

SECRET



10 DOWNING STREET

*From the Private Secretary*

20 October 1983

PUBLIC EXPENDITURE SURVEY: DEFENCE

The Chancellor of the Duchy will shortly be starting work as one of the Lord President's group of Ministers which will be considering the outstanding public expenditure issues. The largest item on their agenda will be the defence budget. Material on this will be circulated by the Treasury in due course. Meanwhile, the Chancellor of the Duchy might like to have, for his personal use, a note produced by the Policy Unit setting out the figures and arguments on the defence budget.

I am sending a copy of this letter and its enclosure to Peter Gregson (Cabinet Office).

(ANDREW TURNBULL)

Alex Galloway, Esq.,  
Chancellor of the Duchy of Lancaster's Office.

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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	+340	+1620
Chief Secretary	-270	-280	+ 160
Total	420	630	1460

The MoD's and Chief Secretary's bids for 86/87 include... an agreed settlement of £450m for the Falklands.

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			450 (agreed bid)
3% real growth			560
Total	150	340	1620

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 £684m and £552m respectively. Public and Parliamentary expectation is that Falklands costs will decline after 1986/87. Treasury and MoD have agreed a bid of £450m for 1986/87.

### 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			450 (agreed bid)
Total	-270	-280	+160

\* 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.



## 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:

	<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 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.

	<u>Expenditure</u>	<u>per capita</u>	<u>%GDP</u>
		\$ 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.

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Your Ref

**with compliments**

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Message for Turnbull

It is clear from the newspapers that efforts are being made to obscure the decisions on defence by implying that 1986-87 is not yet firmly settled. This must be stopped. No.10 and Treasury Press Officers must say.

" Firm decisions have been taken by Cabinet on cash provision for defence in all three Survey years, including 1986-87. The figure for the first year 1984-85 will be announced by the Chancellor in his Statement next week. Later years figures will be given as normal in the public expenditure White Paper."



Mr Turnbull



10 DOWNING STREET

Andrew

Just a minor point.  
On my revised Defence  
paper (20 Oct) I  
failed to remove

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

on P 3 even though the  
attending figure has been  
corrected.

David Russell  
told P Gregson  
& CDK's office.