



~~CEB9~~

MO 8E

mb

1. ~~CDP~~ ^{CDP} + fee
2. Prime Minister ²
 As Yinger's bids are in
 the annex.

CHIEF SECRETARY TO THE TREASURY

JDS
30/5.

PES 86

1. Your guidelines coincidentally but conveniently request bids at a time when I am completing my first look into the Departmental books through our Long Term Costing process. It may be helpful if I indicate briefly the position here as I find it, as background to my approach on PES.

2. What the costings showed was a programme excess against agreed resources over the first few years of the planning period running at more than £1bn a year. I had the excesses analysed, and about half of them are due to PES 85 cuts or to factors, such as defence inflation and uncompensated AFPRB awards, over which we have little control. The remainder consists of cost growth on the substantial programme set in train as a result of the Defence Budget increases since 1978/79. The programme as costed takes into account the present and foreseeable benefits from the efficiency programme, notably in the areas of the control of defence manpower, the procurement of defence materiel, and in supply.



3. The action I have taken is to impose severe cuts, not simply to relieve the short term problem, but to make necessary adjustments to longer term plans. The outcome is that I have plans for the first few years which, subject to what I say below, taking one year with another, and on economic assumptions about the relatively favourable economic situation, would enable me to manage, but only just. As you will have seen from my comments on this year's Defence White Paper, I have had to strike a careful balance in presentation both to acknowledge the problem and to indicate that we can cope.

4. If we are going to be able as a Government to retain the hard earned credit we have achieved from defence it is crucial that I do not lose more resources through PES. Already, it is becoming very difficult to justify a position in which Defence was enabled to invest in a continuing programme to meet a vital national need, only to find the funds made available being, not stabilised, but taken away. I simply cannot afford arbitrary cuts on the baseline through a cash uplift for 1989/90 lower than the foreseen level of inflation. Even more, I cannot afford any substantive cuts in any year.

5. There are additionally some relatively small adjustments which should be made to the Defence programme which either need not be presented as additional public expenditure or which could be justified on grounds of equity. The Falklands adjustment and



the dockyards pension issue fall into the first category. Full compensation for the AFPRB awards, which we do not determine but simply have to accept and which we cannot offset by reducing the size of the Forces, falls into the second. They would help me out of all proportion to the cost, and are set out in the schedule, enclosed.

6. I am very ready to discuss all this with you if you wish. But I must emphasise that the outcome of PES 86 must give me at least an outside chance of successful management.

7. I need not I think dwell on the contingent claims of which you are already aware such as the EC customs position and vehicle licensing. Perhaps I should add that the outcome of MISC 127 will have to be judged by me in the light of the factors set out above.

8. I am copying this minute to the Prime Minister, to other members of OD and to the Secretary of State for Trade and Industry.

the review of shipbuilding.

J. F. Howe.

Private Secretary.

*Approved by the Defence Secretary
and signed in his absence.*

Ministry of Defence

30th May 1986

ADDITIONAL PROVISION SOUGHT FOR DEFENCE

(£m cash)	<u>1987/88</u>	<u>1988/89</u>	<u>1989/90</u>
1. Baseline	18,817	18,990	19,268

<u>Bids</u>			
2. 3% inflation uplift for 1989/90			94
3. Falklands costs subsumed from 1988/89 onwards			198*
4. Costs of 1986 AFPRB award	105	108	112
5. Cost of post-contractorisation Dockyard pension	36	37	38
6. PRS Part I Civil Works cost	3	6	6

7. Total Bids	144	151	448

* In substitution for the traditional Falklands increment.

1. The proposed additions to defence provision are set out in tabular form above. Line 5 would be offset against a future Paymaster General's liability.

2. Taking the bids in order:

a. 3% uplift for 1989/90

The 1986 Survey Guidelines allow a 2½% cash inflation uplift for all programmes in 1989/90, while GDP inflation for that year is forecast to be 3%. The effect for Defence would be an arbitrary cut of £94m, to add to the 6% reductions proposed for 1986/87-1988/89. The increases agreed for Defence between 1978/79 and 1985/86 are committed to a continuing programme. The substantial efficiency improvements made or planned for the Department are taken into account in the plans. The £94m would impact directly on the programme, and represent a further and visible resilement from this Government's view of

/the ...

CONFIDENTIAL

the requirement for defence. There would be both operational and political consequences.

b. Falklands costs subsumed

In the course of PES 85 the previous Secretary of State for Defence agreed to accept the 1988/89 baseline without an addition for the Falklands. This required the defence programme to absorb £192m in 1988/89 and subsequent years. However, in arriving at the baseline for 1989/90 the cash uplift factor has been applied to the 1988/89 baseline less £192 million. As a consequence of the PES 85 decision the uplift should be applied to the full 1989/90 baseline. The resulting bid for £198 million in 1989/90 removes the need for a separate Falklands addition.

c. 1986 AFPRB Award

Service pay awards are independently assessed and their implementation is subject to Government approval. Defence has not received full compensation for Service pay awards since PES 82, resulting in a reduction in the funds available for the remainder of the defence programme amounting to some £3.7 billion over the 10 year period of an LTC. A consequence of this, within a defence budget that is reducing in real terms, is a switch from capital (equipment) to current (pay) expenditure; SDE 86 shows the proportion of the budget for equipment to be falling to 44.6% in the current financial year. This decline will continue the faster if defence has to absorb further pay rises above the rate of inflation. As a result of the award of 7½% this year, the full additional cost to defence above the level allowed for will exceed £100 million a year, or £1 billion over the period of an LTC.

d. Dockyard Pensions

Contractorisation of the Royal Dockyards is scheduled for early 1987. Once contractorisation has taken place, future pension costs (which currently fall to be met

/in ...

CONFIDENTIAL

in due course by the Paymaster General) will be passed on to MOD as overheads. In the absence of compensation, this means that contractorisation will result in a net loss to defence, a point which has already resulted in unfavourable comment in Parliament. Although full compensation would result in a technical increase in public expenditure, it would be meeting a cost that would otherwise fall in later years to the Paymaster General's Office. Compensation for defence would provide an important presentational advantage for Dockyard contractorisation.

e. PRS Part I Civil Works Costs

The bid reflects the decision that Departments should assume responsibility for the resources in this area from 1 April 1987. The details of the bid will be supplied by officials.

4. Implications for Gross Running Costs. Of the above bids, only (a) and (c) have implications for MOD's gross running costs. The additions implied over the current base-line provision for unning costs are:

(£m cash)	<u>1987/88</u>	<u>1988/89</u>	<u>1989/90</u>
3% uplift in 1989/90	.		27
AFPRB Award	3.5	3.6	3.6

