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From the Principal Private Secretary

18 March, 1981

Dear Brian,

DEFENCE EXPENDITURE, 1981/82

The Prime Minister held a meeting this morning with the Home Secretary, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, the Secretary of State for Industry and your Secretary of State to discuss defence expenditure in 1981/82. Sir Robert Armstrong was also present. The meeting had before it your Secretary of State's minute of 11 March and the Chancellor of the Exchequer's minute of 16 March.

Mr Nott said that the main problem he was facing concerned the long term defence programme and not defence expenditure in the year ahead. The long term costing of the defence programme had just been completed and this showed that the cost of the programme was greatly in excess of the resources likely to be available. He had, therefore, just commissioned an alternative costing. This was a fundamental exercise and was likely to lead to a substantial re-shaping of his programme. He wanted to emphasise that no decisions had yet been taken and he was only at the stage of asking for options to be considered. When the new costing had been completed and he had been able to consider it, he would of course consult his colleagues before any firm decisions about major programme changes were taken. He was very conscious of the political and industrial dimensions of some of the options under consideration.

The problem of defence expenditure in 1981/82 was small by comparison but it was of course more immediate. He would like to go ahead with the £105 million of cuts listed in the annex to his minute, and he recognised that the gap of £36 million would have to be closed in some way. But he did not want to make specific programme cuts now to deal with this gap, for this would compel him to consult NATO again only a few weeks after the last approach to them and this might prejudice the outcome of the much more important longer term exercise. He thought that it should be possible to deal with the £36 million when his department and the Treasury came to

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agree on the adjustment to the cash limit for the Relative Price Effect. It would, however, be essential that the assessment of the RPE was a realistic one: the cost of all defence programmes - British, American, German - was at the moment running ahead of inflation.

The Chancellor of the Exchequer said that he agreed that the Defence Secretary should not find the remaining saving of £36 million in 1981/82 by making programme cuts which would require a further announcement and he accepted that there would have to be an assessment of the RPE later in the year. But a way would have to be found of keeping defence expenditure within the discipline of cash limits. The same was true of the expected overspend of £300 million in 1980/81. He recognised that it would be impossible to claw-back the whole of this amount in 1981/82, but nonetheless the discipline of cash limits was working well for other programmes and must be applied to the defence programme as well, if it was not to be undermined generally. One solution might be to spread the claw-back over more than one year. The matter should be looked at again when the cash limit for 1981/82 was reviewed.

The Foreign and Commonwealth Secretary said that many of the options the Defence Secretary was considering had political implications, and he hoped that his officials could be associated with the studies at the earliest practicable moment. He welcomed the Defence Secretary's assurance that no decisions would be taken until Ministers collectively had been consulted. He hoped that the new costing would not reduce still further our ability to operate outside the NATO area.

The Defence Secretary said that there were no additional resources available for a capability for use outside the NATO area. It would not, for example, be possible to deploy more ships beyond NATO waters, though it should still be possible to send a naval task force to places like the Gulf. There were many competing demands for the limited resources available: he was, for example, very anxious to increase the ammunition stocks in BAOR which at present was capable of fighting a conventional war for no more than four days. As regards the conduct of the new costing of the defence programme, he would see that officials from other departments were brought in by the Ministry of Defence as soon as the costed options were available.

The Prime Minister, summing up the discussion, said that they were agreed that Mr Nott should make the £105 million worth of savings set out in the annex to his minute. They also accepted that he should not make programme cuts at this stage to find the remaining £36 million but that his department and the Treasury should seek to agree on how this gap was to be closed when the cash limit for 1981/82 was reviewed later in the year. They should also use the occasion of the review to attempt to reach agreement on how to accommodate the expected overspend in 1980/81. The Defence Secretary should bring the results of his re-examination of the long term defence programme to his colleagues at the earliest opportunity.

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

Yours ever,

Oliver Sturges

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Ministry of Defence