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Treasury Chambers, Parliament Street, SW1P 3AG  
01-233 3000

3 November 1983

Andrew Turnbull Esq  
No 10

Dear Andrew,

- .. As agreed, I enclose a note on the outstanding issues on Defence, in preparation for the Prime Minister's meeting with Michael Scholar and Ivan Wilson at 9am tomorrow.

Yours ever,  
John Kerr

J O KERR  
Principal Private Secretary

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DEFENCE

(Note by Treasury Officials)

32.

	Emillion cash			
	1983-84	1984-85	1985-86	1986-87
Baseline (of which Falklands agreed)	15,720 624	17,178 684	18,214 552	18,192 450
Mr Heseltine's opening position	15,810	17,330	18,551	19,815
Treasury opening position	15,720	16,910 <sup>100</sup>	17,934 <sup>100</sup>	18,353
MISC 99 proposal	15,720	17,010	18,040	- 2500 18464

£1.36      £1bn      £1.2bn      18464

1. MISC 99's proposals - which will be accepted by the Treasury if they are accepted by Mr Heseltine - would mean giving defence £100m in 1984-85 and £106 m in 1985-86 above the Treasury's starting position. Mr Heseltine will, no doubt, argue that these figures would leave him below the baseline and the Public Expenditure White Paper.

2. MISC 99 has made no proposal for 1986-87, on the ground that this is a matter for the Cabinet and not for a small group of Ministers to resolve. The Treasury's preferred position for 1986-87 would be to uplift an agreed 1985-86 figure by the 3 per cent cash factor applicable to all expenditure programmes and to build in no real growth above that; so as to arrive at a cash total, weaning the MOD away from their 'real' growth aspirations. On the MISC 99 basis this would give a figure of £18,464m. If Mr Heseltine argues for 3 per cent real growth in 1986-87 this would require an additional £530m, giving a total of £18,994m.

3. The Treasury believes that its 1986-87 figure would provide a wholly reasonable profile of defence expenditure over the next three years, with increases above the 1983-84 figure of £1.3 billion,



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£1 billion and £½ billion in the successive years. These increases will be difficult enough to accommodate within total public expenditure plans, given that the outcome of the bilaterals and of MISC 99 - defence apart - leave us short of our target by £87m in 1984-85, £408m in 1985-86 and £242m in 1986-87.

4. Defence is now the second largest programme - higher than health or education - and consumes 5.5 per cent of GDP. In absolute terms our defence spend is the highest in Europe. We have increased the defence budget every year since coming to office; five successive increases is unprecedented since World War II. Since 1978-79, defence spending has increased in real terms by over 20 per cent.

5. This has imposed a heavy burden. Over the same period, GDP has increased by only about 1 per cent. The increases in defence expenditure have been paid for not by economic growth, but by higher taxes and interest rates, and by cuts in other programmes. This cannot continue for ever. For the future, defence must take greater account of our wider public expenditure and economic objectives.

6. Further growth in military capability should come from improving efficiency and output, and obtaining better value for money. There is plenty of scope for making defence resources more effective: the civilian manpower proposals alone - now accepted by Mr Heseltine - will free an extra £120m a year.

7. Besides, MOD have had great difficulty in recent years in spending all the money provided. MOD have swallowed without difficulty the July 7 cut of £240m, plus £100m for the armed forces' and civil service pay; and still look likely to underspend this year.

8. The NATO 3 per cent aim is only an aim, like the UN aim that 0.7 per cent of GDP be devoted to overseas aid. It is not binding. Mr Heseltine has himself made this clear: he wrote to the Prime Minister in May "But the 3% formula is, of course, a target not a binding commitment".



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9. NATO, in any event, is unlikely to cause us difficulty. Other nations will be poorly placed to criticise the UK. The real problem is that other Allies do not follow the UK example. If they did, each European Ally would spend 5.5 per cent of GDP on defence (the current average is 3.8 per cent), and meaningless growth measures could be discarded.

10. We may expect Mr Heseltine to argue that nil growth in 1986-87 will have dire operational and industrial consequences. We do not believe that any weight should be given to these arguments:

a. MOD's internal plans last year assumed no growth at all after 1985-86. Mr Heseltine ought to revert to the force projections that satisfied his predecessor.

b. Real growth in military effectiveness can be achieved without an equivalent increase in input cost. MOD must exploit the substantial scope for increasing defence output by greater efficiency and value-for-money.

c. MOD have cried wolf before (notably in the 1981 Survey: even after making over £1000m of cuts in his 1982-83 programme, Mr Nott foresaw a "programme gap" of £200m - but the real problem in 1982-83 was to avoid a massive underspend). MOD costings are notoriously inaccurate. The margin of error for 1986-87 is too great to attach much reliance to cries of gloom and doom at this stage.

d. Substantial scope exists for economies that do not damage the front line: for example over £1200m a year is spent on Service training; over £700m on social and welfare expenditure; and the value of defence stocks at major depots is £7 billion.

FORMULA FOR 1986-87

11. We will need, of course, to agree a figure for 1986-87 in order to complete the expenditure review for the White Paper. But we will need, also, to agree a form of words to describe this figure.



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12. Mr Heseltine will argue that any figure which gives less than 3 per cent growth should be described as wholly provisional, square bracketed, and subject to review in subsequent years with the aim of meeting the 3 per cent target.

13. The Treasury's aim will be to ensure that the defence planners will work to this figure, so that our commitments do not grow out of step with the available resources, forcing us in future years into damaging cutbacks or unplanned increases in expenditure at short notice. There will be no Treasury objection to describing in public the figure as provisional and subject to review, provided that firm instructions on the above lines are given to the defence planners.

14. So far as the NATO target is concerned we should point to our achievement since 1978-79 (20 per cent real growth) and our plans up to 1985-86 (which would bring us up to more than 25 per cent real growth - Falklands inclusive - by then).

HM TREASURY

3 November 1983





APPENDIX A  
TO ANNEX E

21/12/11

MO 25/2/28/2


21/12/11  
deal

PRIME MINISTER

NATO MINISTERIAL GUIDANCE

The NATO Defence Planning Committee will be meeting in Ministerial session on 1st/2nd June. On present plans I shall not be present during the plenary discussion of the Ministerial Guidance, when we shall be represented by our Ambassador Sir John Graham - we need to decide the line he is to take.

2. As you know, the Ministerial Guidance is the document produced every other year to set the framework for national and NATO planning for the next five year period - in this case 1985-1990. The draft has been under discussion at working level in Brussels for some weeks and is to be considered by Permanent Representatives on 24th May prior to submission to Ministers. The resource guidance section draft is attached. You will see that, in respect of the 3% target for annual real increases in expenditure, it reads as follows:

"notwithstanding economic and financial constraints, the standing Alliance commitment to the 3% formula guidance is confirmed."

This is a repeat of the 1981 formula which John Nott endorsed on behalf of the Government.

3. A firm commitment on defence expenditure to the end of the NATO planning period would cause us difficulties (as it would most of our allies). But the 3% formula is, of course, a target not a binding





commitment. In view of this, the UK's good record on 3% and our public commitment to meet it to 1985/86. (when the Ministerial Guidance will come up again for review), I believe it would be wrong and unnecessary to mount any opposition to a repeat of the formula to which we subscribed in 1981. Internationally, this would provoke an unhelpful transatlantic row in a crucial year for the Alliance. Domestically, the likelihood of the row becoming public could be politically very damaging in present circumstances. On the other hand there may be US pressures to toughen up the 3% formula to stress it as the minimum required (the US are, of course, planning annual average increases in defence spending of 7% over most of the NATO planning period). But the FRG have already made clear that they would not support any substantive strengthening of the 1981 formula and I believe the UK should lend them support in resisting any such US pressures.

4. I therefore propose that the UK should go along with a repeat of the 1981 3% formula but should support the FRG in resisting any US pressures to go beyond this. Additionally, if the opportunity arises, I am content that we should - as suggested by Treasury officials - support any move by others in seeking deletion from the 1981 formula of the phrase 'notwithstanding economic and financial constraints'.

5. Subject to any views of my colleagues, I propose that Sir John Graham should be instructed to proceed accordingly at the meeting of Permanent Representatives on 24th May and subsequently at the Ministerial session.

6. I am copying this minute to the Chancellor of the Exchequer, the Foreign and Commonwealth Secretary, the Chief Secretary to the Treasury, and Sir Robert Armstrong.

*Rummm*

*Approved by the Defence  
Secretary & signed in*

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Ministry of Defence  
20th May 1983



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Treasury Chambers, Parliament Street, SW1P 3AG

4/11/83

Dear Andrew

At this morning's meeting Ivan Wilson undertook to provide a slightly revised version of the Treasury note sent you by Sir Kerr yesterday. It is to be handed to Mr Heseltine if the PM thought it appropriate. This is attached.

One additional point to note - re para 10 - is that nearly half the defence budget is spent on equipment. A constant real level of spending of £8-9 billion a year will lead to the continuing enhancement of defence capability.

Sir Greig.



DEFENCE

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1. MISC 99's proposals - which will be accepted by the Treasury if they are accepted by Mr Heseltine - would mean giving defence £100m in 1984-85 and £106m in 1985-86 above the Treasury's starting position. These figures would leave the defence budget below 1983 Public Expenditure White Paper provision.
2. MISC 99 has made no proposal for 1986-87, on the ground that this is a matter for the Cabinet and not for a small group of Ministers to resolve. The Treasury's preferred position for 1986-87 would be to uplift an agreed non-Falklands 1985-86 figure by the 3 per cent cash factor applicable to all expenditure programmes and to build in no real growth above that; so as to arrive at a cash total (with 1986-87 Falklands costs on top), getting MOD away from their 'real' growth aspirations. On the MISC 99 basis this would give a Falklands-inclusive figure of £18,464m. 3 per cent real growth in 1986-87 would require an additional £530m, giving a total of £18,994m.
3. The Treasury believes that its 1986-87 figure would provide a wholly reasonable profile of defence expenditure over the next three years, with annual increases of £1.3 billion, £1 billion and £½ billion respectively in the successive years. These increases will be difficult enough to accommodate within public expenditure plans, given that the outcome of the bilaterals and of MISC 99 - defence apart - leave us short of our target by £87m in 1984-85, £408m in 1985-86 and £242m in 1986-87.
4. Defence is now the second largest programme - higher than health or education - and consumes 5.5 per cent of GDP. In absolute terms our defence spend is the highest in Europe. We have increased the defence budget every year since coming to office; five successive increases is

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precedented since World War II. Since 1978-79, defence spending has increased in real\* terms by over 20 per cent.

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7. Besides, MOD have had great difficulty in recent years in spending all the money provided. MOD have swallowed without difficulty the 7 July cut of £240m, plus £100m for the armed forces' and civil service pay; and still look likely to underspend this year.

8. The NATO 3 per cent aim is only an aim, like the UN aim that 0.7 per cent of GDP be devoted to overseas aid. It is not binding. Mr Heseltine has himself made this clear: he wrote to the Prime Minister in May "But the 3 per cent formula is, of course, a target not a binding commitment".

9. NATO, in any event, is unlikely to cause us difficulty. Other nations will be poorly placed to criticise the UK. The real problem is that other Allies do not follow the UK example. If they did, each European Ally would spend 5.5 per cent of GDP on defence (the current average is 3.8 per cent), and meaningless growth measures could be discarded.

10. We do not believe that, with a 1986-87 budget of over £18 billion, absence of real growth would have dire operational and industrial consequences.

a. MOD's internal plans last year assumed no growth at all after 1985-86. Mr Heseltine ought to revert to the force projections that satisfied his predecessor.

/ b.

\* GDP deflator basis



b. Real growth in military effectiveness can be achieved without an equivalent increase in input cost. MOD must exploit the substantial scope for increasing defence output by greater efficiency and value-for-money.

c. MOD have cried wolf before (notably in the 1981 Survey: even after making over £1000m of cuts in his 1982-83 programme, Mr Nott foresaw a "programme gap" of £200m - but the real problem in 1982-83 was to avoid a massive underspend). MOD costings are notoriously inaccurate. The margin of error for 1986-87 is too great to attach much reliance to claims of gloom and doom at this stage.

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11. We will need, of course, to agree a figure for 1986-87 in order to complete the expenditure review for the White Paper. But we will need, also, to agree a form of words to describe this figure.

12. The Treasury's aim will be to ensure that the defence planners will work to the agreed figure, so that our commitments do not grow out of step with the available resources, forcing us in future years into highly visible cutbacks or unplanned increases in expenditure at short notice. There will be no Treasury objection to describing in public the figure as provisional and subject to review like other PES figures, provided that firm instructions on the above lines are given to the defence planners.

13. So far as the NATO target is concerned we should point to our achievement since 1978-79, and our further plans up to 1985-86 and emphasise that thereafter real growth will come from increasing efficiency and outputs, not from expenditure input.

HM TREASURY

4 November 1983