



Ref. A07896

PRIME MINISTER

Defence Expenditure

At the meeting of OD on 27 January I was asked to clarify some of the figures for the defence programme included in OD(82) 2 and OD(82) 4.

2. My minute of 2 December 1981 put on record the basis on which agreement had been reached on the figures to be included for defence expenditure in 1982-83, 1983-84 and 1984-85. The following table sets out the 1981 Public Expenditure White Paper (Cmnd 8175) figures, as revalued, and projected for 1984-85, the increases and reductions agreed in November and the resulting provision:

	1982-83	1983-84	1984-85
	£m	£m	£m
(1) White Paper (Cmnd 8175) revalued and projected for 1984-85 (1983-84 total carried forward and revalued by 5%)	13624	14881	15625
(2) Changes agreed before 20 October (3% real growth)			+ 480
(3) Agreed increases			
a. Carry-through of extra costs of 1981 armed forces' pay award	+ 85	+ 88	+ 92
b. Change in Royal Ordnance Factories net borrowing	+ 19	+ 4	- 8
c. Other	+ 375	+ 325	+ 250
(4) Net changes agreed in November (Serial 3)	+ 379	+ 417	+ 334
(5) Agreed provision*	14103	15298 ^φ	16439 ^φ

* The agreed provision shown in the last line of the above table is the same as shown in para 2 of OD(82) 4.

^φ The figures for 1983-84 and 1984-85 are provisional.



3. As the Secretary of State for Defence explained in OD(82) 2, the excess of the defence costings above the agreed provision was caused principally by changed expectations about industrial performance on equipment contracts since last summer and the effect of movements in defence prices.

4. The cash required to fund the equipment programme is derived in the first instance from the aggregation of the sums required for individual projects. Historical experience has shown that although the estimates for individual projects are the best that can be achieved at the time, in aggregate they tend to overstate the totality of the funds required. There are various reasons for this, but the principal factor is industrial shortfall. In order to correct the estimating, a "block adjustment" is made to the aggregated figure. Throughout the 1970s this adjustment was set at a high level - and generally not high enough, as evidenced by successive underspends. In the current recession civil work has fallen off, and contractors have concentrated more on defence work. When the defence programme for 1982-83 was constructed last year, a moderate level of adjustment was applied to the aggregated figure. With the continuing recession it is now clear that even this was too high.

5. This meant that, when the 1982-83 programme was recosted in the autumn during the preparation of Estimates, it was £500 million higher (at 1981-82 prices) than expected. A further £500 million excess (at 1981-82 prices) materialised in the autumn, because 1981-82 defence prices were higher than expected. Implementation of savings measures as in OD(82) 2, together with the cash additions agreed last November, enabled these amounts to be accommodated: the Secretary of State for Defence proposed, and the Defence and Overseas Committee agreed, measures to reduce the defence programme, which he assessed would leave it about £170 million (at 1981-82 prices) above the provision for 1982-83 compared with the initial excess of £1335 million.

6. The Ministry of Defence has further work in hand on the reconciliation of the programme with the agreed cash limit, and is in touch with the principal defence equipment suppliers about their claims for 1982-83.

7. I am sending copies of this minute to all members of OD and to the Chief Secretary, Treasury.

Robert Armstrong
ROBERT ARMSTRONG

23 March 1982