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Prime Minister (2)



MINISTRY OF DEFENCE *ms 8/10*
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MO 8

8th October 1982

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Dear John,

DEFENCE EXPENDITURE TO 1985/86

On his return from his overseas tour, the Defence Secretary has now seen your predecessor's letter to me of 9th September. Although defence expenditure is now under active discussion and Mr Nott is hopeful that a satisfactory settlement can be reached, he has asked me to place on record the following points.

The Chief Secretary is critical of the fact that MOD were unable to spend the enhanced cash limit in 1981/82 except by bringing forward expenditure from 1982/83. Mr Nott's view is that this reflects the very tight control exercised over defence expenditure earlier in the year when an enhancement to the cash limit could not be guaranteed. He points out that the Treasury forecasts changed much more dramatically during this period than the cash flow forecasts of the MOD - precise estimating in difficult economic conditions down to the last 1% of Defence expenditure on a £6 bn procurement budget is a mammoth task, obviously subject to variations within the year. He has also observed that if the addition to the cash limit had not been secured and spent, real growth over 1980/81 would not have been 1.2% but minus 1.2%. That would have been a serious embarrassment, quite apart from the loss of military capability. He reminds the Chief Secretary that our defence spending has been growing less fast than that of any of the other principal NATO nations (see the attached table).

The Chief Secretary refers to possible underspending this year against the defence cash limit. Mr Nott agrees that the indications point to some underspend. He intends to ensure that the defence programme continues to be managed sensibly and that the best possible use is made of the resources available. As part of this, he will be advancing a pay day to bring it into the present financial year. In so far as there is any unavoidable underspend this will enable the extent of supplementary provision for Falklands costs to be reduced. But Mr Nott's view is that to encourage an underspend on the main programme would be highly damaging to our defence capability (we can now pay for some absolutely vital elements which have been deferred for years) and would be contrary to

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declared Government policy to fund the Falklands costs in addition to 3% growth. He has commented that we have a country to defend - and there are other important parts of Government policy as well as the PSBR.

Mr Nott has been informed that the reference in your predecessor's letter to MOD calculations of price rises in 1981/82 justifying a cash increment of only £100 million is based on a misunderstanding which has been explained to Treasury officials and he hopes has been brought to the Chief Secretary's attention.

Finally, Mr Nott has observed that the Chief Secretary's reading of the Unwin Report (on which I shall be writing separately) must have been highly selective. The Report found 'no major systematic errors' in the MOD's pricing methodology and recognised the objections to using general non-defence specific indices such as the CSO index on which the Treasury's calculation of real growth is based. Mr Nott has asked me to confirm that the real growth figures he has quoted both internally and publicly are the most accurate available and should be regarded as the only authoritative figures that there are.

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 etc,

Richard Mottram

(R C MOTTRAM)

Real Increases in Defence Expenditure by NATO Countries 1979-81

<u>Country</u>	<u>1979</u>	<u>1980</u>	<u>1981</u> (provisional)	<u>Average</u> <u>1979-81</u>	<u>Ranking</u>
United States	3.7	5.0	5.7	4.8	1
France	2.5	3.9	3.5	3.3	2
Italy	2.6	4.9	1.5	3.0	3
Germany	1.8	1.9	3.4	2.4	4
United Kingdom	2.1	2.9	1.7	2.2	5

DEFENCE: TIME PREFERENCE BUDGET

PART 9

-8 OCT 1982

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5 6 7 8 9

ANNOTATED AGENDA
THE DEFENCE PROGRAMME

The following table shows the baseline and bids which were the basis for the figures reported to Cabinet in the Chief Secretary's paper (C(82) 28).

	£ million cash			
	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u>
Survey baseline	14072.5	15277.8	16424.2	17596.3
Additional bids in PESC Report:				
(i) Cost of 1982 AFPRB TSRB and DDRB awards	33.4	42.0	44.1	45.9
(ii) Restoration of 3% commitment		215.0	566.0	606.0
(iii) Allowance for defence non-pay relative price effect		264.0	584.0	956.0
Sub-total	33.4	521.0	1194.1	1607.9
(iv) Cost of Falklands operation and consequentials				
			Unquantified bid	

2. The bids at (ii) were based on the 1982 Budget forecasts of general inflation. In the light of the Cabinet decision to apply a $3\frac{1}{2}\%$ factor for public service pay; of Treasury advice that the forecast of general inflation in 1983/84 is 6%; and on the assumption that in future years the existing cash planning factors remain appropriate for the present, the Defence Secretary is willing to reduce his bid to:

-43.5 46.7 50.2

FALKLANDS EXPENDITURE

3. The Government has announced that all the equipment lost in the Falklands conflict will be replaced - not necessarily on a like for like basis - and that these costs, together with the cost of the Falklands campaign and of any future garrison, will be met out of monies in addition to the 3% annual rate of real growth.

The Campaign and Replacement Equipment

4. Officials have agreed that the best available assessment of the full additional cost of the campaign and of replacing lost equipment is as follows:

	£M 1982/83 Prices				
	<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u>	<u>Later Years</u>
Cost of campaign	705	125	55	25	} 400
Replacement of lost equipment	25	145	225	230	
Total	730	270	280	255	400

(These costs are at 1982/83 prices and for future years will need to be converted to cash on the same basis as the non-Falklands programme).

5. It has been agreed that a once for all settlement of the funds to be added to the Defence Budget on account of the campaign and the replacement of lost equipment should be reached; that these amounts should be separately identified in the text of the 1983 PEWP; that they should be managed as an integral part of the defence programme; and that in future decisions on public expenditure after 1985/86 the defence budget should make full allowance for continuing costs associated with the Falklands in accordance with the Government's commitment.

6. It was left unresolved at the bilateral whether the Falklands additions for equipment lost should cover the full additional cost of the replacement equipment (eg the 4 Type 22s planned to replace the lost type 21s and 42s). It has been argued that the additions to the Defence Budget should be only the value of the equipment lost, ie should exclude an amount corresponding to the "betterment", that is, the degree of improved capability resulting from the replacements. This "betterment" amount would then be a charge on the main defence budget. On the other hand it is argued that this would be contrary to the sense of the Ministerial agreement. Moreover no claim has been made for "worsenment" arising from the loss of capability pending delivery of replacement assets and from damage to assets not lost. Rough estimates have been made ^{by MOD} of the value of worsenment and these have been found largely to cancel out the Treasury's estimates of betterment.

The Garrison

7. MOD have estimated that the cost of the garrison described in the attachment to the Defence Secretary's minute of 2 September to OD(FAF), including the cost of the air base, will be:

<u>1982/83</u>	<u>1983/84</u>	<u>1984/85</u>	<u>1985/86</u>
[140	500	500	400]

with continuing significant costs in later years. OD(FAF) are to have a further discussion in November about the future garrison and this may lead to changes in the estimated costs.

8. There are two alternative ways of handling the costs of whatever garrison is agreed by Ministers. First, specific figures could be agreed and added to the defence budget in exactly the same way as has been agreed for the costs of the campaign and of replacing equipment lost. Secondly, no figures could be published at this stage but the Government's commitment to fund the costs of the garrison in addition to 3% growth could be reaffirmed in the PEWP and should be met as required from the Contingency Reserve.

9. The advantage of the first course is that it demonstrates more clearly the Government's determination to guarantee the security of the Falklands; it gives the MOD a firmer basis for planning its 1983/84 programme; it would be politically difficult to resist publishing such information once Cabinet has determined the garrison size; and it should help to clarify the implications of decisions now before Ministers as to the size of the garrison if

he costs have to be specifically added to future defence expenditure totals. Moreover provision will have to be taken in Estimates for costs associated with the garrison. This course is preferred by the Defence Secretary.

10. In the Chief Secretary's view the second course would be more practical, at least at this stage, Cabinet will consider public expenditure on 28 October. OD(FAF) are unlikely to consider proposals for the garrison before the first week of November, and may not be in a position to take firm decisions immediately for all the Survey years. The Chief Secretary therefore proposes that in the Public Expenditure White Paper provision for garrison costs should be made in the Contingency Reserve rather than on the Defence Budget; this need not be inconsistent with defence planning, a public announcement, or the presentation of Estimates once firm decisions are taken for 1983-84. But he would see presentational problems meanwhile in putting to Cabinet or announcing garrison costs of £500m per annum.

11. *It is for consideration which course should be adopted.*

NON-FALKLANDS EXPENDITURE

1982 Pay Awards

12. The cost of the 1982 Armed Forces, Service top salaries and Service doctors and dentists pay awards exceeded the provision of 4% made in Estimates 1982/83. In accordance with past practice the Defence Secretary seeks an increase in cash provision for 1982/83 and in subsequent years to meet the excess. The Chief Secretary is opposed to this on the basis that extra provision is unnecessary.

13. It is for consideration:

- a. whether the 1982/83 cash limit should be increased for the extra costs of the 1982 Armed Forces, etc pay awards;
- b. whether additional provision should be made for the extra costs of the awards in later years.

Restoration of 3% commitment

14. The Defence Secretary considers that the baseline provision in 1984/85 and 1985/86 will not enable the NATO target of 3% annual real growth to be met, although the figure for 1983/84 is more than sufficient. The revised bid in paragraph 2 represents the changes to Survey baseline provision needed to secure 3% growth on the basis of the latest Treasury forecast of general inflation in 1983/84, the 3 $\frac{1}{2}$ % public service pay factor in 1983/84 and the cash factors of 5% in 1984/85 and 4% in 1985/86.

15. The Chief Secretary agrees that a reduction is necessary in 1983/84 but believes that existing provision in 1984/85 and 1985/86 is more than sufficient to meet the NATO target since the path of 3% real growth underlies the additions made at the end of the 1981 Survey.

16. It remains for consideration what changes to the baseline provision are required to enable the Government to meet its commitment to plan to implement in full the NATO 3% target.

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Defence non-pay relative price effect

17. MOD predict that prices on defence non-pay expenditure will, on average, increase faster than overall prices by 2.8% each year over the Survey period. In the Defence Secretary's view, additional provision is needed to avoid jeopardising the NATO real growth commitment.

18. In the absence of evidence of the inevitability of a future RPE and given the dangers to cash control and counter-inflation strategy of over-provision, the Chief Secretary sees no reason to make advance provision for it. He accepts that the public expenditure system allows for the adequacy of cash provision to be considered in the course of each year in the light of the movement in defence prices.

19. The Defence Secretary's bid remains for consideration.