

Prime Minister.

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PRIME MINISTER

You should read this before you see Mr Nott. He wrote it before he decided to ask whether he could have a word with you over the week-end.

I suggest that you avoid committing yourself when you see him tomorrow. You must get the

I have been considering whether I should after all return for Cabinet next Tuesday, given the importance of your public expenditure discussions or whether I should stick to my plan to run the opening session of the NATO Nuclear Planning Group in Scotland. Somewhat reluctantly I think it really is in all our interests that I should be in Gleneagles to support Caspar Weinberger given the great importance of the nuclear issues we will be discussing and our own unique role in interpreting the Americans to the Europeans and vice versa. If I am not to be at Cabinet however I must let you know that I do not accept the proposals in the Treasury papers as they affect defence.

Chairman's note. I think that you should see Mr Nott that Cabinet will have to carry out its defence expansion to its meeting on 29 October. I think, given his absence on 20 October, the defence budget in particular should be left over till the latter meeting.

2. When I put our new defence policy to Cabinet (C(81)31) I was putting forward major adjustments in the defence programme which will put defence on a sustainable basis in the longer term, given reasonable resource allocation meanwhile. Cabinet endorsed my proposals (see C(81)24th conclusions), which provided for an increase in defence expenditure in real terms of 3% per annum up to 1985/86. Cabinet acknowledged the need for realistic cash provision, including the defence relative price effect which I specifically dealt with in cash terms (appendix J to C(81)31) and Cabinet authorised me to enter into conversation with our Allies on this cash basis. The Cabinet accepted that this decision would have implications for other public programmes.

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3. I cannot therefore accept that the defence position is as the Chief Secretary describes in his latest paper. We settled on all this in June and I am not now making any extra "bids". The position of the defence programme cannot be reopened by the Treasury in this way without another major defence review, something which is quite clearly impossible in current circumstances.

4. It was agreed with my predecessor that this year's cash figures would be subject to review and adjustment in the light of defence price movements. I have discussed the latest pay and price information with both the Chancellor and the Chief Secretary. At our last meeting the Chief Secretary offered an adjustment of £250M after taking account of Service pay and of my agreement to pay a "fine" of £64M for last year's overrun and to be "fined" a further £40M for the programme cuts which colleagues were reluctant to make last January. Even on the basis of £300M, however, I shall need to take at least an additional £100M off defence expenditure with industry, having already this year clawed back £200M from the Tornado, shipbuilding and other programmes.

5. £300M is needed to achieve the published defence figure for this year; and you and I have been consistently on record in public as saying that defence expenditure would grow by 8% in our first three years of office - and 3% per annum thereafter. This is the basis on which our programme was planned and announced and it cannot now be changed four months before the end of the financial year.



6. If I agree to anything less than £300M the MOD is bound to overspend. I see no gain to the MOD, the Treasury or the Government for us to be involved in two supplementary Estimates, one now for a lesser figure than £300M and one later. This would represent the negation of cash discipline for my Department.

No
7. I am certain that the consequences of decisions on this year's cash limit must in turn become the base from which next year's Estimates are calculated, and which we have already agreed should represent a 3% volume increase. The Chief Secretary's proposals recognise this in the case of Armed Forces Pay, but make no provision for carrying forward the consequences of this year's final cash limit in respect of other expenditure. The new system of cash planning simply will not work if it does not start with a fair base from which to calculate the following year's figures, - all logic demands this. To do otherwise would make it impossible to honour the Cabinet's decision to provide for 3% annual real growth in defence expenditure up to 1985/86.

8. If we assume that this year's cash limit is settled on the basis of the £300M I referred to above, my present calculations suggest that if this is not taken into the base line for next year, and on the Chancellor's assumption about prices generally, then the planned and announced 3% growth in the defence programme in 1982/83 will be reduced to almost nil. If there is no allowance for defence relative prices then the programme will actually shrink in volume. Every 1% of RPE represents about ½% off growth. Under the normal conventions all these effects would be cumulative in subsequent years (though I presume that the Chief Secretary's proposed further substantial cuts in 1984/85 cannot apply to the defence programme on which we have taken decisions up to 1985/86.)



9. I am quite clear that although defence prices relative to general prices do fluctuate from year to year, there has been a positive trend over the last ten - and indeed 15 - years at an annual average rate of 2%. Economic analysis in MOD suggests that it will be positive over the next few years as we come out of the recession, and forecasts for next year indicate that it could be substantially higher than 2% - perhaps 5%. However, I would put more confidence in the trend rate and I would be prepared to stick by the figure of 2% which was what I presented to Cabinet prior to agreement on the new defence programme.

10. In my defence review I avoided hammering British industry, by finding savings by contracting the size of the surface fleet, closing two Dockyards with the loss of 11,000 jobs, by reducing service manpower by 19,000 and by cutting MOD civilians by 15-20,000. I believe this was the right course particularly given the severity of the current recession. Indeed it would have been ~~impossible~~ impossible then to get major cuts in the aerospace and high technology industries through Parliament. It would be even more difficult now. In the attached Appendix however I have set out what could be needed to meet the cuts that are the consequence of the Treasury proposals in the papers under discussion next week. The only way of living within those cash provisions would be to reduce the defence programme before the start of the year. I shall be scrutinising my Estimates as they are compiled towards the end of next month, but it is already clear that a significant cash squeeze cannot be accommodated without measures of the kind described in the attached list.



11. I would much rather that we embarked on next year's defence programme with a firm cash limit to which my Department is required to work. Last year we started the year with a cash limit which was recognised to be inadequate and which had to be subject to review. The events leading up to this had become the subject of public disagreement. Our defence review was designed to put an end to all that. We only just got the results of the defence review through Parliament, the Party and our Allies. We cannot embark on such a course again. The answer must be to give the Ministry of Defence a cash limit which is realistic but which requires tight cash discipline, and which reinforces rather than undermines the new cash planning system.

12. Although I would of course be prepared to return for next Tuesday's Cabinet should you wish it, there is the danger that this would be portrayed by the defence correspondents at Gleneagles as a crisis move. I hope, however, that it will be possible to have an early word with Geoffrey and you together on my return about how we handle the tricky problems I have outlined in this note.

13. I am sending copies of this to Geoffrey Howe and Leon Brittan and to Robert Armstrong, but to no-one else.

A handwritten signature in blue ink, appearing to be "S. N." followed by a period.

Ministry of Defence

16th October 1981