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Treasury Chambers, Parliament Street, SW1P 3AG

M Scholar Esq  
Private Secretary  
No.10 Downing Street  
London SW1

14 October 1982

Dear Michael

DEFENCE PROGRAMME

... The Chief Secretary has asked me to send you the attached annotated agenda for the meeting with the Prime Minister on Monday afternoon.

The agenda has been agreed with the Defence Secretary, who I understand shares the Chief Secretary's view that following their discussion and subsequent consultation between officials the differences between our Departments are now much reduced and should be capable of resolution on Monday.

I am copying this letter to John Kerr, Richard Mottram and Richard Hatfield.

Yours sincerely

J.S. Gieve

JOHN GIEVE

Private Secretary

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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 Defence Secretary's bids at (ii) were based on the 1982 Budget forecasts of general inflation; on the basis of the Cabinet decision to apply a 3½% 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 changes required to secure 3% growth would become:

-43.5      46.7      50.2

NON-FALKLANDS EXPENDITURE

1982 Pay Awards

3. 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.

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4. 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

5. 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; the figures shown in paragraph 2 represent 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 3½% public service pay factor in 1983-84 and the cash factors of 5% in 1984-85 and 4% in 1985-86.

6. 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.

7. 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.

Defence non-pay relative price effect

8. 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.

9. 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.

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

FALKLANDS EXPENDITURE

11. 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

12. 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	700	115	70	40	} 365
Replacement of lost equipment	25	95	230	230	
Total	725	210	300	270	365

(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.)

13. 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.

14. 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

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 largely cancel out the Treasury's estimates of betterment.

### The Garrison

15. 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 of the order of:

<u>1982-83</u>	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>
<u>140</u>	<u>500</u>	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.

16. 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 they could be met as required from the Contingency Reserve.

17. 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 the 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, who is reviewing the minimum garrison and air base requirements for consideration by OD(FAF) at the beginning of November.

18. 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.

19. It is for consideration which course should be adopted.



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May I have a word with the Treasury first. nt.

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Prime Minister ①

You would also wish the Chief Secretary to be present?

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PRIME MINISTER

DEFENCE EXPENDITURE

Leon Brittan and I have now had a bilateral meeting about defence expenditure and he has no doubt made a report to you on it. Although we were able to establish the framework of the points which need resolution, I do not believe there is any scope for taking the issues further bilaterally. Instead I think that the best way forward would be to have a small political meeting to look at all the outstanding issues as a single package and to settle them. I do not believe that the issues are of such intrinsic difficulty that it will prove impossible to do this at a single meeting.

2. Could I therefore ask you to consider convening a meeting with the Chancellor of the Exchequer and myself to sort out on a political basis how we are to handle defence expenditure. I think that the timing that would make most sense from everyone's point of view would be for this to be done before my departure for the Falkland Islands on 21st October.

EW

Ministry of Defence  
8th October 1982