



Defence (2)  
Prime Minister

MUS 10/9

Should we ask

Treasury Chambers, Parliament Street, SW1P 3AG

R C Mottram Esq  
Private Secretary to the  
Secretary of State  
Ministry of Defence  
Main Building  
Whitehall  
London SW1A 2HB

Wait - until we return

for the Unwin  
at X  
Report - or that  
it be circulated?

9 September 1982 MUS 10/9

Dear Richard,

DEFENCE EXPENDITURE TO 1985-86

The Chief Secretary has seen your letter of 6 September.

He has asked me to say that he regrets that there still appears to be disagreement about the basis of the £1,200 million cash additions made to the defence programme at the end of the 1981 Survey. He agreed the cash additions last November because of the severe difficulties that were then perceived by Mr Nott to be facing the defence programme. It was said then that another MOD overspend was inevitable in 1981-82, if the cash limit uplift was less than £300 million.

In the event MOD had to take special action to avert a massive underspend in 1981-82, notably by advancing a bill-paying date from 1982-83, so that some £300 million of extra payments could be made to contractors in 1981-82.

The Treasury understand that, Falklands apart, there are similar underspending problems on the defence budget in the current year. The Ministry of Defence is apparently contemplating yet again action to counter this, including advancement of a bill-paying date from 1983-84. The Chief Secretary's preference would be that the underspend on "normal" expenditure be used to accommodate some of the South Atlantic costs, thus reducing the charge on this year's Contingency Reserve. And in so far as action is taken to advance payments from next year into this, it certainly reduces any case for additions to next year's cash programmes.

One of the arguments for a cash limit increase in 1981-82 was that the allowance for defence prices was thought inadequate. The Treasury never accepted the MOD forecasts of defence inflation. In the event subsequent analyses by MOD officials showed that defence non-pay prices rose only 12.3% in 1981-82. This was slightly more than the original cash limit allowance. It might have merited an increase of up to £100 million. In the event the increase made was £300 million.

X | The report of the joint review of the MOD methodology of calculating movements in defence prices - the Unwin report - found widespread shortcomings in the MOD system; and concluded that MOD price methodology tended to overstate defence inflation, and to understate "volume" and real growth. It is understood that Mr Nott has endorsed the Unwin recommendations to implement reforms in the MOD system of price calculation. Meanwhile the findings of the Unwin report raise doubts about MOD's figures for real growth in defence spending - quoted for example in your memorandum C(82)33 as well as in your Private Secretary's letter. Calculations based on the CSO's defence procurement deflator suggest that the 1981-82 level of defence spending was in fact 11% higher, in real terms, than in 1978-79. This would be well in excess of the NATO target and of the aim announced in Cmnd 8288.

In absolute terms, the UK defence budget, even leaving aside Falklands expenditure, is higher than any of our European allies and second only to the US. The UK's record on defence spending - despite our economic difficulties - is excellent; and deserves proper credit, not least in NATO.

I am copying this letter to the Private Secretaries to the Prime Minister, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, and to Sir Robert Armstrong.

*Yours sincerely*

*Terry Matthews*

T F MATHEWS

Private Secretary



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6th September 1982

New John,

DEFENCE EXPENDITURE TO 1985/86

The Defence Secretary has seen the Chief Secretary's letter of 11th August, on which he has made the following observations.

First, he has noted that the Chief Secretary is 'reluctant to reopen the agreement' reached last year, with the implication that last year's figures should be allowed to stand in PES 1982. He has asked me to point out that it was part of last year's agreement that the figures for 1983/84 and 1984/85 were provisional and Cmnd 8494 made clear that they would be reviewed in the 1982 Survey.

Secondly, Mr Nott has asked me to point out that Mr Brittan's reference to the defence budget additions agreed in PES 1981 does not correctly reflect the basis on which the case for the increases was made. As my predecessor explained in his letter of 25th February this rested on the higher prices in the defence programme actually experienced in 1981/82, which had to be reflected in increased cash provision in PES 1981 if the 3% commitment was to be maintained. Mr Nott rejects absolutely the view that the PES 1981 additions were 'on top of 3% real growth provision' (together with the implication of the Chief Secretary's third paragraph that he was not justified in seeking a revision of the defence cash limit). If this were the case, real growth in 1981/82 (over 1978/79) would be significantly greater than the 8% for which Cmnd 8175 provided; and growth in 1982/83 would be correspondingly greater than the 11.3% provided in Cmnd 8175. In fact growth in 1981/82 - when the cash limit was spent in full - is calculated at less than 7½% and this figure has been quoted by Defence Ministers with the agreement of the Treasury. The growth implied by the cash provision for 1982/83 is in line with Cmnd 8175 (ie 11.3%). Indeed, Mr Brittan himself has said - and was the first Minister to do so (in his Oxford speech in April) - that the 1982/83 cash provision represents a real increase of about 11% over 1978/79. The Chief Secretary's assertion that the PES 1981 additions were on top of 3% growth is simply not

J Gieve Esq

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reconcilable with these statements and the facts which support them and Mr Nott is surprised that Mr Brittan should have reverted to a position which events have shown to be unsustainable.

Mr Nott therefore maintains his view that, for the reasons set out in his letter of 5th August, additional provision is required if we are to meet the 3% commitment. NATO have been informed, with Treasury agreement in the UK DPQ 82 response that existing cash provision in 1983/84 and 1984/85 allows less than 3% growth, if inflation is in line with the cash factors, and there is bound to be criticism within the Alliance if we fall short again.

Finally, as to the defence non-pay relative price effect which the UK - along with our major NATO allies - experiences, the Defence Secretary has indicated his willingness to discuss how provision should best be made for it. He does not, however, understand Mr Brittan's reference to paragraph 2(v) of Sir Robert Armstrong's minute of 2 December 1981. In his view that subparagraph was intended to close the books on PES 1981, not to rule out all future consideration of RPE; the remaining subparagraphs of Sir Robert's minute are consistent with this view.

I am copying this to the Private Secretaries to the Prime Minister, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and Sir Robert Armstrong.

*Yours sincerely,*

*R. C. Mottram*

(R C MOTTRAM)

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8 SEP 1982

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Prime Minister

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LW  
13/8



Defence

Mr Butler

To be aware

LW  
13/8

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon John Nott MP  
Secretary of State  
Ministry of Defence  
Whitehall  
London SW1A 2HB

*Handwritten initials*

11 August 1982

*2 Jan.*

DEFENCE EXPENDITURE TO 1985-86

I have seen a copy of your letter of 3 August to the Chancellor and our offices have now agreed that we should meet on 29 September to discuss your PES bids.

Geoffrey and I were glad to hear that the defence programme is now in better balance with the cash provision this year. This is particularly reassuring in view of the programme gap of £200 million that you foresaw last January - your memorandum OD(82)2.

No doubt one factor that helped to ease your 1982-83 problems was the advancement of the monthly bill-paying date planned for April, and the acceleration of over £300 million worth of expenditure into 1981-82. The manoeuvre did call into question however, whether it was necessary, as you claimed last November, to increase the 1981-82 defence cash limit by £300 million.

*Defence, Budget, p17*

I would be reluctant to reopen the agreement we reached last year. But that agreement - recorded in Sir Robert Armstrong's minute of 2 December - will of course form the essential background to our discussions this autumn. In recognition of the difficulties then perceived to be facing the defence programme, additions were made to defence provision as follows:

	1981-82	1982-83	1983-84	1984-85
£m	300	375	325	250

It was quite apparent at that time that the additions for 1983-84 and 1984-85 were not 3% higher than the £375 million increase agreed for 1982-83. But this was simply because the 1982-83 increase was disproportionately large, reflecting the pressure you then foresaw. It was never intended to be carried through, 3% higher each year, in perpetuity: a response to perceived difficulties in one year cannot be taken to imply further special treatment thereafter.

In short, the additions recorded on 2 December 1981 were on top of 3% real growth provision. They were not to be built into the baseline from which 3% growth is calculated. This is of course the very principle that will also apply to the Falklands additions we agree.

I was surprised, in view of the agreement recorded in paragraph 2(v) of Sir Robert's minute, to see a renewed bid for a defence relative price effect - claimed now to be 3 percentage points extra on defence prices in each of the next few years. This assertion - that MOD will be unable to prevent defence prices increasing at a rate some 50% faster than forecast general inflation - carries major implications, for the level of industrial wages as well as for our expenditure strategy. We will have to look very closely next month at the case supporting your rpe bid of over £1800 million.

Indeed there are a number of other issues that will need to be covered in the bilateral. By the autumn, more up-to-date information should be available - not least on Falklands costs and on forecast inflation. Inflation in the current year is rather lower than we expected last autumn; and I myself would hope that public sector cost increases, not least pay, can be held below the level of general inflation. I look forward to discussing these issues in September.

I am copying this letter to the Prime Minister, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer and to Sir Robert Armstrong.



LEON BRITTAN