was more concerned about the proposals in Annex A of Mr. Pym's minute, than those in Annex B. Many of them would have to be declared to NATO, and the proposed reduction in fuel stocks would reduce the Services' ability to conduct training exercises. As regards the items in Annex B, he did not think it would be politically possible to disband 41 Commando Royal Marines; if Deal had to be closed, the possibility of moving them elsewhere should be considered. More generally, he agreed with the Chancellor that the defence programme was over-committed in relation to the budgetary constraints. In fact, the UK and NATO as a whole were spending more on defence than the Warsaw Pact countries; yet the overall effectiveness of our defence effort was inferior because it was spread so widely. It was necessary, in his view, for the Government to reconsider the pattern of defence spending, and it would also be highly desirable to persuade the new American Administration of the need for a review of NATO spending. The Prime Minister could put this to President Reagan when she visited the US in February.

Summing up, the Prime Minister said that the defence estimates for 1981/82 should be prepared - notwithstanding all the difficulties - on the basis of the spending decisions reached by Cabinet in November, and including whatever specific reductions were needed for the faster spending on existing contracts in 1981/82 than had earlier been anticipated. But further consideration should be given to the question of property disposals, and she would ask Mr. David Young to get in touch with Sir Frank Cooper to give assistance in this matter. On the items set out in Annex B of Mr. Pym's minute, she would like to be consulted again before final decisions were taken; and in putting forward his proposals, Mr. Pym should take into account the points made in discussion. She would also like to be consulted on the handling of all the cuts, including those in Annex A, which were to be made. Whatever final decisions were taken, they should not be made public - except in so far as it was absolutely essential to inform contractors - until the publication of the estimates and the defence White Paper in March. Finally, a re-assessment in conjunction with our allies of the pattern of defence spending would be highly desirable, and it would be for consideration over the next few weeks whether and how she should take this up with President Reagan when she visited Washington.

I am sending copies of this letter to George Walden (Foreign and Commonwealth Office), John Wiggins (HM Treasury), and David Wright (Cabinet Office).

David Omand, Esq.,
Ministry of Defence.

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