cc A Walters
A Duguid
J Vereker

38

Prime Minister

The Chief Secretary is not going to reply going over all the old ground again: you may wish to refresh your memory of the Treasury case (Play A and B) MCS 18/11

MO 8

PRIME MINISTER

PUBLIC EXPENDITURE

We meet on Thursday to discuss the Defence Budget. It may assist you if I set out the latest position, based on MOD's provisional Estimates for 1982/83, which have become firmer in the past week.

2. I hope that we can avoid disagreement about the facts of the June Cabinet decision. It was a decision taken in volume terms, with the agreed proviso that there should be realistic translation into cash. The difference now is about how that translation should be made. As the Home Secretary's draft paper shows, for 1982/83 we are £374m apart; and the amounts widen thereafter.

3. In June I offered two options for getting expenditure back onto a more stable basis, in relation to available resources (1) a crash programme which involved 3% volume increase until 1985/6 plus £200m volume a year extra or (2) a gradualist programme involving a 3% volume increase until 1987/8 without any addition in the early years. The Cabinet decided on a 3% volume increase, but restricted the commitment to 1985/6. Cabinet chose the gradualist approach, for good political, industrial and employment reasons. The Treasury's proposals assume we could carry out the crash programme of reductions but without the cash to pay for cancellation charges and redundancy payments: an impossible problem.

4. But that is history - the reality is as follows.

5. MOD can tackle the problems of those Votes which are comparable to other Departments' expenditure, even although we have had to cut back Services' activities and works programmes in order to deal with the volume squeeze - and you will recall that the inflation factor chosen by Cabinet last month has already been shown to be inadequate - which will produce continuing difficulties particularly in relation to oil purchases.

6. The problem now overwhelmingly concerns Vote 2 - defence equipment - and in particular the Air and Sea Systems area. Tornado, the greatest single difficulty, exemplifies the situation. Production is now flowing in accordance with pre-arranged tri-national plans fixed years ago. Annual programme costs amount to over £1 bn. Ship deliveries amount to nearly £500m. Deferment pushes added costs into later years, and beyond a certain point involves paying compensation which increases costs in 1982/3 as well.

7. As we approach 1982/83 I find that of the total Vote 2 equipment budget about 80% is already contractually committed. Not all of the residue can be readily cut, since, for example, some spares have to be provided to keep equipment serviceable. The gearing is such that to cut back on uncommitted funds would involve quite disproportionate damage to our weapons programme, and such new projects as have survived the Defence Review.

8. Our Defence Review was meant to achieve a better balance between expenditure on platforms and expenditure on weapons, sensors etc, and the enhancement of our hitting power and staying power.

Having trimmed our plans for platforms (eg the reduction in the size of the surface fleet), we should be foolish now to degrade our defence capability by failing to provide the desperately needed weapons for our remaining ships and aircraft. Similarly, we cannot go on as has happened year after year, robbing war stocks and running down our combat capability. Each year's deferments have increased the following year's problems. We are now down to an essential minimum - and in some areas we are below NATO minima (which are themselves pathetically low).

9. My judgement after reviewing the whole position again is that I require the full cash figures set out in the draft MISC 62 paper. My study of the Defence Estimates, reinforced by the meetings of the Service Boards which have taken place this week, reinforces my view. Anything less will be unsustainable in Parliament. In broad terms the three Services Estimates were initially £1300M above the financial remit I had given them for next year - and this was before revaluation to 1982/83 prices and without any provision for the Relative Price Effect. This staggering excess can broadly be broken down into three categories:

a. an estimated under provision of more than £500M of cash. The Treasury factor for defence prices this year is 5% low. Included in this are Exchange rate variations amounting to up to £300M. This is the effect of applying a cash squeeze before Estimates are compiled;

b. a very significant strengthening of the Block Adjustment relating to industrial activity, amounting to £500M. This is a factor which seeks to offset the <u>speed of deliveries</u> from

the contractors. The recent Reeves Report recommended lower margins, and the likely condition of British industry next year requires this.

Both factors a. and b. above are new this year; and having to adjust the long established volume programme within a 5 month period is just impossible.

c. slippage of programmes, primarily deferments to meet demands for "savings" in earlier years, together with some real cost growth, amounting to about £300M excess. Until we have closed the dockyards, completed the Service redundancies, worked through existing contracts etc, hopefully by 1985/86, each year's "savings" aggravates the succeeding year.

10. We have already subjected the Estimates to the closest scrutiny in order to bring the cost of the programme down to a provision of £14333M (my figure) next year. This will involve us in any event in major cancellations and deferments. I am being faced here for instance with the disposal of Dreadnought (a fleet nuclear submarine), slowing down the Sea King helicopter replacement reducing the Army ammunition and vehicle programmes (including the major new combat vehicle project), cancelling the collaborative SP70 self-propelled gun, reducing funding for future tank development, deferring various weapons programmes and stopping all new Army works commitments; and cutting Tornado deliveries to the RAF from 52 to 44 a year and foregoing the conversion (mentioned as a possibility in Cmnd 8288) of the last 20 Tornado GR1s to the F2 air defence role. These are hard decisions which could bring job losses running into thousands

rather than hundreds. The impact on BAe, on BS, on Vickers and Guest Keen and on the West Midlands will be marked. But in my judgement we can get the package through Parliament, without abandoning Cmnd 8288.

11. I see no hope on the other hand of removing the remaining £374M gap without taking measures which would totally undermine our declared defence programme, and have severe military, industrial, and political effects. I believe we should have to cancel the AV8B, Sea Eagle and the conversion of 3 Nimrods to the maritime role and of the Hawks for air defence; cancel Wavell and Bates and the Gervantes mortar locating radar; cancel destroyers and frigates in the yards on contract; defer the new Type 23 and the new Fleet Minesweepers; dispense with the new conventional class of submarines; cancel the kinetic energy round required to pierce the frontal armour of modern Soviet tanks; withdraw from European/US collaboration on the air-to-air missile package; and significantly reduce effort on weapon sights, thermal imaging and electro-optics. Even this whole list would not close the gap completely.

12. The cumulative effect of these measures on British industry would be acute. Shipbuilding could lose 10,000 or more job opportunities in addition to the rundown of 14,000 already planned to take place by 1985. Associated industries would also be hit. Cancellation of the RAF requirement for AV8B would lose some 5,000 job opportunities, and put at risk BAe's full participation in the US order and the prospects of collaboration with the US on advanced short take-off and vertical landing aircraft (STOVL). Cancellation of Sea Eagle and withdrawal from the US/European air-to-air missile

package would cause over 1,000 redundancies and loss of about 1,900 job opportunities; BAeD could not remain a major contractor for air-launched guided weapons or play a reasonable role in future European collaborative arrangements. There would be serious industrial implications for Shorts (Belfast). Major reductions in ammunition and other programmes would seriously damage the Royal Ordnance Factories, which are already underloaded. The electro-optics industry would suffer substantially: the UK's excellent thermal imaging capability would be threatened, we could lose most of our image intensifier work to the US.

13. There is no conceivable way in which I can get such a package through the House - and for the sake of the sums at issue between the Treasury and myself it would be madness to attempt it.

14. I must stick, therefore, to my position. In June I delivered maximum savings in the middle and long term which I believed to be politically sustainable. I will do the same now, although the going will be rougher. The Chancellor needs every pound that he can find. But it would be irresponsible of me to offer the £300-£400M of extra savings next year when I cannot deliver them.

15. The position remains, therefore, as follows:

	1981-82	1982-83	1983-84	1984-85
My proposal	12754	14333	15816	17317
MISC 62 proposal	12629	13959	15219	16422
Gap	125	374	597	895

16. I am copying this minute to the Home Secretary, the Chancellor of the Exchequer, the members of MISC 62, and to Sir Robert Armstrong.

Ministry of Defence
18th November 1981

Private Secretary for

J N

(approved by the Secretary of State and initialled in his absence)