

MR. TURNBULLPublic Expenditure: Defence1984/5 and 1985/6

MISC 99 has invited Michael Heseltine to accept the following figures for 1984/5 and 1985/6.

	Total	Savings below Baseline
84/85	£17.01 billion	ca £170 million
85/86	£18.04 billion	ca £180 million

The 84/5 figure is based on the reduced 83/4 baseline (following the July reductions of £240 million) uplifted by a 5% cash factor across the board and 3% real growth in line with the NATO commitment. The 85/6 figure uplifts the 84/5 baseline by a cash factor of 4% and by 3% real growth.

These proposals require a concession by the Treasury that the above cash factors should also apply to pay, i.e., 5% instead of 3% for pay in 84/5. This concession is worth about £100 million per year. If this compromise were accepted by MOD it would also be accepted by the Treasury, and the indications are that Michael Heseltine might well accept.

1986/7

Real growth in 1986/7 remains the major problem. If no real growth is included the defence budget would be £18.464 billion. If 3% real growth were conceded this would cost an extra £530 million and raise the total budget to £18.994 billion. Michael Heseltine is likely to argue for some real growth in 1986/7 but may not press for the full 3%.

Comment

We consider that a decision not to extend the 3% NATO commitment beyond 1985/6 should not cause significant defence policy difficulties nor be difficult to present either to NATO or to the public. The following points are relevant with particular emphasis on presentation:

- it is unlikely that such a decision would necessitate a major review of our defence roles as set out in John Nott's 1981 White Paper Cmd. 8288
- there was no Manifesto commitment after 1985/6
- 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.
- 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.

	<u>Expenditure</u> \$ million	<u>per capita</u>	<u>%GDP</u>
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 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:

	<u>Defence</u>	<u>GDP</u>
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 or real increases in defence expenditure uncertain and questionable".

- 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 may 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 when the Review Body reports later this 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.

Conclusions

We consider that the proposed compromise for 1984/5 and 1985/6 is acceptable. We do not consider that any real growth should be included in the budget for 1986/7.

DLP.

David Pascall

3 November, 1983.

SECRET