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P.01149

PRIME MINISTER

Public Expenditure Survey 1983: Defence

BACKGROUND

... The basic figures are summarised in the note by officials circulated as MISC 99(83)3 (copy attached for ease of reference).

2. An agreed settlement was reached this morning at a bilateral meeting under the chairmanship of the Lord President for the years 1984-85 and 1985-86. The outcome is as follows:

	1984-85	£m cash 1985-86
MoD proposed provision	17,330	18,551
Treasury proposed provision	16,910	17,933
<u>Provision now agreed</u>	<u>17,010</u>	<u>18,040</u>
of which, Falklands	684	552

As you will see, the Treasury has conceded only £100 million out of the original gap of £420 million for 1984-85, and £106 million out of the original gap of £618 million for 1985-86.

3. To achieve this result the Secretary of State for Defence has withdrawn his bids for compensation for the 1983 pay review body awards and for inflation compensation. In the latter case the Treasury has conceded in return the following formula:

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"Alone of its public expenditure programmes, the Government's defence policy is currently expressed both in ~~volume~~ and cash terms. In order to fulfil the Government's commitments up to and including 1985-86, the cash provision will be reconciled year by year in the light of the volume requirement and of the most up to date forecasts of inflation and appropriate adjustments made."

The Treasury has also reduced the cuts it was seeking below baseline in 1984-85 (£167 million rather than £267 million) and in 1985-86 (£174 million rather than £280 million).

MAIN ISSUES

4. The purpose of your meeting is to settle the provision for 1986-87. The outstanding issue is whether there should be any increase on the 1985-86 figure over and above the increase resulting from the cash factor of 3 per cent which applies to all programmes.

5. The Secretary of State for Defence originally made a bid for an additional volume increase of 3 per cent. He is however now prepared merely to uprate by the 3 per cent cash factor, provided that this can be accompanied by a suitable form of words. The figures would run as follows:

	£m cash
Figure agreed for 1985-86	18,040
Less Falklands provision	552
	<u>17,488</u>
Plus 3 per cent cash factor	18,014
Plus Falklands provision already agreed for 1986-87	450
	<u>18,464</u>

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18714 2
19004
+ words ↙

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6. Looked at purely in terms of the figures this would be a substantial victory for the Treasury. It is only about £100 million above the Treasury's original proposal for 1986-87 and, because of the other bids already withdrawn, it is around £1.35 billion less than the MoD's original proposal for 1986-87.

7. The Secretary of State for Defence proposes however that the figure should be accompanied by the following form of words:

"The Government has not yet determined the provision for defence after 1985-86 which will be considered in the light of international developments and economic circumstances nearer to the time. The figure for 1986-87 is therefore that for 1985-86 (excluding Falklands provision) increased by the appropriate cash factor, together with £450 million to meet the costs of the Falklands commitment in 1986-87."

8. The Treasury do not like this approach because it leaves them vulnerable to claims for a volume increase at some time in the future. Their preference would be to concede a higher figure for 1986-87 in the hope that this could be made to stick in cash and that the Government's future policy on NATO commitments would be constrained like other policies by cash disciplines.

9. The Secretary of State for Defence is likely to argue that for the Government to commit itself now to a precise figure which is inconsistent with continuation of a 3 per cent volume commitment in 1986-87 would be damaging politically and would give the wrong signal to our NATO allies.

10. You will wish to keep in mind the danger (to which the Lord President gives considerable weight) that the Treasury's approach might lead to the worst of both worlds, ie a firm commitment now to some volume increase in 1986-87, adverse reactions from abroad and from the defence lobby, and the need for reassurances eventually which had the effect of maintaining the full 3 per cent volume commitment to NATO.

Handwritten notes and calculations on the left margin, including a large arrow pointing to paragraph 7 and various numerical scribbles.

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HANDLING

11. You will wish to begin by saying that the purpose of the discussion is not to re-open the decisions already taken about 1984-85 and 1985-86 but to see whether the position for 1986-87 can be settled before Cabinet. You might invite the Secretary of State for Defence to put forward his proposals and then seek reactions from the Chancellor of the Exchequer and/or the Chief Secretary, Treasury.

CONCLUSIONS

12. You will wish to reach conclusions, if possible, on:
- i. the figure for 1986-87;
 - ii. if necessary, any accompanying form of words.

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P L GREGSON

4 November 1983

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PES 1983: DEFENCE

	£ million cash			
	<u>1983-84</u>	<u>1984-85</u>	<u>1985-86</u>	<u>1986-87</u>
Baseline	15719.6	17178.0	18214.4	18192.2
(of which Falklands)	(624.0)	(684.0)	:(552.0)	-
Agreed bid: Falklands				+ 450.0
<u>Disagreed proposals for increases/reductions</u>				
<u>MOD bids:</u>				
inflation compensation		+ 59.3	+ 240.0	+ 508.8
Service pay awards	+ 90.4	+ 93.1	+ 96.8	+ 99.7
1986-87 3% "real" growth				+ 564.1
<u>Total MOD bids</u>	+ 90.4	+ 152.4	+ 336.8	+1172.6
<u>Treasury proposals:</u>				
limit growth to 3% in 1984-85 and 1985-86	-	- 267.6	- 280.7	- 289.1
MOD proposed provision	15810.0	17330.4	18551.2	19814.8
Treasury proposed provision	15719.6	16910.4	17933.7	18353.1

Inflation bid

The MOD bid for inflation compensation is based on the March FSBR forecasts of inflation with an extrapolation for 1986-87 (5½%, 5% and 4½% respectively for 1984-85, 1985-86 and 1986-87). It is designed to maintain the real value of the Cmnd 8789 plans.

2. The Treasury view is that provision should continue to be based-as for other programmes - on the Cabinet agreed cash factors (5%, 4% and 3% respectively for 1984-85, 1985-86 and 1986-87). The autumn forecast for 1984-85 is likely to confirm that the cash factor of 5% is adequate. The cash provision for later years (1985-86 and 1986-87) can be reviewed in subsequent Surveys in the light of inflation and other economic factors.

Service Pay Awards

3. The MOD claim is that the defence budget should receive additional provision, in accordance with past practice, to meet the extra cost in all years of the 1983 AFPRB, TSRB and DDRB awards. In their view this is necessary in order to maintain the real growth in defence expenditure of the Cmnd 8789 plans.

4. The Treasury reject this bid, since in their view the 3% growth commitment can be honoured without accepting it and the extra costs can be accommodated by improved efficiency.

Limitation to 3% growth 1984-85 and 1985-86

5. The Treasury proposal is to limit growth to 3% per annum and no more in 1984-85 and 1985-86, in accordance with the statement in the Defence White Paper 1983 that "We remain committed to plan to implement in full the NATO target of 3% real growth in defence spending each year until 1985-86". In effect this means calculating 3% growth from the current 1983-84 provision (ie, after the July cash limit cut and excluding Falklands provision) rather than reverting to a higher baseline. If the cash limit reduction is not carried through the result will be real growth of more than 5% in 1984-85.

6. The MOD consider the Treasury proposal to be inconsistent with Government policy as stated in the 1981 White Paper Cmnd 8288, that "the intention will be provision for 1985-86 21% higher, in real terms, than actual expenditure in 1978-79". MOD calculate that, Falklands provision exclusive, the Treasury proposal would limit real growth in 1985-86 to 18½% over 1978-79. An increase of 5.2% in 1984-85 over the reduced 1983-84 provision is necessary to catch up on the path to 21%.

1986-87 growth

7. MOD point out that the agreement by NATO Heads of State and Government - reaffirmed in June 1983 - is to aim for real increases in defence spending of 3% a year up to 1990. MOD therefore bid for a full 3% real growth in non-Falklands provision in 1986-87.

8. The Treasury view is that the NATO guidance is not binding. After 1985-86 defence must take greater account of public expenditure and economic objectives. There should be no real growth after 1985-86 following increases of 3% in both of the preceding years. Defence provision should be planned in cash like other programmes.

Manpower

9. The Chief Secretary has proposed an MOD manpower target of 170,000 for 1 April 1988. This would represent a reduction (ROF privatisation exclusive) of 6.3% on the 1984 MOD target, which would be consistent with contributions from other major departments. The MOD see the reduction as effectively 8.8% because of the need to provide for unavoidable growth.