



Prime Minister

(2)

I think you have
already

Treasury Chambers, Parliament Street, SW1P 3AG
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seen this?

Michael Scholar Esq.
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MUS 20/12

Dear Michael,

LONG TERM PUBLIC EXPENDITURE: DEFENCE

John Gieve has already sent to you some briefing on long term defence expenditure, as background for the Prime Minister's meeting in January. The Chancellor thought the Prime Minister might also be interested to see the enclosed note which has been prepared within the Treasury. This analyses the 1981 NATO Ministerial Guidance which extended to 1988 the original Alliance agreement to aim at 3 per cent growth. The note also discusses the way in which this aim has been interpreted by other NATO countries.

Yours sincerely,
Margaret O'Mara

MISS M O'MARA
Private Secretary

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L/PE: DEFENCE EXPENDITURE

The 1981 NATO Ministerial Guidance extended to 1988 (FY 1988-89) the original 1977 agreement to aim at growth in the region of 3% per annum in real terms (copy attached). The UK subscribed to this guidance.

2. Supporting the principle of the broad 3% aim does not commit any country to achieving it. For example, the UK has for some years endorsed the UN aim that at least 0.7% GDP should be devoted to overseas aid; but the UK has never achieved it.

3. NATO and the individual member countries recognise that implementation of the growth aim has to depend upon countries' economic circumstances. Indeed, the Resource Guidance specifically makes this proviso. Hitherto the UK has accorded defence the utmost priority despite economic difficulties. It seems improbable that UK economic circumstances will permit both indefinite expansion of defence expenditure and reduction in public spending as a whole (central to the economic strategy).

4. That the 3% aim is not binding is demonstrated by countries' achievement and plans to date. Defence expenditure in other European NATO countries has had to take account of harsh economic realities; in some years reductions have been necessitated:

	1980 or 1980-81	1981 or 1981-82	1982 or 1982-83	1983 or 1983-84
US	4.1	7.8	10.3	8.2
UK *	2.8	1.3	3.8	3.3
Germany	2.3	3.3	-0.2	1.4
Italy	4.9	-0.5	2.8	-1.6
Belgium	2.0	0.9	-6.6	-2.3
Netherlands	-1.7	3.3	2.1	1.4

* excludes Falklands expenditure: calculation by MOD's internal pay and price methodology

Source: NATO Defence Planning Committee 1982 General Report

From 1982 onwards, only four other countries in all (US, Canada, Norway, Luxembourg) forecast increases of 3% or more. There are five countries (Belgium, Denmark, Germany, Italy, Netherlands)

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where defence spending this year and next will either decline in real terms or grow at a rate well below 3%.

5. In terms of money, the UK defence budget is currently second only to the US. On present expenditure plans - which provide for 3% real growth each year with Falklands costs on top - the UK's defence effort in 1985-86 will compare even more favourably with the rest of Europe.

6. There is nothing in the NATO guidance which suggests that only NATO-dedicated expenditure counts against the aim. Nevertheless, on top of "NATO" spending, the UK will also have committed by 1985-86 some £3 billion on "Falklands" expenditure. As Cmnd 8758 (the Falklands White Paper) recognises, much of the "Falklands" spend will benefit the UK defence effort (and thus NATO) as a whole.

7. The rest of NATO will no doubt encourage the UK to continue to increase defence spending indefinitely while tempering their own commitments with economic realism. But the UK would be entitled to rest on its laurels - at least until other Allies catch up with our achievement. Such a position ought to be easy to sustain in Brussels. Indeed, with £3 billion extra "Falklands" provision before 1985-86, the UK could claim to have exceeded its Cmnd 8288 commitments and achieved all its 3% growth well in advance.

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N A T O C O N F I D E N T I A L

1977 Resource Guidance

Text of Paragraphs 42 and 43 of DPC/D(77)6(Final)

42. Accordingly, if a continued deterioration in the NATO-Warsaw Pact balance is to be avoided, an annual increase in real terms (i.e. after full compensation for the inflationary impact of rising pay and price levels) should be aimed at by all member countries. This annual increase should be in the region of 3%, recognizing that for some individual countries:

- economic circumstances will affect what can be achieved;
- present force contributions may justify a higher level of increase.

43. It is moreover indispensable that nations increase the cost-effectiveness of their defence expenditures, i.e. that they improve the share of capital expenditures devoted to major equipment, as well as the amounts of these categories per soldier, but without detriment to combat readiness. Improved methods of assessing cost-effectiveness should be developed."

Defence :

Budget :

LONG TERM PUBLIC EXPENDITURE: DEFENCE

This note offers advice for the meeting with the Defence Secretary to discuss the implications for the defence budget of reductions in long term public expenditure. Your objective will be to secure agreement to the CPRS proposal for defence spending.

- ... 2. The LTPE assumptions for defence spending are at Annex A. In brief it was assumed that defence expenditure would increase each year by 3% in real terms until 1988-89, and thereafter by 1% each year in real terms. No account was taken of additional expenditure in respect of the Falklands.
- ... 3. The CPRS proposal for defence spending is at Annex B. In brief, it was proposed that defence expenditure cease to increase in real terms after 1985-86. Thus the CPRS in no way advocated a cut in defence spending (in contrast to other programmes); in recommending it be held at its 1985-86 level they were suggesting an annual spend "only" 9% higher in real terms than in the current year.
4. MOD were never happy about the presentation or the moral of the LTPE figures. For the September Cabinet discussion, Mr Nott circulated his own memorandum - C(82)33 - which concluded, "It is not defence expenditure which needs curbing ... but public expenditure generally, if that can be done." Mr Nott believed that defence ought to be accorded "around 15% of total Government expenditure"; that is, about £2bn more than has been provided for 1983-84.
- ... 5. It is not clear whether, following Cabinet decisions on LTPE (CC(82)41st Conclusions), Mr Nott accepts that his budget must play its part in overall reductions; or whether he still holds that defence spending should be absolved from any further review. Annex C discusses the sort of arguments the Defence Secretary might deploy for ignoring LTPE considerations and maintaining growth in the defence budget. The main one could be to quote the NATO target; but this is not meaningful, and ought to be replaced by something better.

The Case for the CPRS Proposal

6. As Sir Robert Armstrong said in his minute of 23 November, if the exercise as a whole is to achieve anything significant, the "big four"

/ programmes,

programmes, which account for two-thirds of total expenditure, must contribute their share. It will be difficult enough to achieve LTPE objectives if defence spending merely maintains its 1985-86 level. If, after 1985-86, defence spending continues to increase, the pressure on other programmes will be even more severe.

7. The LTPE exercise is in no sense intended to reopen or lament recent PES decisions. But you may need to remind Mr Nott that defence spending since 1979, and defence expenditure plans until 1985-86, have been largely immune from the public expenditure and economic pressures that have beset other programmes. The Government has not only stood by its commitment to plan for 3% real growth each year at a time of declining GDP; it has recently agreed, on top, defence Falklands additions of some £3 billion over the PES period. The Defence Secretary ought reasonably to accept that this process cannot continue indefinitely without intolerable strain on public expenditure and/or the economy. ... Some general discussion of UK defence expenditure is at Annex D.

8. The great advantage of the CPRS proposal for defence is its ready feasibility. It does not run against the existing commitment to plan for 3% growth up to 1985-86. Moreover internal MOD planning, in their Long Term Costings, - Falklands apart - currently assumes exactly the CPRS path of future provision. So there should be no adverse operational or industrial penalties from disruption of current plans.

9. It also follows that, if it is agreed to adopt the CPRS recommendation, no further LTPE work on defence need be undertaken; internal refinement and adjustment of MOD forward programme can simply continue as usual.

Conclusion

10. It would be possible to exclude the defence budget from LTPE considerations. Defence spending could continue to increase ad infinitum at a rate of 3% per annum, with Falklands cash (£3 billion so far) on top. This would either jeopardise the Government's commitment to reduce public expenditure; or severely exacerbate the pressure on other programmes. But our military capabilities would certainly be enhanced; and both the defence industrial lobby and other NATO countries (especially those who are not pulling their weight) would be well pleased.

11. The Government's expenditure and economic strategies however demand some restraint in defence spending. The CPRS proposal is not to cut the defence budget, but simply to maintain it at a level some 9% higher in real terms (Falklands apart) than it is today. This is exactly the level assumed by MOD forward planning. So no disruption should result. Equally, no new LTPE studies need be launched beyond the normal refinement of the forward programme. But it may be for consideration whether efforts should be made to secure a more sensible NATO resource objective than 3% real growth ad infinitum (paras 5-9 of Annex C refer), and Ministers may wish to seek further advice to this end.

DM1 DIVISION

December 1982

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1. DEFENCE

1.1. The likely path of defence expenditure over the next decade is determined by the Government's commitment to the NATO target of 3 per cent annual real growth. At present this commitment does not extend beyond 1985-86. The UK supported the 1981 NATO Ministerial Guidance extending the Alliance's commitment to 1988.

1.2 In both scenarios, 3 per cent per year real growth is assumed, starting from the 1982-83 cost terms figure. It is assumed that the Government's commitment will be extended to the end of the NATO target period (1988-89) and there will be 1 per cent annual growth thereafter.

1.3. For the relative price effect (RPE) of non-pay expenditure alternative assumptions have been adopted of zero and 2 per cent positive from 1982-83. The effect of these assumptions on the projections for 1990-91 is shown in the table below.

TABLE 1.1. DEFENCE EXPENDITURE

	1979-80	1982-83	1990-91			
			A		B	
Non-pay RPE (increase per year) 1982-83 to 1990-91	-	-	0	2%	0	2%
£m (1980-81 cost terms)	10880	11732	14800	16400	14800	16400
% GDP	4.6	5.0	5.0	5.6	5.6	6.7

DEFENCE

Proposal

1. LTPE projections assumed that defence spending would increase in volume terms by 3 per cent a year from 1982-83 until 1988-89, with 1 per cent a year thereafter. The United Kingdom commitment to the 3 per cent growth target currently runs only to 1985-86. The proposal is to maintain the 1985-86 level in real terms, which would save about £1½ bn a year by 1990-91 as against LTPE. Internal forward planning in the Ministry of Defence currently assumes no growth in the defence budget after 1985-86. Hence this option could be achieved either by providing for no additions to spending at present planned, or by reductions to make room for some inescapable additions, eg by cancelling Trident. But the present planning assumption is deliberately cautious, to allow for some flexibility, so it does not follow that the option could be achieved without affecting military capabilities.

2. The political and diplomatic difficulties of this option would be reduced if NATO could be persuaded to reduce the 3 per cent target to a level which all or most member countries could realistically be expected to achieve.

Background

3. The present defence base-line is uncertain, in relation both to the level of spending in 1982-83 and to any revisions of plans in the immediate aftermath of the Falkland conflict. But defence spending cannot be ignored in this exercise. It now accounts for about 12 per cent of total public expenditure programmes, and on the basis of the LTPE assumptions (including the assumption that defence prices rise 2 per cent faster than prices generally) it will account for 15 per cent in 1990-91. On these projections, defence is responsible for more than a third of the total expenditure increase (in cost terms) from 1982-83 to 1990-91 - a much larger share than any other programme - though a different base year, or a different assumption about relative prices, would give different results.

Arguments in Favour

4.

i. If defence spending is not slowed down, it will continue to rise in relation to GDP, to around 6 per cent on the projection we have taken. Sooner or later, depending on the performance of the economy, this rise is very likely to be found unsustainable, so that drastic cuts will have to be made. It would be more sensible to plan from the outset for a sustainable rate of defence spending, as in the proposal.

ii. In the past a number of other countries have failed to meet the NATO target (even among those with GDP growth rates higher than the United Kingdom), and after 1980 (the last year for which comparative figures are available) their performance is likely to continue to fall short.

iii. The lower expenditure path would be feasible. It would be broadly in line with the forward planning now being undertaken in the MOD (though this deliberately leaves room for flexibility - para 1). Spending with British industry could still be higher than it is today (£6-7 bn per annum).

iv. A lower rate of spend on defence R & D would free scarce resources (high-quality scientists and engineers) for employment in civil R & D.

Problems

5.

i. There would be political problems, international and domestic, in changing course after 1985-86. Last year the United Kingdom supported the NATO Ministerial Guidance extending the commitment to 1988. Present political pressures are for more defence spending, not less.

ii. The absence of real growth in the defence budget, as against the increase in complexity and cost of major equipment, would entail a reduction in United Kingdom military capabilities.

not true:
see Annex C
para 4

The case against the CFRS proposal

1. Because the defence programme has not hitherto been planned to exceed the resources implied by the CFRS proposal, the Defence Secretary should not point to any equipment cuts that would be implied. He might choose to emphasise the sorts of equipment (frigates, tanks, aircraft, weapons etc) that he could purchase with more resources than he anticipates. But this is hardly a defence-specific argument; the more money available, the more can be bought.

2. The Defence Secretary will probably wish to refer to the might of the Warsaw Pact threat. Soviet military capability is real enough. But there is no direct correlation between the level of UK defence spending and Russian military might; and the latter needs to be seen in perspective - not least against the Chinese threat and against the economic difficulties facing Mr Andropov. Is it realistic for the USSR or the West to suppose that Soviet military spending will be able to continue regardless of national resource pressures?

3. Another favourite theme is the problem of "cost growth" in defence equipment (this refers to the trend whereby a new generation of weaponry costs more than the old - Tornado more than Canberras, Stingray more than the Mk46 torpedo etc). But "cost growth" is simply a reflection of the increasing sophistication of modern weaponry. Since Tornado is much more capable than the aircraft it is replacing, it is not surprising that it is more expensive. In general, the "cost growth" argument - a simplistic numbers comparison - tends to obscure the far superior capability afforded by sophisticated modern weapon systems. Furthermore, "cost growth" cannot be simply a NATO problem; the USSR is as subject to the expense of modern technology as any nation.

4. In paragraph 5 of his memorandum C(82)33 Mr Nott asserted that the level of expenditure implied by the CFRS (£15-17 billion each year) would lead to a "rapid diminution of our defence capabilities". On the contrary, with this level of resources each year our military forces could hardly fail to be substantially improved.

5. The main argument against restraining defence expenditure after 1985-86 is that NATO has extended its 3% growth target to 1988-89. It will no doubt be extended again into the next decade. Indeed, SACEUR has recently declared his view (though on what basis is not clear) that 4% annual growth is necessary to meet the Soviet conventional threat.

6. What level NATO spending in general ought to be is not a mathematical exercise. For its part the UK would have a strong case after 1985-86 (when, Falklands apart, defence spending in real terms will be 20% higher than in 1978-79, and will consume nearly 6% of GDP) for simply maintaining rather than increasing its contribution to NATO.

7. A more positive approach would be to persuade NATO to recognise the shortcomings of the arbitrary and simplistic 3% growth aim and substitute something better. 3% rhetoric may well have served its purpose in 1977, when the Alliance (and especially the US) were anxious about resource scarcity. By the middle of this decade however, some more meaningful measure should be used - not least since the less meaningful the target, the less likely it is to be observed. A better yardstick - and objective - might be the proportion of GDP devoted to defence; defence expenditure would thereby be linked with, and not independent of, economic circumstances.

8. The weaknesses of the 3% growth target are as follows:

a) It takes no account of absolute levels of spend (£15bn is a better annual defence spend than £14bn whether or not it involves 3% growth).

b) The target applies simply to all defence expenditure: all expenditure counts - on weapons, on paper, clips, on salaries - whether or not it is militarily effective.

c) The target is expressed merely in terms of input. No attempt is made to measure outputs. Gains from improved efficiency or cost-effectiveness are ignored. NATO has repeatedly resisted UK attempts to launch a review to improve the use made of Alliance resources.

d) Performance is measured in simplistic year-on-year terms. The vagaries of one year (eg. higher or lower level of spend) feed through to the next.

9. A useful concomitant of the Longer Term exercise would be to pursue within NATO more effective criteria for members' defence contributions. ,

UK DEFENCE EXPENDITURE.

1. The Defence programme next year will consume about 5.5% of GDP - the highest level since the sixties. It will be higher than education and health for the first time in over 10 years. It will consume 13.2% of total expenditure in 1983-84.

2. The UK defence effort already compares extremely favourably with that of our major allies. In absolute terms, the UK defence spend is second only to the US. As a percentage of GDP the UK is second; in per capita terms third:

	total expenditure 1981 US\$ million	% GDP	per capita expenditure US\$
US	167,800	5.8	730
UK	25,200	4.9	439
France	23,800	4.2	442
Germany	23,100	3.4	377
Italy	8,700	2.5	151

Source: 1982 Statement on the Defence Estimates
UK figures exclude Falklands expenditure

3. The UK's achievement to date against the 3% target has been good. Mr Nott's memorandum C(82)33 quotes figures based on MOD's internal price methodology. This has been found by the Unwin report to overestimate defence inflation and to understate "volume"; calculations based on the CSO defence procurement deflator show the UK's growth performance to be equal second to the US. The figures are as follows:

	1979	1980	1981 (provisional)	average
US	3.7	5.0	5.7	4.8
*UK	4.7	4.1	1.1	3.3
France	2.5	3.9	3.5	3.3
Germany	1.8	1.9	3.4	2.4
Italy	2.6	4.9	1.5	3.0
**UK	(2.1)	(2.9)	(1.7)	(2.2)

* CSO defence procurement deflator: financial year figures

** MOD price methodology; calendar year figures

4. Moreover, the UK has achieved these increases despite severe economic difficulties. The 1977 NATO Resource Guidance (which formally recorded the 3% aim) recognised that what countries could achieve would depend on their economic circumstances. GDP growth of the principal NATO nations has been as follows:

	1979	1980	1981	average
United States	2.8	-0.4	1.9	1.4
France	3.3	1.2	0.3	1.6
Italy	4.9	3.9	-0.2	2.8
Germany	4.4	1.8	-0.3	1.9
United Kingdom	1.9	-2.1	-2.2	-0.8

Source: OECD

5. UK performance in the future should compare even more favourably. For example provision has been made for real growth of well over 3% (Falklands apart) in 1982-83 and 1983-84. On top of this additions have been made for some £5b of Falklands costs up to the end of the PES period. It is

/ increasingly

increasingly unlikely that Germany or France, in the light of their economic difficulties, will even attempt to meet the NATO aim in the near future. The US, by contrast, are increasing defence spending, but seem to have abandoned the economic strategy of a balanced budget.