

Ref: B06387

PRIME MINISTER

c Sir Robert Armstrong

The Defence Programme  
OD(82) 2, OD(82) 3, OD(82) 4

BACKGROUND

When the Cabinet agreed in November the figures for defence expenditure for 1982/83, 1983/84 and 1984/85, the Defence Secretary was invited to circulate to OD his proposals for the programme decisions required to give effect to these figures. He has now put forward 2 papers: OD(82) 2 on the problems posed by the 1982/83 defence estimates; and OD(82) 3 on the concept of flexibility between financial years. The Chief Secretary, Treasury, has tabled counter-proposals in OD(82) 4.

2. The Defence Secretary does not overtly ask for an increase in the 1982/83 defence expenditure figure agreed by the Cabinet in November: £14,103 million at 1982/83 Estimates prices. But he does not believe he can stay within it without making cuts which he regards as unacceptable for parliamentary reasons, and unnecessary if the system can be made more flexible. So he suggests in effect that he should budget for an overspend which should be allowed under the new flexibility system canvassed in his second paper. The Chief Secretary objects that this is precisely the sort of thing the new cash limits discipline is designed to prevent; whatever flexibility's merits, it should not be used to fudge the basic issue of whether the Ministry of Defence should budget to live within its allocation.

3. The Defence Secretary explains why his budget for 1982/83 was running more than £1,300 million above target. His figures and arguments are the same as they were last November, when the Cabinet agreed on the extra allocation he should receive on these grounds. Thanks to that allocation, plus certain windfalls, plus the cuts listed in his Annex A, he has been able to cut back the excess to £342 million. He seeks the Committee's



agreement to finding half the balance (£172 million) by the ~~same~~ cuts listed in his Annex B. But he could not find the other £170 million without starting on the drastic further cuts listed in his Annex D.

4. He further points out that his deficit figure for 1982/83 is likely in the event to be higher than £170 million. It is already clear that it will rise by £80 million (to £250 million) because of the cash squeeze resulting from the 1982/83 inflation rate <sup>being now forecast</sup> ~~proving~~ to be one per cent higher than the 9 per cent <sup>earlier</sup> assumed. It will rise further if sterling depreciates significantly against the dollar and DM; if his civil servants in the end get more than the 4 per cent allowed; and/or if defence prices rise faster than average and he cannot persuade the Treasury to compensate him for the resultant RPE.

5. The Defence Secretary does not make clear whether his proposed 1982/83 overspend would be repayable by underspending to a corresponding extent in 1983/84. That is the logic of his proposal. In terms of the NATO 3 per cent target this would produce an increase of 4 per cent in 1982/83 and of 2 per cent in 1983/84, which would not matter. The real problem is that, unless the Defence Secretary now starts cutting his programmes to match his resources, repaying £250 million or more in 1983/84 will seem just as hard as saving it in 1982/83 seems today. There will in any case be problems about 1983/84 (and 1984/85), though they do not need to be addressed now; the Defence Secretary is insisting on the agreed 3 per cent real growth rate being "realistically" translated into cash, ie he wants immunity (which the Treasury will not wish to allow) from a repetition of the factors listed in paragraph 4 above.

6. The Chief Secretary has no objection to officials studying the concept of financial flexibility as proposed in the Defence Secretary's second paper. But in his view it would not necessarily be unique to the defence budget; and its main purpose would be to cater for accidental underspend. He might not rule out it also catering for accidental overspend. But he would regard a deliberate 1982/83 overspend as an open evasion of the agreed terms of the "peace treaty" between himself and the Defence Secretary last November. These terms were set out in Sir Robert Armstrong's minute



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of 2nd December, which he attaches. They stipulate inter alia that the Ministry of Defence will do its best to live within its 1982/83 cash limit as then agreed; whereas the Defence Secretary is now proposing to live outside that limit to the tune of at least £250 million. Even if this were agreed by OD it would have to come from the Contingency Reserve and would require Cabinet approval. (It should be noted that the figures in the peace treaty were at 1982/83 Estimates prices, whereas the figures in OD(82) 2 are at 1981/82 out-turn prices; thus the defence increase agreed in November is £375 million in the former and £344 million in the latter.)

7. Following a request from your office, the Defence Secretary will today be circulating an account of the positive side of the defence programme's industrial implications in 1982/83; ie the programmes which will continue even if all cuts (including Annex D) were implemented.

## HANDLING

8. The Defence Secretary should introduce his two papers, and the Chief Secretary his counter-paper. The Chancellor of the Exchequer may also have general comments. Thereafter, it may be easiest to focus on the specific 1982/83 problem (OD(82) 2) before the more general issue of flexibility (OD(82) 3).

9. On 1982/83, the following points should be addressed.

(a) Is it agreed that the defence budget decisions taken last November cannot now be reopened?

(b) Do the Committee agree that the Defence Secretary should make the cuts proposed in his Annex B? Since these will come on top of the measures in his Annex A (which have been taken and in some cases announced), the Secretary of State for Industry will wish to comment on their cumulative effect as set out in Annex C.

The Lord President should comment on their acceptability to Parliament; and the Foreign and Commonwealth Secretary on the reactions of our allies, particularly the United States.



(c) In the last resort, and contrary to the Defence Secretary's advice, would the Committee regard the cuts in the Defence Secretary's Annex D (worth just over £300 million) as a lesser evil than allowing him to exceed his cash limit by £250 million or more? Again, the Secretary of State for Industry, the Lord President and the Foreign and Commonwealth Secretary should comment on the industrial, parliamentary and Alliance consequences. The Defence Secretary's supplementary note of today's date will be relevant here.

(d) If the Annex D list is not acceptable to the Committee, could it be pruned to remove its most chilling features; eg the reductions in fuel for the Royal Navy (No.3), in the RAF's front line (No.20), the cancellation of the Av8B (No.23) and the disposal of the recently acquired Chinook helicopters (No.24)? Could substitutes not be found for these? More generally, can the Defence Secretary say why it is not possible to manage the cash-flow on the defence equipment programme so as to limit the amount of cash spent with British industry to the amount available in the budget?

(e) If no other acceptable solution can be found, are the Committee prepared - contrary to the Chief Secretary's advice - to fudge the issue by authorising a deliberate overspend? If so, should there be an outside limit for this (eg £250 million)?

(f) If there is to be an overspend, is it agreed that this must be repaid in full the following year? Is the Defence Secretary prepared to start to budget for that now? How confident can he be of succeeding, given that he cannot be sure of getting his way on immunity from cash squeezes?

10. As regards flexibility, there is only one key question.

Is flexibility to be examined on its objective merits, as a technique which would be applicable to all programmes? or is it to be used as a procedural device for fudging the issue of whether the Defence Secretary should live within his 1982/83 income?



## CONCLUSION

11. On the 1982/83 problem, the basic decision to record is the Committee's choice between 3 alternatives -

(i) is the Defence Secretary to live within the cash limit which was agreed last November on the basis of the same figures as are now before the Committee?

(ii) or is he to be given extra money, now that the practical consequences of (i) are more apparent?

(iii) or is the issue to be fudged by the procedural device of permitting deliberate overspend under the guise of flexibility?

Since no one will argue for (ii), the real alternatives are (i) and (iii).

12. If the choice is (i), the Defence Secretary should be invited to submit a new paper to the Committee setting out what would be the least damaging list of extra cuts required, in the light of the present discussion.

13. If the choice is (iii), you will need to note in your summing up whether there is a limit to the proposed overspend and whether it is for repayment in 1983/84. The Defence Secretary should also be invited to put a paper to the Cabinet, seeking their agreement.

14. On flexibility, the conclusion will depend on what is decided about 1982/83. If the Committee goes for (i) above, flexibility should be studied on its merits and in a wider context than defence. If they go for (iii), a more urgent and narrowly-directed examination will be needed of how to use flexibility as a cover story. In either case, the Chief Secretary should be invited to arrange for the necessary investigation and report.

26th January 1982

R L WADE-GERY



26 JAN 1982



COMPLIMENT