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CHIEF SECRETARY TO THE TREASURY

Prime Minister

To note at this stage - for decision later in the Public Expenditure discussions.

MCS 19/10

PRIME MINISTER

DEFENCE EXPENDITURE

Geoffrey Howe will not be back from Luxembourg until later tonight. In his absence I send you this quick comment on John Nott's minute of 16 October to you.

attached

2. I agree with John's view that we should have an early word about how to handle the problems he has outlined. I cannot however accept the solution he proposed, which is in effect to underwrite the defence programme with substantial cash additions both this year and over the next three years, regardless of the implications of this for our public expenditure strategy and our plans for the adjustment of the economy. I attach a note spelling out the objections in more detail.

3. Geoffrey and I have discussed these matters with John on several occasions recently. We have offered him a substantial increase in his cash limit this year to help him over the transitional problem of adjusting the defence programme to the lines of the proposals the general thrust of which Cabinet endorsed. We are not now seeking to reopen the Cabinet decision on 3% p.a. real growth as John alleges. We cannot accept his implied view that cash planning and cash limits are different for defence than for other programmes, and that the defence figures should be enhanced by the use of special and favourable price factors which apply only to defence.

4. By any criteria the cash additions John is seeking are substantial: £600 million in 1982-83 rising to £1,100 million in 1984-85. This would imply a defence programme in cash terms in 1984-85 of some £5 billion (40%) higher than the original 1981-82 baseline.

5. The proposals for defence in my Cabinet paper are consistent with the NATO 3% target. The underlying real growth endorsed by Cabinet would be sustained, since the cash provision would be determined by the price factors Cabinet have approved for general application.

6. We have seen no convincing evidence that defence prices are rising and are bound to rise in future faster than prices generally. The indices of defence procurement prices available to the Treasury do not indicate that defence prices are moving faster than prices in general this year, nor have they done so for the past three years. There is no justification for the proposition that the trend rate of RPE of 2% said to have been experienced on average over the last 10 years should be assumed to emerge again during the survey period. Indeed, as the economy picks up and industry takes on more non-defence business, the reverse may apply.

7. As indicated above, enormous sums of money depend on the view taken of defence prices. To accede to John's suggestion would jeopardise our approach to other public expenditure programmes, the PSBR and the tax position.

T. Mattews

for LEON BRITTAN
[Approved by the Chief Secretary
and signed in his absence]
19 October 1981

The Tsy have copied this minute to the MOD and Cabinet Office.

[illegible]
21X.

TREASURY COMMENTS ON MR NOTT'S MINUTE OF 16 OCTOBER TO THE PRIME MINISTER

Treasury Ministers are not seeking to overturn the June Cabinet decision; the proposed provisions fully reflect 3% real growth enhanced by the general revaluation factors agreed by Cabinet. Cabinet accepted that there should be a realistic translation of the Defence programme up to 1985-86 from volume to cash but confirmed that, like every other programme, the Defence programme should be expressed in cash not in volume, with the figures for review and final settlement at the conclusion of the current public expenditure exercise. The figures quoted by Mr Nott (Appendix J of C(81)31) were explicitly illustrative; were clearly indicated as such in the Cabinet paper; and were calculated on a different basis from the proposals he now puts forward.

2. Mr Nott's proposals for future years are very substantial; £600m in 1982-83 rising to £1100m in 1984-85 above the baseline revalued.

3. The Treasury remains unconvinced that there is any case for these additions. There is no evidence that so far this year defence prices have been rising faster than prices generally but Treasury Ministers acknowledging the pressures on the Defence Budget have offered a transitional increase of £250m for this year only.

4. The defence case for future relative price effect provision of 2% per annum above the general cash factors for non-pay items is related to the annual average over the past 10 years and a claim that defence suffers a positive RPE when productivity is increasing. The past trend is distorted by a few very high figures. For the last 3 years the RPE has been negative. In any case the pattern has been erratic and past trends give no reliable indication for the future.

5. Treasury economists reject the MOD forecasting techniques as unsound. There is no convincing evidence to support MOD's claimed link between productivity and RPE, nor have MOD tried to separate out the effect of excessive wage increases in the defence industries.

6. If advance provision is made for higher price increases in defence,

/there

there would be every incentive for defence contractors to accede to high wage settlements and no pressure on MOD to contain these costs.

7. Cabinet envisaged in June that any increases in defence spending would have to be met by adjustments to other public expenditure programmes; such reductions in other programmes do not now seem possible. To accept the MOD bids would be to jeopardise the approach to public expenditure in general and to increase the PSBR or taxes (or both). The defence programme cannot be increased regardless of the implications for public expenditure strategy and Government plans for the adjustment of the economy.