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7 October 1983
Policy Unit

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PRIME MINISTER

PUBLIC EXPENDITURE: 1983 SURVEY

Our overall assessment of the 1983 Survey's progress to date is that:

1. It is possible to hold to the White Paper totals for 1984-85 and 1985-86.

2. The political cost of doing so can be minimised by concentrating mainly on three areas: defence, nationalised industries, and support for industry and agriculture.

3. You can mobilise a majority against these three big spenders in a Cabinet discussion. Ministers with social portfolios would then be less reluctant to contribute savings of their own.

DEFENCE

The arguments here are not about defence issues but about how to interpret commitments and cost factors. Nowhere in the bilateral discussion has Michael Heseltine contended that acceptance of the Chief Secretary's bid would harm a vital defence capability. He could hardly do so: procurement expenditure has risen by 40 per cent in real terms over the last five years; the recruitment position is sound; our forces are now very much better equipped and motivated.

The expenditure arguments are so technical and confusing that I venture to attach David Pascall's note which explains them as clearly as humanly possible.

The key points are:

1. We cannot allow literal interpretations of the NATO commitment to propel defence expenditure beyond our means when the UK is the highest defence spender in NATO after the USA, both in relation to GDP and in absolute terms.

2. The MOD operates an indulgent procurement policy with a lot of fat in it, both in the procurement executive (35,000 staff) and in supplying industries (notice how British Aerospace improved its ALARM bid by £100 million when the issue was seen to be in doubt). We estimate that more competitive procurement and greater NATO standardisation could save 20 per cent of procurement cuts over 10 years: we need to act now to restrain the vaulting equipment costs.

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3. Defence expenditure will eat up other programmes if it is allowed to grow at 3 per cent within a total public expenditure budget which is not growing at all. At this rate, it will rise, in 10 years, from 13 per cent to 18 per cent of the budget, displacing other programmes worth £6 billion. Since 1978-79, defence expenditure has risen by 21 per cent against economic growth of 1 per cent. We cannot hope to carry on at this rate and effectively restrain expenditure on the NHS.

NATIONALISED INDUSTRIES

In respect to three energy industries combined, the Chief Secretary is still looking for £280 million, £500 million and £375 million over the next 3 years. The ESI, NCB and BGC will invest, respectively, £5.1 billion, £2.6 billion and £2.6 billion over this period - a total of over £10 billion. Do we need to invest so heavily in all energy industries? The ESI has substantial surplus capacity; Sizewell B is not needed at all on capacity grounds and will absorb £300 million over the next 3 years. The NCB's investment in uneconomic pits was heavily criticised by the MMC. Treasury want to reduce its annual investment programme of £900 million by £100 million.

INDUSTRY

The gap here is only £35 million, on a budget of £1,400 million. The Chief Secretary was looking for this saving from the Research and Development programme. This could be trimmed back without any harmful effects. Industry's profitability is recovering; it saw fit to pay earnings increases last year of 3 per cent in real terms. Why does it therefore need 33 per cent grants for its R&D? 25 per cent grants would achieve no less. Selective assistance could also be pruned back: why support projects which, if they are sound, would go ahead anyway? We see additional savings here of £50 million which would cause hardly a ripple of protest.

AGRICULTURE

The gap here is only £50 million. This reflects a far too modest ambition on the Treasury's part. MAFF is spending £760 million in support of an industry which already receives enormous price support - a policy of belt and braces. Surely our longer-term aim must be to phase down support to a minimum level consistent with regulatory and health responsibilities. Next year, should we not look for an additional £50 million, deploying the argument that the rates of grant should at least come into line with those offered to manufacturing industry, which is exposed to the full blast of international competition?

These savings sum up as follows:

1. £420 million from Defence (CST's bid)

2. £280 million from energy industries (CST's bids)

3. £85 million from DTI (CST's £35 million plus £50 million from selective assistance)

4. £100 million from MAFF (CST's £50 million plus a further £50 million from grants and research)

£885 million Total in 1984-85

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PUBLIC EXPENDITURE: DEFENCE

THE FIGURES

In summary the differences between the MoD and the Treasury are:

	84/85 £m	85/86 £m	86/87 £m
MoD	+150 (+93*)	+340	+1790
Chief Secretary	-270	-280	+ 110 (-110*)
Total	420	620	1680

* The figures in brackets were quoted in the Chief Secretary's minute but are incorrect.

MOD'S BIDS

The Mod's bids consist of:

	84/85 £m	85/86 £m	86/87 £m
Service Pay Awards	93	97	100
Inflation Compensation	59	240	510
Falklands			620 ← now agreed at 450
3% real growth			560
Total	150	340	1790 (1170 excl Falklands)

Taking these in turn.

Service Pay Awards

This bid is intended to compensate the MoD for the 1983 Armed Forces Pay Review Board proposals of about 7% which were above the Government's planning assumption of 3½%. The Treasury argue that the excess costs should be absorbed by improved efficiency.

I agree with the Treasury, particularly as there is no commitment to increase provision on account of service pay awards.

Inflation Compensation

MoD claims that inflation factors of 5½%, 5% and 4½% should be used for 84/85, 85/86, 86/87 respectively. Treasury consider that the cash factors agreed by Cabinet of 5%, 4% and 3% should be used. If these cash factors for future years prove unreasonable they can be looked at again in future surveys. However, to allow the principle of compensating cash factors by actual inflation rates would be incompatible with cash planning and cash limit discipline. The MoD bid should be resisted and no commitment to adjust future cash factors in line with inflation should be given.

Falklands

Falklands expenditure in 84/85 and 85/86 is planned at £684 m and £552 m respectively. Public and Parliamentary expectation is that Falklands costs will decline after 1986/87. The MoD bid of £620 m is unacceptable and should be no higher than the equipment and running costs of the garrison which total about £450 m.

3% Real Growth

MoD wish to extend the 3% real growth commitment after 1985/86. £560 m is included in MoD's bids for this purpose in 1986/87. This bid is unacceptable and is discussed in detail below.

TREASURY PROPOSALS

The Chief Secretary's proposals are based on:

	84/85 £m	85/86 £m	86/87 £m	
Reduction to limit annual growth to 3% on 83/84 provision	-270	-280	-290	
Falklands			400	
Total	-270	-280	+110	(-110*)

* This figure is incorrectly given in the Chief Secretary's minute.

Taking these in turn.

Limiting Annual Growth to 3%

MoD base the 3% commitment on the original baseline figures applying from 1979/80 onwards. They wish, therefore, to reinstate the £240 m July reduction as the baseline on which 3% real growth for 1984/85 is calculated. This results in a bid for 1984/85 of 5.2% real growth which MoD claim is compatible with the NATO commitment. It should also be appreciated that even after the July cut the 1983/84 figure was still more than 3% above the actual figures in 1982/83. This was because the MoD underspent by about £400 m in 1982/83.

The Treasury do not accept this catching up and are only prepared to accept real growth of 3% in 1984/85 and 1985/86. It would be completely unacceptable to concede the MoD real growth in excess of 3% and the Treasury proposal should be supported. The presentational aspect of this conclusion is discussed later in the comments on the 3% commitment in the longer term.

Falklands

The Treasury proposal offers MoD £400 m for Falklands in 1986/87 compared with the MoD bid of £620 m. I understand that a compromise of £450 m has been agreed which I consider acceptable in view of my earlier above comments on Falklands.

THE 3% COMMITMENT

Logic and the pressures on public expenditure generally argue for the Chief Secretary's interpretation of the 3% commitment up to 1985/86 and for no renewal of the commitment after 1985/86. However, political and presentational considerations are likely to be equally influential in the final decision. The following points are relevant.

Up to 1985/86

- A real rise of 5.2% in 84/85 could not be presented easily to the public nor to Ministerial colleagues.

- The MoD claim that the 3% commitment also implies a cumulative growth commitment of 21% to 1985/86. If there is any relevance in the 21% figure (which I doubt as the 3% gets all the emphasis) it will be exceeded if Falklands is included. Even without Falklands, real growth can be presented in cost terms as over 21% if GDP cash deflators are used rather than MoD's own indices. Why present the UK achievement in the worst light?

- The June 1981 White Paper referred to the intention of achieving 21% cumulative growth. Intentions are not commitments. The NATO commitment is for annual growth.

After 1985/86

- Continued growth in defence spending is incompatible with the Government's wider public expenditure and economic objectives. Since 1978/79 defence growth has far outstripped economic growth - 21% against 1%. Nor is the economy likely to achieve 3% annual growth in the next two years.

- The effect on NATO of UK plans should be seen in proper context. Other European countries do not follow the UK example. If they did, each would devote more than 5% GDP to defence whereas the European NATO average is less than 4% GDP.

- There was no Manifesto commitment after 1985/86.

- The Europeans are poorly placed to criticise us. The UK's performance on defence has been and will continue to be impressive. Between 1979 and 1982 annual average real expenditure increases compared with GDP growth were:

	Defence	GDP
UK inc Falklands	2.9	-0.4
exc Falklands	1.9	
Germany	1.7	1.6
Italy	2.4	2.4
Netherlands	1.9	0.2
Belgium	-0.4	0.7

UK figures are based on MoD's deflators which relate to defence-specific items. Expenditure based on GDP deflators would be higher at 4.0 (inc Falklands) and 2.7 (exc Falklands) respectively. There is no standard approach to deflators in NATO which has recognised that "various uncontrolled and unchecked deflators is a major weakness in defence planning and makes comparisons of real increases in defence expenditure uncertain and questionable".

- Of the major Allies, the UK contribution to NATO is already second only to the US in absolute terms, per capita and as a proportion of GDP. MoD ought to be striving to reduce the unfairness of the UK defence burden, not to increase it.

	Expenditure	per capita	%GDP
	$ million		
US	198500	856	6.6
UK	24200	432	5.1
Germany	22500	364	3.4
France	22000	407	4.1
Italy	8900	155	2.6
Netherlands	4500	313	3.2
Belgium	2800	283	3.3

- The US does have concerns about burden sharing between the US and Europe. Nevertheless any decision on 3% does not alter our commitment to NATO. Our aim will be to increase resources in the future when economic conditions allow. However, future economic prosperity depends upon the UK Government controlling expenditure. Reductions in the growth of defence expenditure are necessary at a time when most programmes are being cut.

- Increasing growth in defence could swing public opinion against defence in general and Trident and Cruise in particular.

- MoD will argue that 3% to 1990 is the NATO aim and that this was confirmed in June. However, at the time Michael Heseltine accepted that a firm commitment to the end of the NATO planning period would cause us and most of our Allies difficulties and explicitly emphasised that the 3% formula is a target and not a binding commitment.

- Defence capability will increase from 1986/87 as the benefits of earlier expenditure are realised.

- The 3% principle does not necessarily link with operational capability. It concerns only inputs and covers non-operational and support expenditure. It does not allow for increased efficiency nor for a shift of resources from non-operational to operational objectives.

- There are potential savings in the equipment budget through greater specialisation and standardisation in NATO and through a more open and competitive procurement process (our recent work on procurement and cost growth inflation is relevant here). Profit rates on non-competitive contracts will certainly be revised downwards in November when the Review Body reports. A 5% reduction, the minimum likely figure, could save perhaps £75 m per year.

- Substantial scope exists for economies that do not damage the front line - civilian manpower, training, social and welfare expenditure, stocks, R & D establishments etc, not to mention the expected savings from MINIS.

CONCLUSION

Defence is not a special case and economic necessity must prevail over military aspirations. Such an objective is not incompatible with defence policy. There is no case for conceding any of the MoD's bids and every case for supporting the Chief Secretary's proposals. It is important that some of the smaller bids are not conceded in pursuit of a favourable decision on the 3%. The net result would be savings over the three years up to 1986/87 of £2.8 billion. This outcome could be presented both to the public and to NATO with little problem.

DLP.

DAVID PASCALL