

pa public expenditure

Treasury Chambers
Parliament Street London SW1P 3AG

Telex 262405

Telephone Direct Line 01-233 5746
Switchboard 01-233 3000

D R Norgrove Esq
10 Downing Street
LONDON
SW1

Your reference

Our reference

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*Dear David,*DEFENCE EXPENDITURE AS A PROPORTION OF GDP

I promised to let you have the figures for defence expenditure as a proportion of GDP in 1988-89 on the assumption of level real terms provision.

This is in the attached note (outcome D), which also refines the figures for other possible outcomes in the earlier DM note. The figures in the latter were more heavily rounded, and constrained to be close to those calculated by MOD (so that if the Chief Secretary and the Secretary of State for Defence had returned to the issue in the second bilateral, they would at least have been using the same figures). For the same reason, the earlier note used MOD's figures (published in evidence to HCDC) for the earlier years, including 1978-79. However, these were calculated last December: recalculating using the latest GDP estimates would produce a ratio of 4.34 for 1978-79.

That aside, the revised figures confirm that whatever the outcome the GDP ratio will be within a fairly narrow range and will have fallen quite markedly compared with the earlier years of this decade.

*Jams**Frank*

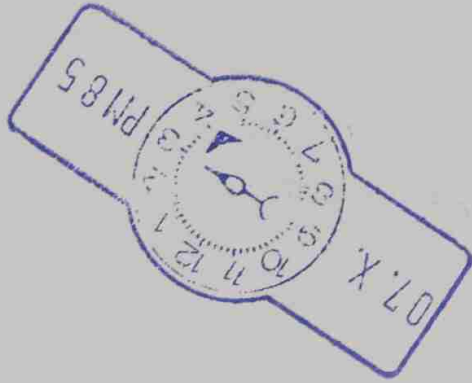
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DEFENCE EXPENDITURE AS A PROPORTION OF GDP

Percentage of GDP at market prices	<u>1988-89</u>
Outcome A: Baseline plus Falklands costs	4.54
Outcome B: Baseline plus <u>all</u> MOD bids	4.71
Outcome C: Baseline plus Falklands costs less Treasury reductions (£600m)	4.40
Outcome D: Baseline plus Falklands costs plus Inflation adjustment (£464m) ¹	4.65

Note: ¹ Sufficient to provide level real terms provision after 1985-86



*Defense briefing, for public
expenditure file. RW 2/10*

if it were a fund built up from contributions made in the past; and since the past pensions paid under the PCSPS have already scored as public expenditure as a proxy for those contributions, it would be double counting to score the transfer payment itself as public expenditure.

5. The proper treatment of the PCSPS in public expenditure was discussed briefly in the Review of Public Expenditure Classifications (REPEC) but no firm conclusion was drawn and the issue is still being considered. It is argued by some, that where a scheme is non contributory (ie pay as you go) such as the PCSPS pensions actually paid under the PCSPS should score as public expenditure -as that reflects the reality of annual cash expenditure. However, such treatment would ignore the fact that pensions paid in any one year reflect liabilities built up in the past. For this reason, others argue that what should score as public expenditure is a proper actuarial estimate of the contributions that would be necessary, if the PCSPS were funded, to pay the future pensions of presently employed civil servants.

6. This argument is not yet resolved, and so we should follow the present treatment - which has the virtue of being consistent with past practice and with the national accounts. The attached note which has been prepared by GEP describes and defends this treatment. If you are content, I will send it to the TCSC.

RICHARD PRATT

UK DEFENCE EXPENDITURE AS A PROPORTION OF GDP

Mr Heseltine's line of argument at the 17 September bilateral was that, if the Treasury has its way (that is, if all Mr Heseltine's non-Falklands bids fail and if the Treasury reductions in the existing baseline are implemented), by 1988-89 UK defence expenditure would only be the same proportion of GDP as in 1978-79, the last year of the Labour Government. His argument was that this would be politically indefensible.

2. The attached table provides figures for defence expenditure as a proportion of GDP over the 1978-79 to 1988-89 period, with the figures for the Survey years on three alternative bases - A, present baseline plus Falklands costs 1988-89; B, baseline plus all MODs bids; and C, baseline plus Falklands costs but less Treasury option reductions. The figures confirm that Mr Heseltine's basic comparison is broadly correct; if C is the outcome of the Survey, defence expenditure in 1988-89 will be much the same proportion of GDP as in 1978-79 (when the ratio was the lowest in the post-war period).

3. But arguably the comparison is fairly meaningless. It ignores the substantial growth in defence expenditure in the period up to 1985-86, and the fact that the later decline in the GDP ratio primarily reflects the relatively healthy (2 per cent a year) GDP growth currently forecast. It is hardly a point of criticism that, defence expenditure having been raised to a much higher level in absolute terms, it falls as a proportion of GDP mainly because of the growth of the latter. This is leaving aside the fact that even a ratio of 4.5 per cent in 1988-89 would be likely to be significantly higher than those of our major European allies - France currently has a ratio of 3.4 per cent and Germany 3.3 per cent. In this context it might be noted that the commitment in the 1983 Labour Manifesto was:-

"Labour will reduce the proportion of the nation's resources devoted to defence so that the burden we

bear will be brought into line with that of other major European NATO countries..."

4. Nevertheless, Mr Heseltine's comparison touches on an important issue for defence in the Survey - the political presentation of the resulting totals. If the Treasury has its way the programme will be declining quite markedly in real terms over the Survey period - by 2 per cent in 1986-87 and 1987-88, and a further 1.5 per cent in 1988-89. This is likely to cause concern to some Government supporters and, arguably, to provide the Opposition with more ready ammunition than comparisons of GDP ratios. The following therefore attempts to provide counter-arguments to both potential lines of criticism.

Government planning to spend a lower proportion of national wealth on defence than did last Labour Government?

- We will be spending a lower proportion of our national wealth on defence because our national wealth will grow substantially;

- both in cash and after adjusting for inflation, during our term of office we have massively increased the resources devoted to defence - in 1985-86 defence spending is £18 billion, compared with the £7.5 million spent by the Labour Government in 1978-79. In real terms we have increased spending by nearly 30 per cent, adding nearly £4 billion a year to the defence budget;

- and we will continue to spend a much bigger proportion of our national wealth on defence than other major European countries.

Defence spending planned to fall in real terms?

- since Government took office, defence spending has increased by nearly 30 per cent in real terms. In cash terms, spending has more than doubled, from £7.5 billion in 1978-79 to £18 billion in 1985-86.

- this is a massive step increase in defence expenditure, the bulk of which will run on to future years. In 1988-89 defence spending will still be 18 per cent higher in real terms than in 1978-79 and the programme will still have some £2.8 billion more cash a year than if the 1978-79 level had been maintained level in real terms;

- the result is more men and women in the Forces, better paid and better equipped.

5. Finally it is worth noting that Mr Heseltine played this political card in the 1984 Survey. The No 10 letter of 1 November 1984 recording the outcome of the Prime Minister's meeting on defence expenditure includes the following:-

"The Secretary of State for Defence said that he was not arguing that Britain's defence needs could not adequately be met within the provision recommended.... The problem he faced was a political one...."

"The Secretary of State for Defence said that if he accepted the Group's offer on figures and words, it would be essential to present the Government's case to the defence constituency with greater vigour... The Prime Minister assured him that he would have the full support of colleagues in this."

ANNEX: DEFENCE EXPENDITURE AS A PROPORTION OF GDP

<u>Financial Year</u>	<u>Percentage of GDP at market prices</u>		
1978-79*		4.4	
1979-80		4.5	
1980-81		4.8	
1981-82		4.9	
1982-83		5.1	
1983-84		5.1	
1984-85		5.3	
1985-86		5.1	
	<u>1986-87</u>	<u>1987-88</u>	<u>1988-89</u>
Outcome A: Baseline plus Falklands costs 1988-89	4.9	4.7	4.6
Outcome B: Baseline plus <u>all</u> MOD bids	5.0	4.9	4.8
Outcome C: Baseline plus Falklands costs less Treasury reductions	4.8	4.6	4.5

* The lowest ratio in the post-war period. But throughout the 1970s defence expenditure was a comparatively low proportion of GDP, the highest ratio during that decade being 4.8 per cent.

UK DEFENCE EXPENDITURE: SOME FACTS AND FIGURES

How we compare

- In absolute terms, UK spends more on defence than any other European country - in 1984, \$22.7 billion compared to \$20.4 billion in Germany and \$20.1 billion in France;

- UK spends more as a proportion of GDP than these other major European countries - in 1984, 5.3 per cent, compared to 3.4 per cent for France and 3.3 per cent for Germany;

- and we also spend more per head than these countries - \$405 in 1984, compared to \$370 in France and \$330 in Germany;

- Moreover, the UK spends a higher proportion of its defence budget on equipment than any other NATO country, including the US.

The record since 1978-79

- over the 1978-79 to 1985-86 period defence spending has grown by 150 per cent in cash terms. This year the UK is spending £18 billion, compared with £7.5 billion in 1978-79:

- over this period, spending has increased by 29 per cent in real terms (using GDP deflators, not MOD's unreliable price indices);

- the result of this real growth is that the defence budget now has £4 billion more cash a year than if the 1978-79 provision had been maintained level in real terms. Even MOD admit to a £3 billion a year cash increment;

- spending on defence equipment has grown even more strongly. In 1985-86 it is £9.1 billion, compared with £3.3 billion in 1978-79:

- in real terms, equipment expenditure has grown by 48

per cent over this period, providing an annual cash addition of nearly £3 billion;

- and over the period defence spending has also taken on increased share of total public expenditure. In 1985-86 the defence budget is 13.7 per cent of total public expenditure, compared with 11.4 per cent in 1978-79.

What the money has bought

- More service personnel. In 1985, UK Regular forces total 326,000, compared with 315,000 in 1979. Reserve and Auxiliary forces total 203,000 compared with 180,000.

- the second largest navy in NATO, an air force almost as large as those of France and Germany and an all-professional army. All benefitting from a major and continuing re-equipment programme.

Manifesto commitments

The attached annex reproduces the commitments on defence in the 1979 and 1983 Conservative manifestoes.

ANNEX: EXTRACTS FROM CONSERVATIVE MANIFESTOES1979 Manifesto (page 29)

IMPROVING OUR DEFENCES

During the past five years the military threat to the West has grown steadily as the Communist bloc has established virtual parity in strategic nuclear weapons and a substantial superiority in conventional weapons. Yet Labour have cut down our forces, weakened our defences and reduced our contribution to NATO. And the Left are pressing for still more reductions.

We shall only be able to decide on the proper level of defence spending after consultation in government with the Chiefs of Staff and our allies. But it is already obvious that significant increases will be necessary. The SALT discussions increase the importance of ensuring the continuing effectiveness of Britain's nuclear deterrent.

In recent times our armed forces have had to deal with a wide variety of national emergencies. They have responded magnificently despite government neglect and a severe shortage of manpower and equipment. We will give our servicemen decent living conditions, bring their pay up to full comparability with their civilian counterparts immediately and keep it there. In addition, we must maintain the efficiency of our reserve forces. We will improve their equipment, too, and hope to increase their strength.

1983 Manifesto (page 43)

We have substantially increased our defence expenditure in real terms. We have honoured our promise to give our regular and reserve forces proper pay and conditions and the equipment they need to do the job.

There could be no greater testimony to the professional dedication and the quality of equipment of the British Armed Services than the brilliant recapture of the Falkland Islands in just 74 days. We take pride in their achievement.