

## PRIME MINISTER

## PUBLIC EXPENDITURE SURVEY: DEFENCE

The Chief Secretary's first minute (Flag A) sets out the overall position he has reached. Additions to programmes will be to £11½/15/18 billion. Final decisions have yet to be taken on the size of the reserve and the figure for privatisation proceeds. The net effect might be additions to the planning total about £3 billion lower in each year, allowing the figure to squeeze, just, below £200 billion in 1991-92. The ratio to GDP will rise from 38 ¾ per cent this year to 39½ per cent next, and remain there over the rest of the Survey period. This is still 4 points lower than you inherited and still at the levels of the mid 1960s.

The sole programme unsettled is Defence. The CST is anxious to get the best outcome possible here. Although he claims an outcome below Mr. King's latest offer would help improve the ratio, in practice the difference between them (£250 million) is hardly large enough to affect ratio. The real reasons are the comparisons with other programmes and the desire to show some benefits from the defence reductions announced in July.

The Chief Secretary has sent a separate minute (Flag B) on Defence. To this he has attached the draft of a minute (Flag C) he would like to send you, but before committing himself to it and copying it to Mr. King he would welcome a pointer from you.

The positions are summarised in the Annex (Flag D). Mr King's "final" offer was

<u>22,770</u>	<u>23,400</u>	<u>23,400</u>
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The Chief Secretary's "final" offer was

<u>22,720</u>	<u>23,300</u>	<u>23,150</u>
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but Mr. King has also offered an extra 100 off either year 2 or year 3. If this were applied to year 2 the gap between them would be

50

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250

The Chief Secretary then adopts a rather unusual procedure. He says that if he were going to Star Chamber he would have reverted to a lower offer

22,670

23,100

23,000

on the grounds that those going to Star Chamber should not have the assurance of doing better than they would have done in bilaterals. He therefore recommends this lower line to you.

The defect of this the way of proceeding is that he is not going to Star Chamber but seeking a bilateral settlement, albeit with your help. He is expecting that he can take his final offer off the table without expecting Mr. King to do the same. He has also revealed to the arbitrator what his negotiating point is.

You need to take a view on three issues

- (i) What view do you take of the positions reached.
- (ii) Should the Chief Secretary minute in these terms.
- (iii) Where do you think the settlement should emerge.

(i) Assessment of the positions

The Chief Secretary argues that Mr. King's bid is still too high because

- in year 2 it shows a cash increase over baseline of £445 million at a time when the public will expect defence expenditure to be declining (all this is without prejudice to any extra expenditure needed in the Gulf). £115 million

of the increase is the war widows decision, £35 million is expenditure on the intelligence agencies, and £135 million an accounting adjustment on rates. You should also bear in mind that the price level in 1991-92 will be 4½ per cent higher than envisaged a year ago, but the increase over previous plans is only 2 per cent. So there is a real cut of 2½ per cent.

- by 1993-94, on Mr. King's figures, spending is £2 billion higher in cash terms than in the current year (with a possible claim on the reserve of another £300 million though this will not be shown in the figures). But in real terms this is 5 per cent less than in the current year.
- there are a host of ways in which savings could be made which do not impinge on policy e.g. research, general efficiency savings, procurement.

(ii) The Chief Secretary's minute

I do not think a minute to you in the style of a Star Chamber position paper is the best way to proceed. It will cause Mr. King to readjust his position and take us away from a settlement. It would be better to set out his offer and use the arguments about efficiency etc. as evidence for why Mr. King can meet him without suffering dire consequences.

✓ (iii) A possible outcome

In year 1 the two are 50 apart. For a programme of this size they could be asked to split the difference. If Mr. King's further offer of £100 million is applied to year 2 the gap is eliminated. The gap remaining is 250 million in year 3. You could ask Mr. King if he could meet the Chief Secretary half way in year 3 as well, to settle at £23,275 million. This would be a cash increase over the current year of 8.9 per cent compared to an increase in prices of 14.9 per cent.

