

Ref. A04487

PRIME MINISTER

Defence Expenditure 1981/82

MW 9.00  
You are meeting the Chancellor of the Exchequer and the Secretary of State for Defence at 8.30 tomorrow morning to discuss their minutes to you of (respectively) 16th and 11th March. The Home Secretary, Foreign and Commonwealth Secretary and Secretary of State for Industry will also be present.

2. To meet his agreed expenditure reduction target for 1981/82, Mr. Nott now believes that he would need to cut his programme by:

(a) £141 million, being the final slice of his £200 million cut agreed last November plus an allowance for further deterioration in his costings prospects since that date.

(b) About £300 million, being the likely extent of his 1980/81 overspend. He proposes a painful but tolerable way of finding £105 million towards (a). But the steps needed to save the remaining £36 million under (a) would in his view be "politically daft". He therefore wishes to defer consideration of this until June/July, when his major review of defence policy options will be complete and when the 1981/82 cash limit is in any case due to be reviewed. He also wishes to be excused the £300 million under (b) altogether.

3. Sir Geoffrey Howe is unable to accept either of these two wishes. His reaction is very understandable. Although it is given comparatively little space in either of their minutes, the missing £300 million under (b) is what really matters. Letting Mr. Nott off this would not only make a large dent in his public expenditure policy but would also incite other hard-pressed colleagues to seek similar derogations. The missing £36 million under (a) is small beer by comparison. But there is clearly no basis for the belief that finding it will somehow be easier in June/July. On the contrary, over 90 per cent of the defence budget is already committed and the further the year progresses the smaller is the scope for making any savings at all.



4. You will therefore need to support the Chancellor on the issues of principle involved. But in practical terms your meeting cannot simply order Mr. Nott to meet his cutting obligations in full regardless of the consequences. In his view even cutting £36 million more than he proposed will be politically disastrous in terms of the Government's relations with its own supporters at home and with its American and other allies abroad. The items identified on his list below the thick line are all highly "visible" in military, industrial and political terms. Cutting these plus £300 million would obviously be ten times worse. If existing defence expenditure commitments are allowed to stand, the sort of measure which would be needed might be a total ban on recruitment to the Services for the whole financial year - which would be impossible for the Government to defend in the light of their declared defence policy.

5. The problem has to be viewed in the light of the main elements into which the defence budget for 1981/82 (or any other year) breaks down. In round figures, the total is £12 billion: £2 billion of that goes on works and non-warlike stores; £5 billion on personnel; and £5 billion on military equipment. Over half the personnel bill is Armed Forces pay; the balance is pensions and civilians' pay. About half the equipment bill is for new items; the other half is e.g. ammunition, fuel and spares for existing items.

6. Against this background you may wish at tomorrow's meeting, after probing to see if there is any give in either the Chancellor's or the Secretary of State for Defence's position, to explore what seem to be the only two ways out of the impasse, both of which would involve controlled breach of commitments.

- (a) New equipment (about £2½ billion). Most major contracts are already let and cannot be cancelled without heavy penalties. But if the main industrial suppliers concerned were confronted starkly enough with the alternatives, they might be willing to accept, however reluctantly, some small deferment of Ministry of Defence payments into 1982/83. Deferment of 10 per cent would go a long way towards closing Mr. Nott's gap. Bankruptcies should be avoidable, given that companies would have a "bankable" Government promise that the missing payments would be



available as early in 1982/83 as was wanted. Industrialists who refused to co-operate would have to recognise that the dislocation which this might cause to the whole procurement programme, over more than one year, could well be much more costly to them in the end.

- (b) Armed Forces pay (about £2½ billion). The Chancellor is in principle committed to giving the Ministry of Defence extra money to cover the extent to which Armed Forces pay rises by more than 6 per cent. The Government is formally committed to implementing whatever the AFPRB recommends; we do not know what that will be, but it could well be considerably over 6 per cent. Each 1 per cent over 6 per cent will cost the Chancellor about £25 million. If the Secretary of State for Defence could be persuaded to absorb any excess pay costs over 6 per cent in return for being let off the £300 million, the Chancellor would be better placed to be more understanding about the £300 million excess. This would be likely to represent a good bargain for the Secretary of State for Defence (though the precise value is not yet quantifiable), but would avoid reneging on the promise to the Armed Forces and would partly preserve the equipment programme.

7. Given the less mathematical approach of the new United States Government, you will not want to spend too much time on the question of what is likely to happen to our 3 per cent defence expenditure increase target in 1981/82. In constant price terms, the overspend in 1980/81 is likely to mean that we shall do a bit better than 3 per cent in 1980/81 and (if the overspend is repaid as Sir Geoffrey Howe wishes) a bit worse than 3 per cent in 1981/82; i. e. over the two years taken together the average annual increase will not be far off 3 per cent. But in volume terms, because defence costs are rising faster than the inflation rate, we shall show little or no increase; and it is this which will worry the Americans, and the Government's supporters.

REA

ROBERT ARMSTRONG

17th March, 1981