SECRET

HDA

Ref. A06053

PRIME MINISTER

Defence Prices

At last night's meeting to discuss defence expenditure it was agreed that the Cabinet Office, in consultation with the Treasury and Ministry of Defence, should urgently look into the explanation and justification for the higher prices of defence equipment. In the time available our objective has been to provide you and the other Ministers who were at last night's meeting with a short note agreed by the Treasury and the Ministry of Defence which sets out the problem as dispassionately as possible.

2. It is common ground that there is a genuine difficulty in deciding precisely how to translate the volume decisions of last June into cash on a realistic basis. It is also common ground that there should at least be some transitional addition to the defence budget in the current year and throughout the period 1982-83 to 1984-85. The question of how large that addition should be depends on the last analysis on the balance to be struck between the Secretary of State for Defence's wish to avoid further major cuts of a controversial nature and the very difficult issues arising from other expenditure programmes and the overall position.

3. I am sending copies of this minute to the Chancellor of the Exchequer, the Secretary of State for Defence and the Chief Secretary, Treasury.

DJWW

ROBERT ARMSTRONG

(approved by Sir R Armstrong & signed on his behalf)

20th November, 1981

SECRET

DEFENCE PRICES

Note by Officials

1. We were asked to review the evidence relating to the Ministry of Defence's claim for increases in the defence budget due to higher prices for defence equipment, goods and services. There are two separate questions -

a. the movement of prices in 1981/82;

b. the relative price effect (RPE) in future years - ie the difference in the movement of prices for defence goods compared with prices of goods in general.

Defence Prices in 1981-82

2. The Ministry of Defence's (MOD) latest monthly forecast of the outturn of expenditure for the year is that it will exceed the cash limit by £300 million. All of this is in their view attributable to higher prices including those attributable to the fall in sterling in 1981, than were allowed for when the cash limit was fixed. They also forecast a volume shortfall resulting from the measures already taken to control the programme under the cash limit.

3. The MOD's methology which has been used to prepare the volume figures published in previous Public Expenditure White Papers, distinguishes between the volume of goods purchased and the price level of those goods. This distinction cannot, however, be wholly objective. In a few cases MOD can compare the actual contract price paid for an item this year compared with last; in other cases they judge the price increase by reference to indices appropriate to the industrial sector concerned, eg electronics, aerospace and shipbuilding. MOD statisticians prepare an overall defence equipment price index. The movements of this during 1981-82 do not support the MOD's view of the actual movement of prices. The defence equipment is, however, merely an index of the cost and price movements in those sectors of industry from which the MOD purchase equipment and does not reflect actual purchases by the MOD. If for example the prices charged by the relevant sectors of industry to buyers other than MOD have risen by less than the average, the index will not accurately reflect the actual prices paid by the MOD. In any

case it is often difficult to distinguish that element of price changes which reflect a quality improvement. Conclusive evidence is consequently not available to prove either the MOD's contention that above-average price rises have been occurring or the Treasury's view that the existing cash limit allowance of 11 per cent for price rises (other than pay) is adequate.

4. Under the new system of cash planning introduced this year, whatever figure is agreed for price rises in 1981-82 would have to be added to the base line figure for the programme for 1982-83 and the succeeding years if a volume squeeze is to be avoided. If excessive allowance is made for price rises, the consequence is that the defence budget will be over-provided; if, on the other hand, insufficient allowance is made, the volume of the defence programme will have to be cut.

1982-83 and Succeeding Survey Years

5. MOD point out that over the last 10 years the prices of defence goods have increased faster than prices in general by an average of 2 per cent per annum. Their analysis is that defence costs, other than the pay of MOD employees, will rise faster in 1982-83 than the allowance of 9 per cent for non-pay factors agreed for public expenditure as a whole. Their reasons are that much defence procurement is of highly sophisticated items where comparable gains in productivity cannot be achieved. In addition, many items of defence ~~for~~ equipment produced in this country have a high import content, both in materials and components, whose prices are higher when sterling falls. If sterling falls MOD's overseas costs could rise in sterling terms. MOD, as a large consumer of oil, is vulnerable to erratic fuel prices.

6. The Treasury maintain that to incorporate into the Government's plans provision for a positive RPE would permit defence contractors to agree to high wage payments and would reduce pressure on the MOD to limit costs. The MOD strongly disagree: pressure on suppliers to limit costs is already intense. Since 1978, the defence RPE has been negative, but it is inevitably a matter of judgment as to whether this pattern will be repeated over the next few years.

20 November 1981

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Let me see some of the contracts

It looks as if the M.O.D. have been taken for a ride but the private sector has been sharper!

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'They were cheaper last year.'

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20 November 1981

The Defence Non-pay RPE

Annual percentages

1971	-1.6
1972	+4.4
1973	+4.2
1974	+6.5
1975	-2.3
1976	+6.3
1977	+0.4
1978	-0.7
1979	-0.1
1980	-2.3

Measured as: CSO's index of prices of defence non-pay ÷ gdp(market price) deflator.