

P.0587

PRIME MINISTERPublic Expenditure: Defence

Annex B(i) of the Home Secretary's note summarises the position reached by MISC 62 and in correspondence up to 9 November. The Secretary of State for Defence's letter of 12 November to the Chief Secretary adds little; his letter of 18 November is of more substance.

2. The gap identified in the Home Secretary's annex is made up as follows:

	1981-82	1982-83	1983-84	1984-85
<u>MoD's bids</u>				
i. higher prices	400	436	462	484
ii. 2 per cent RPE	-	169	381	643
iii. ROFs	-	19	4	[- 8]
iv. Total i.-iii.	400	624	847	1,120
v. Treasury offer	275	250	250	225
vi. Gap	125	374	597	895

- i. is for higher equipment prices in 1981-82 carried forward to the later years (paragraph 2 of annex)
- ii. is for MoD's view that there should be a 2 per cent additional allowance for the relative price effect of defence equipment by comparison with the general price factors (paragraph 3)
- iii. is for the Royal Ordnance Factories; it is being dealt with separately and you will not need to discuss it
- v. is the Chief Secretary's offer endorsed by MISC 62, to ease the transitional problems for Defence of the move to cash planning.

3. There will be reference to Cabinet's decisions on 18 June on the Defence Budget (CC(81)24th Conclusions, Item 4). The key points in your summing up were:

"The Cabinet agreed that the highest priority must be given to the defence programme, and accepted that that entailed lower priority to other expenditure programmes approved the general thrust of the Secretary of State for Defence's proposals as set out in C(81)31 Like every other programme the defence programme should be expressed in cash terms, not in volume terms. The Cabinet agreed that there should be a realistic translation of the defence programme up to 1985-86 from volume to cash terms; but in taking account of relative price effects for defence expenditure it would be important not to countenance excessive increases in overhead rates and wages of the kind which some defence contractors had recently been seeking to apply. The cash figures for defence, like those for other programmes, would be for review and final settlement at the conclusion of the current Public Expenditure Survey."

The question at issue now is what 'realistic translation' to cash means. The Secretary of State for Defence argues that unless special provision is made to recognise the relatively high costs of defence equipment it will be impossible to honour the Government's commitment to increase defence expenditure in real terms by 8 per cent between the Election and the end of 1981-82 and by 3 per cent in each of the three subsequent years. The Chief Secretary argues that there is no evidence to justify a special allowance for higher prices for defence equipment and that use of the general inflation factors will not therefore represent a cash squeeze on the defence budget.

4. In summary Treasury Ministers are likely to argue:

i. If there is to be any chance of getting near to an acceptable outcome to the present public expenditure exercise the enormous Defence bid has to be eliminated, or at least very substantially reduced (the Chancellor of the Exchequer's minute of 13 November to you on public expenditure).

ii. MoD's claim for a 2 per cent RPE from 1982-83 onwards is unproven: it is based on annual averages over the last ten years, but for the last three years the RPE for defence equipment has been negative and there is no evidence that it will be positive in 1981-82.

11
 iii. To make provision for the possibility of higher defence prices would be to absolve MoD from the cash disciplines now applying to all other programmes.

iv. It would take the pressure off MoD's Procurement Executive to negotiate lower prices and, in turn, off their contractors to hold down wage settlements in their industries.

v. The transitional offer (line v. above) will help, provided it is understood that any deal for 1982-83 cannot be re-opened later in the year; the figures for 1983-84 and 1984-85 will be provisional anyway and subject to review in the next annual Survey.

vi. Apart from the Americans, no other ally is likely to meet its NATO target.

Klay's
 5. The Secretary of State for Defence, in his minute of 18 November, now judges that he needs the full cash figures for which he has bid if there are not to be drastic cuts in his programme, notably in aerospace and shipbuilding; there would be practical difficulties in 1982-83 where 80 per cent of the equipment programme is already contractually committed. He summarises the problem, as he sees it, in his paragraph 9. The Treasury will dispute that (their factor for defence prices in 1981-82 is 5 per cent low) and will argue that the other difficulties identified should have been apparent at the time of the Summer defence review. It seems that the Secretary of State has now abandoned arguments about the RPE in favour of a simple claim that he needs the money to maintain as much as possible of the volume of expenditure envisaged in the Summer.

6. MISC 7 will meet on 24 November to discuss the Trident programme. So far as the period up to 1984-85 is concerned, the cash flow for the bigger Trident now proposed is likely to be less than earlier assumed and so, to that extent, does not affect the present argument. But since the total costs of Trident have risen substantially (largely because of improvements which would be necessary whichever version we go for) the cuts in conventional forces and programmes in the later years which will be necessary will be criticised both by industry and by our NATO allies. The criticism will be greater if such cuts have to be combined with a squeeze resulting from the present public expenditure exercise.

7. The Treasury seem to be on strong ground in arguing that the case for higher defence prices is unproven. You will wish to press the Secretary of State for Defence hard on this and to establish whether the reality is that his assumptions in the summer were wrong so that he is now having to ask for more cash to minimise the disruption to programmes which he then thought were practicable.

8. You might then examine the possibility of a compromise on the following lines:

i. If the Treasury offer of £250 million in 1982-83 (where there is the problem of contractual commitments) were to be increased by, say, £50 million, could MoD live with that and seek to close the gap by further economies and, perhaps, by seeking to check the speed of deliveries?

ii. For the later years could the Secretary of State accept the Treasury figures on the understanding that they will be reviewed in the 1982 Survey when further evidence on defence equipment prices will be available?

9. Whether or not you are able to record agreement on the figures or to identify a remaining gap, it would seem right that the report to Cabinet should draw attention to the cancellations and deferrals which seem likely to arise anyway. The Secretary of State for Defence will need to discuss these in more detail with the Secretary of State for Industry and with other Ministers concerned.

PLG
P L GREGSON

19 November 1981