SECRET

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PART 7 42.41

Confidential Filing

Defence Budget
Defence Exp. 80-81
UK Military Asst. Scheme (UKTMAS)

DEFENCE

PART 1 May 1979

PART 7 JULY 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
(new cover) 12.2.82							

S 806

PREM 19/687

PART 7 ends:-

CAW to PM of 12/2/82.

PART 8 begins:-

S/S MOD to PM of 1/3/82.

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(81) 26th Conclusions, Minute 2	2.7.81
OD (82) 1st Meeting, Minutes	27.1.82
OD(82) 2	21.1.82
OD(82) 3	21.1.82
OD (82) 4	25.1.82

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed C Wayland Date 9 August 2012

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

House of Commons Hansard,
7 July 1981, columns 274 - 288
"Defence Programme"

Signed CWayland Date 9 August 2012

PREM Records Team

CONFIDENTIAL

2

PRIME MINISTER

Defence and the Public Expenditure White Paper

I attach immediately below the Chief Secretary's response to Mr. Nott's minute to you about what should be said about defence in the Public Expenditure White Paper (Flag A).

I understand that Mr. Brittan's reply produced, predictably enough, a strong reaction from Mr. Nott who promptly drafted a very stiff answer himself. He has been dissuaded from sending it, and his officials are now preparing something more reasonable.

In the meantime discussion between Treasury and MOD officials has led to the Chief Secretary agreeing in the course of the day that the words "in full" which he had sought in his letter below to omit should be allowed to stand in the text.

His other reservation - about the words "the basis" - is not likely to cause any problem.

MOD officials will be reporting all this to Mr. Nott over the weekend. Subject to his concurrence, we now have an agreed text for the White Paper.

But I am afraid that this is not an end to the matter. Mr. Nott's officials expect that he will still insist on returning to the charge on the general points made by the Chief Secretary in the penultimate paragraph of his letter, and that is why they are drafting the minute to which I have referred in paragraph 2 above. It may be when we see this minute that we shall have to advise you to intervene in the correspondence to try to bring the exchange to a conclusion.

AW.

12 February 1982

CONFIDENTIAL

Prime Minister

This should, surely, settle the dispute?

MCS 11/2

cc AD
JV.
2 PPS

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon John Nott MP
Secretary of State
Ministry of Defence
Main Building
Whitehall
London SW1A 2HB

11 February 1982

Dear John,

Thank you for sending me a copy of your minute of 9 February to the Prime Minister about the problems you perceive in relation to the defence chapter of this year's draft Public Expenditure White Paper.

The form of words for the White Paper, annexed to your minute, omits a second sentence which I wished to include in the Part 2 piece; that is, "The cash provisions throughout the planning period are intended to reflect this commitment". But, in the interests of securing agreement, I am prepared to accept your drafts subject to the deletion of "in full" in line 2 of the Part 2 piece, and of "the basis" in the second sentence of the Part 1 piece. I would expect you to follow a similar line in dealing with this issue in the Statement on Defence Estimates.

The figures in the White Paper are of course those that were agreed in November; these formed the basis of Sir Robert Armstrong's minute of 2 December, and were quoted in paragraph 2 of my memorandum OD(82)4. These decisions should not be reopened now.

I do not share your view of the gravity of the arithmetical problem over the later years' figures. As Sir Robert's minute records, we agreed in November to additions to the defence budget totalling £1250m as follows:

	1981-82	1982-83	1983-84	1984-85
£M	300	375	325	250

It was quite apparent when this agreement was reached that the additions for 1983-84 and 1984-85 were not 3% higher than the £375m increase agreed for 1982-83. But this was because the 1982-83 increase was disproportionately large. The 1982-83 increase was disproportionately large because the problem in that year was so acute; I accepted the need for higher expenditure in the estimates year because of the understandable transitional difficulties being

encountered in reshaping the defence programme. It would indeed be unfortunate if the particularly favourable treatment enjoyed by defence in 1982-83 were to be misconstrued by some of our supporters; but I would hope that, with proper presentation, this problem can be overcome. By any criteria, the defence effort postulated by expenditure plans rising from £14bn in 1982-83 to £16.5bn in 1984-85 has to be an impressive one.

More generally, it has to be recognised that there are inevitable difficulties in seeking to reconcile fully our decision to plan to implement the NATO 3% aim with the Government's commitment to cash planning and cash limits; the former is a "volume" target, whereas programmes have to be planned and managed in cash. Once cash totals have been agreed, however, programmes have to live within them. The cardinal principle of cash planning is that levels of service must be determined in the light of the finance available; and this principle must apply to defence as much as to other programmes.

I am copying this minute to the Prime Minister, the Chancellor of the Exchequer, the Chief Whip and to Sir Robert Armstrong.

Leon

LEON BRITTAN

Prime Minister
MCS 9/2
cc AW
AD
JV

A

MO 8

p.a. M 11/2

PRIME MINISTER

PUBLIC EXPENDITURE WHITE PAPER: DEFENCE

The Defence Chapter of the draft Public Expenditure White Paper is likely to cause the Government a major problem.

2. In July Cabinet agreed a forward Defence Programme based on a 3% volume growth until 1985-86. The programme was framed in volume terms in accordance with the methods prevailing at that time and it was accepted that it should be sustained in volume terms until 1985-86 by a "fair translation of the volume figures into cash". The Public Expenditure White Paper now proposes publishing "provisional" figures involving only 2.3% real growth in the later PESC years. If this is now to be the planning assumption for the later years - provisional or not - then the basis of the Defence Review has been undermined and equally important, the central feature which led to the Party's acceptance of the defence cuts will seem to have been abandoned.

3. This is a major issue of substance which I believe I must bring to your personal attention. The points which concern me are well brought out in the enclosed letter which my Permanent Secretary sent to Sir Anthony Rawlinson. I believe that the Chief Whip may communicate to you separately giving his view, which I share, of the impact of this question on the Party.

4. If the figures are to be put right then additions are needed of £100M in 1983-84 and £214M in 1984-85. Such figures would, of course, not represent a final commitment by the Government since they would be subject to review in the next Public Expenditure Survey but they would allow us to say that the cash provision for

defence was enabling us to plan to implement the NATO 3% aim. If, however, the figures were to remain as currently proposed in the draft White Paper then we certainly could not describe them as fulfilling the 3% commitment, which is what the present text says.

5. Since Sir Frank Cooper wrote his letter, MOD and Treasury officials have looked again at the text to try and find a way of making it consistent with the figures. Copies are enclosed of their revised wording of the two paragraphs in the PEWP which cause me most concern - paragraph 14 of Part I and paragraph 3 of the Defence Chapter. I have to say that even stressing the provisional nature of the figures in this way does no more than try to conceal the major issue of substance.

6. I am sending copies of this minute to the Chancellor of the Exchequer, the Chief Secretary, the Chief Whip and to Sir Robert Armstrong.

SN

Ministry of Defence
9th February 1982

ANNEX

REVISION OF PARAGRAPH 3, CHAPTER 1 TO PEWP PART 2

The Government adheres to its commitment to plan to implement in full the NATO aim of real increases in defence spending in the region of 3% a year. The figures for 1983-84 and 1984-85, as for all other programmes, are provisional and will be reviewed in the 1982 Survey in the light of this commitment, the economic circumstances and prospects at the time and all other relevant factors.

NEW DRAFT PARAGRAPH 14 TO PEWP PART 1

Provision for defence is intended to reflect the Government's firm decision to aim for real increases in the region of 3% a year in line with the NATO target. Additional provision has been made for 1982-83 and the subsequent two years to cover the cost of carrying forward the 1981 Armed Forces Pay Award and to provide the basis for the restructuring of the defence programme described in "The Way Forward" (Cmnd 8288).

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MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1A 2HB
Telephone 01-218 2193 (Direct Dialling)
01-218 9000 (Switchboard)

PERMANENT UNDER-SECRETARY OF STATE.
SIR FRANK COOPER GCB CMG

PUS/82/118
20/1

Sir Anthony Rawlinson KCB
HM Treasury
Parliament St
London SW1

29 January 1982

Dear Anthony.

I am worried that it has not yet proved possible, despite Ministerial correspondence, to draft the Public Expenditure White Paper in such a way as to be acceptable to both our Departments. As you know, my Secretary of State is personally involved in the matter and I believe that he will wish to raise it with the Prime Minister when he returns next Wednesday from his visit to Italy. I very much hope you will agree therefore that we should use the few days to seek to agree at official level upon a text which we can both recommend to our Ministers.

2. The essence of our position is that the figures contained in the draft White Paper show growth (on the basis of the cash planning factors of 6% and 5%) of about 2.3% only in 1983/84 and 1984/85; that any competent observer will be able to work out these figures; and that Defence Ministers could not possibly refuse to translate the cash figures into constant price terms for Parliament (eg in the Statement on Defence Estimates for which there is a standing request by the HCDC), let alone for NATO whose staff can readily work out the figures. Accordingly we could not support a text which stated that the cash figures are in line with the 3% commitment. This simply would not be true.

3. The Treasury position, as I understand it, is that in an era of cash planning it is neither appropriate nor possible (since there are no agreed forecast deflators) to translate the cash figures into constant price terms; that our line will have to be that the cash plans will enable 3% real growth to be achieved but that there are no planned constant price figures to substantiate this; and that Parliament and NATO will have to accept this.

CONFIDENTIAL

4. I must say that I find the position puzzling. I do not see how it can be claimed that the cash figures cannot be translated into constant price terms when they were derived in the first place from plans expressed in constant prices by the application of cash planning factors put forward by the Treasury as the best available. If those factors were good enough for the construction of cash plans, they must be good enough for deflating those plans to constant prices. And, in any case the Treasury's own statement that the cash provision is in line with the commitment to 3% real growth (though incorrect) could only be made if deflators were available.

5. To refuse to give constant price equivalents of our cash plans would be interpreted as resiling and a cover-up. The credibility of the 3% commitment as reaffirmed in Command 8288 would be very quickly undermined if we claim that the published cash provision is in line with 3% real growth but refuse to reveal the underlying figures that support that claim. I know that my Secretary of State would not be prepared to adopt that position.

6. The problem seems to me to stem from an apparent conflict between the twin objectives of cash planning (which the Ministry of Defence accepts and supports) and of a planned 3% real growth commitment in defence. Both are important aspects of Government policy and we should seek not to allow them to work against each other but to reconcile them.

7. On a smaller point, I know that my Secretary of State will not find it possible to accept the wording of the second sentence of Paragraph 14 of Part I of the White Paper which on any account seems unnecessarily tendentious.

8. I shall myself be in Italy next Monday and Tuesday with Mr Nott but Desmond Bryars stands ready to try and find a sensible accommodation.

9. I have sent a copy to Robert Armstrong together with the relevant Ministerial correspondence.

Yours ever
Frank Cooper

FRANK COOPER

Defence

Government Chief Whip
12 Downing Street, London SW1

CONFIDENTIAL

PRIME MINISTER

I am considerably alarmed by reports that a question has arisen over our ability to maintain annual growth in defence at 3% in the years 1983-4 and 1984-5.

As I understand it, there is a difference between John Nott and Geoffrey Howe on the cash figure for this year and the amount which the Treasury are proposing will not, in fact, achieve a 3% growth.

My principle concern is not with the merits of the arguments but rather with the effects on the Party both in the House and in the Country generally. Two of our main electoral promises were increased expenditure on Defence and law and order.

Through no fault at all of the Home Secretary, the law and order situation in the Country has deteriorated as evidenced by the riots in the cities last year and the increasing levels in crime. Our backbenchers are increasingly unhappy on this.

Our backbench Defence Officers are already giving the Department a very rough ride. They will be increasingly uneasy later this week at the Dreadnought announcement. If, within a few weeks we announce that we are climbing off our NATO commitments, I predict there will be very serious trouble.

I must urge that if we are going to take this step; then Cabinet ought to be aware of it, before we announce it.

9th February 1982

From: N J S Abbot,
Private Secretary to Sir Arthur Hockaday KCB CMG

010

2ndPUS/87/82

Defence

MINISTRY OF DEFENCE

Main Building, Whitehall, London SW1A 2HB

Telephone (Direct Dialling) 01-218 - 7115

(Switchboard) 01-218 9000

4 February 1982

C Priestley Esq
Cabinet Office
70 Whitehall
SW1A 2AS

Dear Clive,

VEHICLE SALES

Sir Arthur was sorry to learn of the embarrassment caused you by an enquiry from Lord Orr-Ewing about the current state of play on the possible commercialisation of MOD vehicle sales.

2. In fact all past investigations (including the most recent) of the relative financial advantages of commercialisation and the continuation of the present arrangements for vehicle disposals have resulted in comparative figures which were very finely balanced. Had the matter come to a decision last year it is by no means clear that there would have been any good grounds for making a change from present practice. Lord Orr-Ewing is therefore mistaken if he believes - as apparently he does - that MOD is simply temporising over the implementation of a self-evidently reasonable and desirable change in vehicle disposal policy.

3. In the course of last year's study, however, the issue also came to be looked at as part of a broader perspective of possible changes in our logistics and support arrangements; and it now seems possible that new factors strictly extraneous to the consideration of the rival arguments on their own merits may tip the balance in favour of commercialisation.

4. In replying to Lord Orr-Ewing it would be helpful if you could make these points to him. However, wider questions to which I have referred above are not yet resolved. On present indications it looks reasonable to expect a decision within the next few months; but it would probably not be wise to make any promises.

5. Finally I am afraid that we do owe you an apology for not keeping your office in the picture on all this. I shall be sending copies of this letter to interested parties in MOD with a reminder of the need to do so in future.

MLS. → 6. A copy of this goes to Willie Rickett at No. 10.

Sec

Yours sincerely,

Norman Abbot

THE RT. HON. DAVID STEEL, M.P.

R312

HOUSE OF COMMONS
LONDON SW1A 0AA

2.

Prime Minister,

MT.

2nd February 1982.

Dear Prime Minister,

Thank you for your letter of 1st February, which I received with some astonishment.

It was quite clear from the last occasion organised by your predecessor that the defence briefing was purely factual, whatever our differing opinions on defence policy may be. But I am grateful that the decision of the Leader of the Opposition not to take part will not affect its being held.

Yours ever,

David Steel

The Rt. Hon. Mrs. Margaret Thatcher, M.P.,
The Prime Minister,
10 Downing St.,
London SW1.

P.S. No reply needed
DS.

From: Mr D O Arnold-Forster

NBPM
2/2

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1A 2HB
Telephone 01-218 2394 (Direct Dialling)
01-218 9000 (Switchboard)

PARLIAMENTARY UNDER-SECRETARY OF STATE
FOR THE ARMED FORCES

D/US of S(AF)/JW/19/1/1

2 February 1982

Dear Willie,

REORGANISATION OF THE NAVAL MEDICAL SERVICES

The Prime Minister may wish to be aware that it is proposed to include in the Statement on the Defence Estimates 1982 (SDE 82) an announcement on the lines of the attached, making entry to Queen Alexandra's Royal Naval Nursing Service open to both men and women from 1 April 1982. These new arrangements will, for the time being, give male Naval Nurses the opportunity to compete for commissioned appointments in their profession, a change which has been the subject of Parliamentary interest over the years. Similar arrangements have already been adopted by the Army and Royal Air Force. A copy of the proposed Order in Council which will give effect to these changes is also attached.

It is proposed that SDE 82 should also refer to the greater career opportunities now being offered to ratings serving in the para-medical disciplines, eg Physiotherapists, Radiographers etc. There have been few opportunities in the past for such specialists to serve in their chosen discipline on promotion to Officer rank and they have generally been employed in medical administration. Such an arrangement did not use their expensively acquired skills to the best effect and we have now been able to identify a number of rating appointments which are fully deserving of Officer status. This recognises both the high academic standards for entry and the level of skill exercised thereafter. A new range of commissions is necessary to fill these posts. They will be open both to serving ratings on promotion and to fully qualified specialists from the National Health Service. NHS staff will also be eligible to apply for posts in medical administration which, in the past, were often filled by promoted para-medical staff referred to earlier.

Whenever a new Commission is introduced it is the practice to inform the Sovereign and the Defence Services Secretary will inform the Palace on the lines of the attached draft in the near future.

Yours Ever,

David

Private Secretary

W Rickett Esq

AT3(DP)/273/3
dated 9 Dec 81

E1

For STATEMENT ON DEFENCE ESTIMATES 1982

The Royal Naval Medical Service

From 1 April 1982, entry to Queen Alexandra's Royal Naval Nursing Service will be open to both men and women. From the same date, a number of para-medical posts will be upgraded to officer status to take account of the high academic standards and levels of skills now required. These posts will also be open to both men and women, including those who have obtained suitable qualifications in civilian life and who wish to enter the Royal Navy on Short Service Commissions.

E3

DRAFT

AT THE COURT AT BUCKINGHAM PALACE

THE DAY OF 1982

PRESENT

THE QUEEN'S MOST EXCELLENT MAJESTY

IN COUNCIL

Whereas by His Order in Council of 6 March 1902, His late Majesty, King Edward VII, was graciously pleased to approve that the Staff of Nursing Sisters in Naval Hospitals should be designated, "Queen Alexandra's Royal Naval Nursing Service" and should be entitled to wear a badge in the manner and form prescribed in the said Order:

And whereas from time to time ranks and titles of officers of the aforesaid Service and changes thereto, have been authroised by subsequent Orders in Council:

And whereas it is expedient that the opportunity of service, in a nursing capacity in the Queen Alexandra's Royal Naval Nursing Service should also be offered to suitable male persons and that the titles of the officers in the aforesaid Service should be amended accordingly:

Now, therefore, Her Majesty is pleased, by and with the advice of Her Privy Council, to Order, and it is hereby ordered, that suitable male persons shall be afforded the opportunity of service in the Queen Alexandra's Royal Naval Nursing Service, that all persons so entered and employed shall be entitled to wear the prescribed badge, and that the titles of the officers specified in the first column of the annexed Schedule shall be altered to those set out in relation thereto in the second column thereof.

N E LEIGH

D/NMT/110/8/160

SCHEDULE

TITLES OF OFFICERS OF THE QUEEN ALEXANDRA'S ROYAL NAVAL NURSING SERVICE

First Column Existing Titles	Second Column New Titles
Matron in Chief	Matron in Chief and Director of Naval Nursing Services
Principal Matron	Principal Nursing Officer
Matron	Chief Nursing Officer
Superintending Sister	Superintending Nursing Officer
Senior Nursing Sister	Senior Nursing Officer
Nursing Sister	Nursing Officer

KMcC/1C1

DRAFT FOR DEFENCE SERVICE SECRETARY TO SEND TO BUCKINGHAM PALACE

1. The Admiralty Board has been concerned for some time at the lack of opportunities for highly skilled Naval ratings in the para-medical field, (Physiotherapy, Radiography, Laboratory Technology, Environmental Health) to continue to practise their chosen discipline after promotion to Officer rank. At present, ratings in these fields who are commissioned are restricted to medical administration and these restricted career prospects not only deter suitably qualified people from joining the Royal Navy but also give inadequate recognition to the educational requirements and skills required in the para-medical field.

2. The Admiralty Board has, therefore, decided to institute a new range of Commissions in the Medical Technician specialisation. These commissions will be open both to serving ratings who have gained the requisite professional qualifications under Naval auspices and to civilians holding appropriate qualifications and trained within the National Health Service. At the same time, commissions will be offered to suitably qualified NHS staff to fill posts in the field of medical administration, which hitherto have been filled only by ratings on promotion. These commissions will be in the Medical Services specialisation.

3. All the proposed new commissions will be open to both men and women and this change, in this respect, will parallel that proposed for Queen Alexandra's Royal Naval Nursing Service which, subject to the approval of ~~Your~~ Her Majesty's Privy Council, will be open to both men and women from 1 April 1982.

4. Her Majesty will wish to be aware of these arrangements.

FILE

Defence

10 DOWNING STREET

THE PRIME MINISTER

1 February 1982

Dear David,

When I wrote to you on 9 July 1981 I said that I would be in touch with you shortly about possible dates for the classified defence briefing you had asked for.

I am sorry that I have been so slow to follow up that letter, but it has taken Michael Foot some time to decide whether to accept my invitation to attend the briefing. He has now let me know that he does not want to take part.

I have now asked John Nott to go ahead with the arrangements for the briefing and to settle the details with you directly.

Yours sincerely

Margaret Thatcher

The Right Honourable David Steel MP

dl

File *A

10 DOWNING STREET

From the Principal Private Secretary

29 January 1982

Dear David,

We had a word earlier this week about the proposed classified defence briefing which Mr David Steel has asked for.

I told you that we had at last had a response from Mr Michael Foot to the invitation which the Prime Minister sent to him in July to take part in the briefing. He has declined, saying that, while he appreciates the offer, he and his colleagues are doubtful whether such a briefing would really be helpful at the present time. I have consulted the Prime Minister in the light of Mr Foot's reply, and she would be grateful if your Secretary of State would now go ahead and arrange a suitable briefing for Mr Steel. She will be writing to Mr Steel over the weekend to let him know that Mr Nott will be in touch with him.

Yours ever,

Clive Whitmore.

David Omand Esq.,
Ministry of Defence.

AB

Prime Minister (2)

MCS 27/1

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon John Nott MP
Secretary of State
Ministry of Defence
Main Building
Whitehall
London SW1A 2HB

26 January 1982

Dear John,

DEFENCE PRICES AND CASH LIMITS: REVIEW OF METHODOLOGY

Thank you for your letter of 19 January. I note your view that this study might benefit from external advice and would be content for you to approach Ian Hay Davison.

The beginning of April is an appropriate target date for completion of the methodology review but I would not object to some slippage if this is necessary to do the job properly.

I am copying this letter to the Prime Minister.

Yours ever
Leon

LEON BRITTAN

10 DOWNING STREET

Prime Minister

You asked for a paper showing the areas of expenditure in 1982/3. This is at Flag B. Mr. Nott has not circulated it as an OD paper because he believes that such a broad summary, without a great deal of supporting material, would be misleading. But if you wished to circulate it at the meeting we could do so.

Have suggested A.J.C. 26/1.

Copies to circulate

MT

SECRET

47

Ref: B06387

PRIME MINISTER

c Sir Robert Armstrong

The Defence Programme

OD(82) 2, OD(82) 3, OD(82) 4

BACKGROUND

When the Cabinet agreed in November the figures for defence expenditure for 1982/83, 1983/84 and 1984/85, the Defence Secretary was invited to circulate to OD his proposals for the programme decisions required to give effect to these figures. He has now put forward 2 papers: OD(82) 2 on the problems posed by the 1982/83 defence estimates; and OD(82) 3 on the concept of flexibility between financial years. The Chief Secretary, Treasury, has tabled counter-proposals in OD(82) 4.

2. The Defence Secretary does not overtly ask for an increase in the 1982/83 defence expenditure figure agreed by the Cabinet in November: £14,103 million at 1982/83 Estimates prices. But he does not believe he can stay within it without making cuts which he regards as unacceptable for parliamentary reasons, and unnecessary if the system can be made more flexible. So he suggests in effect that he should budget for an overspend which should be allowed under the new flexibility system canvassed in his second paper. The Chief Secretary objects that this is precisely the sort of thing the new cash limits discipline is designed to prevent; whatever flexibility's merits, it should not be used to fudge the basic issue of whether the Ministry of Defence should budget to live within its allocation.

3. The Defence Secretary explains why his budget for 1982/83 was running more than £1,300 million above target. His figures and arguments are the same as they were last November, when the Cabinet agreed on the extra allocation he should receive on these grounds. Thanks to that allocation, plus certain windfalls, plus the cuts listed in his Annex A, he has been able to cut back the excess to £342 million. He seeks the Committee's

agreement to finding half the balance (£172 million) by the further cuts listed in his Annex B. But he could not find the other £170 million without starting on the drastic further cuts listed in his Annex D.

4. He further points out that his deficit figure for 1982/83 is likely in the event to be higher than £170 million. It is already clear that it will rise by £80 million (to £250 million) because of the cash squeeze resulting from the 1982/83 inflation rate proving to be one per cent higher than the 9 per cent assumed. It will rise further if sterling depreciates significantly against the dollar and DM; if his civil servants in the end get more than the 4 per cent allowed; and/or if defence prices rise faster than average and he cannot persuade the Treasury to compensate him for the resultant RPE.

5. The Defence Secretary does not make clear whether his proposed 1982/83 overspend would be repayable by underspending to a corresponding extent in 1983/84. That is the logic of his proposal. In terms of the NATO 3 per cent target this would produce an increase of 4 per cent in 1982/83 and of 2 per cent in 1983/84, which would not matter. The real problem is that, unless the Defence Secretary now starts cutting his programmes to match his resources, repaying £250 million or more in 1983/84 will seem just as hard as saving it in 1982/83 seems today. There will in any case be problems about 1983/84 (and 1984/85), though they do not need to be addressed now; the Defence Secretary is insisting on the agreed 3 per cent real growth rate being "realistically" translated into cash, ie he wants immunity (which the Treasury will not wish to allow) from a repetition of the factors listed in paragraph 4 above.

6. The Chief Secretary has no objection to officials studying the concept of financial flexibility as proposed in the Defence Secretary's second paper. But in his view it would not necessarily be unique to the defence budget; and its main purpose would be to cater for accidental underspend. He might not rule out it also catering for accidental overspend. But he would regard a deliberate 1982/83 overspend as an open evasion of the agreed terms of the "peace treaty" between himself and the Defence Secretary last November. These terms were set out in Sir Robert Armstrong's minute

FnAq A -

of 2nd December, which he attaches. They stipulate inter alia that the Ministry of Defence will do its best to live within its 1982/83 cash limit as then agreed; whereas the Defence Secretary is now proposing to live outside that limit to the tune of at least £250 million. Even if this were agreed by OD it would have to come from the Contingency Reserve and would require Cabinet approval. (It should be noted that the figures in the peace treaty were at 1982/83 Estimates prices, whereas the figures in OD(82) 2 are at 1981/82 out-turn prices; thus the defence increase agreed in November is £375 million in the former and £344 million in the latter.)

7. Following a request from your office, the Defence Secretary will today be circulating an account of the positive side of the defence programme's industrial implications in 1982/83; ie the programmes which will continue even if all cuts (including Annex D) were implemented.

HANDLING

8. The Defence Secretary should introduce his two papers, and the Chief Secretary his counter-paper. The Chancellor of the Exchequer may also have general comments. Thereafter, it may be easiest to focus on the specific 1982/83 problem (OD(82) 2) before the more general issue of flexibility (OD(82) 3).

9. On 1982/83, the following points should be addressed.

(a) Is it agreed that the defence budget decisions taken last November cannot now be reopened?

(b) Do the Committee agree that the Defence Secretary should make the cuts proposed in his Annex B? Since these will come on top of the measures in his Annex A (which have been taken and in some cases announced), the Secretary of State for Industry will wish to comment on their cumulative effect as set out in Annex C. The Lord President should comment on their acceptability to Parliament; and the Foreign and Commonwealth Secretary on the reactions of our allies, particularly the United States.

(c) In the last resort, and contrary to the Defence Secretary's advice, would the Committee regard the cuts in the Defence Secretary's Annex D (worth just over £300 million) as a lesser evil than allowing him to exceed his cash limit by £250 million or more? Again, the Secretary of State for Industry, the Lord President and the Foreign and Commonwealth Secretary should comment on the industrial, parliamentary and Alliance consequences. The Defence Secretary's supplementary note of today's date will be relevant here.

(d) If the Annex D list is not acceptable to the Committee, could it be pruned to remove its most chilling features; eg the reductions in fuel for the Royal Navy (No.3), in the RAF's front line (No.20), the cancellation of the Av8B (No.23) and the disposal of the recently acquired Chinook helicopters (No.24)? Could substitutes not be found for these? More generally, can the Defence Secretary say why it is not possible to manage the cash-flow on the defence equipment programme so as to limit the amount of cash spent with British industry to the amount available in the budget?

(e) If no other acceptable solution can be found, are the Committee prepared - contrary to the Chief Secretary's advice - to fudge the issue by authorising a deliberate overspend? If so, should there be an outside limit for this (eg £250 million)?

(f) If there is to be an overspend, is it agreed that this must be repaid in full the following year? Is the Defence Secretary prepared to start to budget for that now? How confident can he be of succeeding, given that he cannot be sure of getting his way on immunity from cash squeezes?

10. As regards flexibility, there is only one key question.

Is flexibility to be examined on its objective merits, as a technique which would be applicable to all programmes? or is it to be used as a procedural device for fudging the issue of whether the Defence Secretary should live within his 1982/83 income?

CONCLUSION

11. On the 1982/83 problem, the basic decision to record is the Committee's choice between 3 alternatives -

(i) is the Defence Secretary to live within the cash limit which was agreed last November on the basis of the same figures as are now before the Committee?

(ii) or is he to be given extra money, now that the practical consequences of (i) are more apparent?

(iii) or is the issue to be fudged by the procedural device of permitting deliberate overspend under the guise of flexibility?

Since no one will argue for (ii), the real alternatives are (i) and (iii).

12. If the choice is (i), the Defence Secretary should be invited to submit a new paper to the Committee setting out what would be the least damaging list of extra cuts required, in the light of the present discussion.

13. If the choice is (iii), you will need to note in your summing up whether there is a limit to the proposed overspend and whether it is for repayment in 1983/84. The Defence Secretary should also be invited to put a paper to the Cabinet, seeking their agreement.

14. On flexibility, the conclusion will depend on what is decided about 1982/83. If the Committee goes for (i) above, flexibility should be studied on its merits and in a wider context than defence. If they go for (iii), a more urgent and narrowly-directed examination will be needed of how to use flexibility as a cover story. In either case, the Chief Secretary should be invited to arrange for the necessary investigation and report.

26th January 1982

R L WADE-GERY

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1A 2HB
Telephone 01-218 2111/3 (Direct Dialling)
01-218 9000 (Switchboard)

MO 8

26th January 1982

Dear John,

DEFENCE ESTIMATES

You asked me for some supplementary information on the 1982/83 Defence Estimates, in preparation for tomorrow's OD meeting. We have prepared the attached table to show where the money will go, and in particular on which major projects.

I hope that this is of use.

Yours ever,

David Omand

(D B OMAND)

A J Coles Esq

ANNEX

BREAKDOWN OF DEFENCE ESTIMATES 1982/83

		£M at 1981/82 Prices
Vote 1A	Royal Navy pay and allowances	654
1B	Army pay and allowances	1317
1C	Royal Air Force pay and allowances	785
1D	Civilian staff pay and allowances	1145
1E-L	Fuel and utilities, computers, stores personnel and freight movement, clothing, land, NATO infrastructure, and other expenses	1244
Vote 2A-D/H	Research and Development Establishments, Contract Research, common Procurement Executive services	775
2E-G	Sea Systems - development and production	1774

Major projects (with 1982/83 spend) include:

ASW Carriers	80
SSNs	185
Type 42s	95
Type 22s	115
MCMVs (Mine Counter-Measure Vessels)	65

During 1982/83 the RN will take delivery of:

1 ASW Carrier
1 SSN
2 Type 42s
1 Type 22
1 MCMV
1 Seabed Operations Vessel

Copies in attached folder

£M at 1981/82 Prices

Vote 2I-K	Land Systems - development and production		1211
	Major projects include:		
	Challenger and Tank Improvement Programme	100	
	Air Defence (Rapier and Blowpipe)	130	
	Communications (Ptarmigan and Clansman)	150	
	Deliveries during 1982/83 will include:		
	40 Lynx helicopters converted to carry the TOW anti-tank missile		
	270 MILAN firing posts		
	3600 MILAN missiles		
	6500 Clansman radio sets		
2L-M	Air Systems - development and production		2630
	Major projects include:		
	Tornado GR1	680	
	Tornado F2 (air defence variant)	180	
	Nimrod AEW	125	
	Sky Flash air to air missile	45	
	Aircraft deliveries in 1982/83 will include:		
	44 Tornado GR1		
	4 Gazelles		
	5 Chinooks		
	7 Harriers		
	8 Nimrod MR2 conversions		
	3 Nimrod AEW conversions		
Vote 3	Service Pensions		639

		£M at 1981/82 Prices
Vote 4	Accommodation Services	660
	Major works projects in 1982/83 include:	
	Expansion of Imphal Barracks York to accommodate 2 Divisions withdrawn from BAOR	
	New ammunition storage facilities in UK	
	Airfield survival measures at RAF Coningsby	
	New works projects starting in 1982/83 account for £62M	
	PSA staff costs	126
Vote 5	Dockyard services	388
	Total	13348
	Target	13176
	Gap	172

SECRET

cc Mr. Scholar
Mr. Hoskyns

From Minister.

I think you should see this note from Mr Vereker. I agree with him: but it would be worth your while to raise tomorrow the question of a trade-off between equipment expenditure and personnel expenditure in future.

MR. WHITMORE

OD: Defence estimates and Service pay

26.1.82.

OD may find it extraordinary that Mr. Nott's paper for OD tomorrow discusses ways of closing the £335 million "gap" without ever mentioning the cost of Service personnel. As I mentioned to you this afternoon, in an ideal world Ministers would be given an option of offsetting cost overruns in one part of the Defence programme with economies in the other.

The position on Service pay for 1982/83 is not entirely clear. As you know, in the earlier years of this Administration the Defence estimates contained the pay assumption applicable to the public services generally, but the Ministry of Defence were given an assurance that more cash would be made available to meet the cost of the actual award of the AFPRB. Chris France in MOD has now confirmed to me that he is not aware of any such assurance this time round; but he went on to say that it was assumed without question that earlier assurances still applied. Nonetheless he accepts that when Ministers decided to let all the review bodies continue with their reports without interference, they did not say that they would necessarily accept their recommendations.

It would therefore be possible for the Prime Minister to suggest in OD tomorrow that Mr. Nott might find, say, £100 million of his "gap" by taking 4% off whatever the AFPRB awarded. Each 1% on Services pay is worth about £24 million; and I rather doubt that we shall be able to persuade MOD to override the AFPRB rcommendations on any other basis.

MOD's response to this proposition is, naturally enough, that no such deal could be struck because it would involve going back on our assurances to the armed services; and because it is anathema to the Services to be told that savings on Service pay are being made in order to finance equipment. I do not accept these arguments: at a time when we are cutting back on public service pay generally, and have already decided to review the commitment to armed forces

/ comparability

SECRET

comparability, I am sure we can hold the line on our earlier assurances; and I think it is simply absurd for the armed services to think it right that they should go on doing so well out of pay at the effective expense of our defence capability. But I think it is true to say that any attempt to strike a deal at this late stage would fail because of opposition from the Services generally, and that that might prejudice our longer term effort to improve upon the AFPRB system.

I think, therefore, that there would be some advantage in the Prime Minister taking the opportunity in OD tomorrow to say that she hopes that in future years the system will not continue to generate large pay increases for the Services at a time when we are having to cut back on the hardwear.

John Vereker

26 January 1982

Prime Minister

(2)

Mes 27/1

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

MO 26/2

25th January 1982

Dear Leon.

NON-COMPETITIVE GOVERNMENT CONTRACTS

Thank you for your letter of 15th December.

I entirely agree that there should be an independent review and am content with the terms of reference proposed: I understand these will now be put to industry as part of the discussions mentioned in your penultimate paragraph.

I also agree that there is much to be said for using the Review Board for the purpose and am glad that Mr Davison seems willing that the Board should take this on. As for timing, I agree that we should aim for a report within 6-9 months, though there may be a case for an interim report if the study is likely to take longer.

I am sending copies of this letter to the Prime Minister, Patrick Jenkin, Geoffrey Pattie and to Sir Robert Armstrong.

Yours ever

John.

John Nott

The Rt Hon Leon Brittan QC MP

2

Defence 2PPs

NORTHERN IRELAND OFFICE
GREAT GEORGE STREET,
LONDON SW1P 3AJ

Prime Minister

MT
22.1.82

SECRETARY OF STATE
FOR
NORTHERN IRELAND

The Rt Hon John Nott MP
Secretary of State for Defence
Ministry of Defence
Main Building
Whitehall
LONDON
SW1 2HB

22 January 1982

Dear John

I have read with interest your minute of 30 December to Geoffrey Howe about Defence Equipment Procurement and his reply of 11 January.

There are clearly issues of great national importance here. On a purely Departmental question, however, I simply want to underline the fact that defence work continues to be a very important element in the business of Short Brothers, a firm of particular importance to the Northern Ireland economy in a number of significant respects. Northern Ireland has been hit badly by defence economies over the years, through the progressive closure of various defence establishments here and the loss of the civil employment they provided. I would therefore very much like to be kept in touch with the further development of ideas on this front which could have an impact upon manufacturing industry generally and Short Brothers in particular.

I am sending copies of this to the Prime Minister, other Cabinet colleagues and to Sir Robert Armstrong.

Yours
Jim

ssd

1.

PRIME MINISTER

Last summer Mr. David Steel wrote to you to suggest that it would be helpful if you could arrange for him a classified defence briefing similar to the one which Mr. Callaghan arranged for the Opposition in 1976.

You wrote to him saying that you thought that this was a good idea, and that you hoped to be able to find a suitable date for the briefing in the autumn. You also told him that you were writing to Michael Foot inviting him to attend the briefing.

You duly wrote to Mr. Foot on 19 July, 1981. We have since reminded his office at regular intervals that he owed you a reply. But he has had a succession of internal party difficulties over the invitation! He has now at last sent you an answer in which he declines the offer of a briefing (attached).

The question now is whether we go ahead with the briefing only for the Liberals. This seems to me to be hardly worth doing. It would also raise the question of SDP attendance (which was hardly an issue at the time Mr. Steel approached you). Mr. Steel incidentally has not been in touch with us at all to enquire about the delay in arranging the briefing.

If you are inclined to share my view that we should drop the idea of the briefing, would you first like to have a word about it with the Home Secretary and Chief Whip when you see them on Monday morning?

Having offered it - we must go ahead. TAL.

? Labour defence spokesman? Some of our own Junior Ministers would probably like to attend too

22 January, 1982.

Spoke wrong to the Prime Minister who decided that the SDP should be invited. She expressed no reflection that having junior Ministers as hosts at the same briefing might lead to embarrassment. I had had I suppose to Sir T. McCaffrey some time ago that Mr Foot might attend in place of Mr Foot, but he had not taken up the idea. TPL 28.1.82.

ACTION

SECRET

THIS DOCUMENT IS THE PROPERTY OF HER BRITANNIC MAJESTY'S GOVERNMENT

OD(82)2 Copy No. 2

Have we kept a list of reductions? Advice please MT.

CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

THE DEFENCE ESTIMATES 1982/83

Memorandum by the Secretary of State for Defence

Background

1. I undertook to seek the agreement of my colleagues to the measures necessary to keep defence expenditure next year within the agreed figures. (CC(81)38 Conclusions, Minute 5).

2. Estimates have been prepared on the basis of the programme agreed by Cabinet in last summer's Defence Review and published in Cmnd 8288. That programme represented a radical change in previous defence plans but it did not - and could not - provide for the unique conjunction of two special difficulties, one relating to the current recession and the other to the sharp translation to cash planning on a long-lead programme hitherto planned in volume.

3. Thus last November the MOD Estimates came to me £1,335M[1] above the targets set, owing to:

a. The continuing depressed state of the civil industrial market, with British defence contractors concentrating on MOD orders: latest forecasts are that some £500M worth of equipment work will have to be paid out of next year's annual cash limit above the level expected last summer.

?? why - surely we have made arrangements

b. Insufficient allowance being made for the actual increase in defence prices experienced in 1981/82 in

[1] All figures are at 1981/82 outturn prices

SECRET

from: Rt. Hon. Michael Foot. M.P.

HOUSE OF COMMONS
LONDON SWIA OAA

20th January 1982

Dear Margaret

I am sorry not to have replied earlier to your suggestion that the Opposition might participate in the NATO briefing requested by David Steel.

I have now had an opportunity to discuss this with my colleagues. While we appreciate the offer, we are doubtful whether such a briefing would really be helpful at this time.

Michael

The Rt. Hon. Margaret Thatcher. MP

Defence Budget

Prime Minister

MCS 19/1

(2)

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

MO 26/2

19th January 1982

MT

MT

Dear Leon.

DEFENCE PRICES AND CASH LIMITS: REVIEW OF METHODOLOGY

As you know, I attach great importance to the joint review of these matters on which we agreed last November, and I am glad to learn that our officials have begun work. You will recall that we also agreed that there should be "suitable external advice".

There seem to me to be two stages at which external advice might be brought to bear; when the facts are being assembled and when they are being interpreted and judgements made. Each stage might call for a different kind of contribution. I understand that officials plan to review the question of external advice on fact finding when the task has been a little more closely defined. For my part I am content with this, though I must admit to a preference to having some outside help.

I am in no doubt at all about the need to have authoritative external advice at the second stage when the facts are being evaluated where the contribution of a senior and reputable outside figure would seem to me to be indispensable.

For this task I would like to suggest Ian Hay Davison of Arthur Andersen. I know that he has a good deal on his plate but

The Rt Hon Leon Brittan QC MP

I believe that personally he would fit the bill admirably. His work at the Review Board will be relevant; and Arthur Andersen have recently accumulated useful defence expertise to add to their earlier knowledge of the Treasury and Central Government. His time is not inexhaustible and he will also have the review of non-competitive Government contracts on his plate. But I would hope that the additional commitment would be manageable. He need not be involved in the earlier work study (making use of a junior partner if necessary) and the contracts review will be running to a somewhat longer timescale. If you agree, I hope an early approach could be made to him.

I should like to propose a target date of 1st April for completion of the methodology review. There is much ground to be covered, but we must work to as early a date as practicable.

I am sending a copy of this letter to the Prime Minister and the Chancellor of the Exchequer.

Yours ever

John.

John Nott

2. Prime Minister.

This sounds like more trouble ahead. Defence

19.1.82.

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon John Nott MP
Secretary of State
Ministry of Defence
Main Building
Whitehall
London SW1A 2HB

19 January 1982

Dear John,

DEFENCE ESTIMATES 1982-83

As we agreed, and as Sir Robert Armstrong recorded in his letter of 2 December, you will be seeking endorsement later this month of the specific programme decisions required to give effect to the defence expenditure total for 1982-83. I quite understand that until then the detailed defence Estimates sent to the Treasury remain provisional. I hope that the appropriate adjustments can be made relatively easily once decisions have been made.

It is a cardinal principle of the cash system that programmes should be planned realistically to keep within the cash limits agreed. I hope therefore that the measures in the paper you are preparing for OD will be sufficiently comprehensive to ensure that the provision settled for 1982-83 will not be exceeded, even if prices rise by rather more than the 9% and 4% factors used in developing the figures we discussed in the autumn.

I am prompted to put this to you now, because of what I hear of the procedure by which your Department has compiled the present draft Estimates. I am told that the figures were calculated at current (1981-82), not cash (1982-83), prices and then a flat 4% or 9% factor applied to them, without it seems consideration of what actual price movements are now to be expected.

It was particularly in recognition of the potential price increases which may affect the defence programme that the substantial addition of £375 million was agreed in respect of your 1982-83 budget. The corollary was that the Ministry of Defence would do its best to keep its expenditure within the resulting cash figures. This entails taking a realistic view of future pay and price increases and making appropriate adjustments now. I hope that your proposals to OD will cover this.

I am copying this letter to the Prime Minister, the Chancellor of the Exchequer and to Sir Robert Armstrong.

Yours ever
Leon

LEON BRITTAN

File AH

10 DOWNING STREET

From the Principal Private Secretary 19 January 1982

Dear Tom,

What chance of a reply to my letter of 15 December 1981 about the proposed defence briefing ?

Yours ever,

Clive.

Sir Tom McCaffrey

AH

Prime Minister.
As you know, OD is due to consider the defence programme later in the month.
TPL
11.1.82.

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

DEFENCE SECRETARY

MT

Thank you for your minute of 30 December about Defence equipment procurement.

2. The problems you describe are indeed important and difficult. I share your view that there are no easy answers. But your own papers at least identify some helpful steps that could be taken: for example, the measures discussed in paragraphs 11 and 13 of the paper by Sir Frank Cooper. It is indeed rather surprising that they should not already have been adopted to the full.

3. It must surely be out of the question to try to deal with these problems by allocating to Defence ever-mounting additional sums of money. That way lies ruin. These procurement problems are indeed serious; but the essential task of bringing them under control simply has to be tackled in the wider contexts not only of the Defence programme as a whole, but also of the realities of our economic situation.

4. The cash provision we have recently settled for Defence, £14 billion in 1982-83, rising substantially in the following years, is a huge amount of money and a huge burden. Longer term projections for public expenditure suggest that if the NATO 3 per cent real growth target were sustained throughout the decade, the Defence share of GDP could rise by 2 per cent, to almost 7 per cent - about twice as high as the present share in France or Germany.

5, We cannot allow Defence spending to overwhelm all our other efforts. Lower interest rates and tax reductions (of the right kind) are what will most help industry - and must be our main way to better economic performance. Without that we shall not be able to sustain the Defence programme as it is, let alone fresh additions.

6. I am copying this minute to the Prime Minister, to other Cabinet colleagues, and to Sir Robert Armstrong.

G.H.

(G.H.)
11 January 1982

CAP BW 4i may like to see O.R. MAP 31/XII.

Prime Minister

MAP 31/XII.

MO 26

CHANCELLOR OF THE EXCHEQUER

DEFENCE EQUIPMENT PROCUREMENT

One of the root problems facing defence is the persistent real growth in the cost of equipment from one generation to the next. For example: the Harrier aircraft costs in real terms four times more than the Hunter it replaced; and a new artillery shell is double the real cost of its predecessor. These real cost increases are nothing to do with the tendency of defence equipment to rise faster in price than average prices (RPE), they are additional to the burden of higher defence prices.

2. The problem is not new. But in the past we have been able to mask it by reducing overseas commitments and foreign bases; by abandoning roles in the Middle and Far East; by running down our spares and combat stocks, and by generally lowering Service activity levels. This process is now exhausted. We cannot carry on as we are without now accepting a severe decline in our ability to meet the Soviet challenge or perhaps abandoning one of our four traditional NATO commitments (and we know the problems which this would create for an increasingly beleaguered Alliance).

3. Between 1975 and 1980 the percentage of the defence budget taken up with procurement (of equipment) rose from 33% to 44%. This year more than £5B will be spent with British industry. Defence procurement now accounts for about half of the output of our aerospace industry; some of our biggest firms (BAe and Rolls Royce to take but two) would be crippled or become terminal patients of the Exchequer if we were to change direction sharply; and there are thousands of small firms up and down the country which are vulnerable to a further moratorium or similar programme slow-down. MOD expenditure also

represents two thirds of UK expenditure on electronics R&D - including electro optics, and other critical areas at the forefront of technology. They are the industries of tomorrow and MOD is almost the only source of public money for their development.

4. The procurement of defence equipment is a unique process: it cannot be compared with the simple purchase of goods elsewhere in the economy. Given the comparatively modest size of British defence purchases, our defence equipment market in the UK is mainly one of monopoly/monopsony. For the most part, therefore, free 'market prices' do not exist for the domestic defence sector. In order to ensure we are getting fair prices from industry - and giving fair returns to industry - the MOD has a contracts process whose essential aim is to reflect our monopsonist position to counter the monopolist weight of industry. Our contracts negotiators - there are 1250 of them - have performed reasonably well in the past, but I aim to press ahead further with increasing the number of incentive and fixed price contracts let with industry - about 75% by value. (But it should be understood that a period of cost/plus development, for a unique product, can have a part to play in establishing costs for a fixed price contract. We cannot get into fixed price contracts too early without being taken for a ride by our sole suppliers). But I want to tighten up the managing of the contracts themselves - to ensure, for example, that in cost/plus development contracts excessive wage settlements by our contractors are not passed on to the MOD (as in some cases they have been); and I also want to ensure that goods are delivered by industry only when we have planned, and can afford, to receive them. This will greatly help to control industry's cash demands on the Defence Budget - which has been one of the main difficulties I have faced over the last year. Part of our problems in facing rapid delivery in the recession with the consequent burden on our cash limits, is that the incentive contracts have deliberately encouraged higher productivity and early delivery. The success of these contracts has come

back to haunt us in the recession.

5. We are working generally towards achieving still better value for money for our expenditure with British industry. This will of course help us, but the trend of cumulative growth in our expenditure with industry must be reversed. We cannot, from a finite budget, continue to increase spending with British industry at the rate at which we have been doing without totally unacceptable degradation of our front line. Industry's expectations will need to be trimmed and this will have severe political, industrial and employment consequences in the next few years.

6. One of the ways we can help break this spiral, both of escalating costs and reducing numbers of equipment, is to sell more equipment overseas; but this is easier said than done. The Defence Sales Organisation has made excellent progress in boosting our defence exports since we came to power (our sales should be at least £1.5 billion this year against £1.2 billion last). The new Head of Defence Sales is considering how he can take this process further: but it is very clear to me that there are no quick answers. We could for example take a wholly irresponsible attitude and sell arms to allcomers without any concern for the wider political factors. Or we could deliberately cut our standards over a period of time and go 'down market' to sell. But in doing so we could find ourselves giving our Forces equipment quite unsuitable to meet the Soviet threat which grows ever more sophisticated - and could even exclude us from some markets.

7. The problems, therefore, of the MOD's procurement from industry, our financial position, and our defence sales prospects are closely intertwined: and there are no easy answers. I recommend to my colleagues the enclosed paper written by my Permanent Secretary which makes interesting reading. It is a very thorough study of the fundamental dilemma facing defence

procurement and the consequences for British industry over the next two decades. It poses questions to which an answer has to be found: the only option that is not open to us is to avoid the issue by refusing, as we have done in the past, to face the political consequences of moving in this direction. The Ministry of Defence either needs more money, or we must face up to the traumas of deliberately creating a narrower industrial and R&D base.

8. I am copying this minute to the Prime Minister, to other Cabinet colleagues, and to Sir Robert Armstrong.

FN.

Ministry of Defence

30th December 1981

DCP(81)5

DEFENCE COUNCIL

ESCALATION IN EQUIPMENT COSTS

Memorandum by the Permanent Under-Secretary of State

---

1. The Minister of State(DP) has rightly called attention to this phenomenon which largely underlay the review of the defence programme. We need to know more about it, what causes it, and how we can tackle it.

Experience of Cost Escalation

2. The steady growth in the real cost of equipment is not a new factor, nor is it confined to the military field. It has become more marked since World War II, with both the Warsaw Pact and NATO striving to exploit and extend the outburst of advanced technology in posing threat and response. It has three main components:

a. the introduction of entirely new technology into warfare - for example, guided weapons, computers, thermal imaging, satellites, nuclear propulsion, jet engines;

b. major new twists in technology; for example, switching to STOVL flight capability, turning torpedoes into true guided weapons, towed array sonar;

c. straightforward cost growth as each mark or generation of equipment becomes more complex and is improved, in the light of experience or knowledge, to achieve greater effectiveness against the threat.

3. Nine years ago we tried to identify an overall cost escalation factor. Examination of procurement records and predictions suggested an average annual figure of 6-8% on capital production costs of major equipments. This year we re-worked a very small sample to produce Figure 14 in SDE 81. For obvious reasons, the examples quoted were the more spectacular ones; there are others - notably successive classes of nuclear submarines - where real cost growth has been nil or negative. Work in 1979 suggested that about 60% of the equipment budget was liable to significant cost growth.

4. It would not, in my judgment, be profitable or practicable to attempt to arrive at a more accurate average factor. Difficult problems of weighting arise over such things as multi-role or changed-role equipments, the effects (not necessarily upward) of changed reliability and maintainability and the measurement of increased effectiveness. Whether the figure is 6%, 8% or 10%, we must all recognise that it is a major problem.

5. It is a problem which faces all countries with sophisticated forces. We cannot halt either the march of technology or the Soviet bid for arms superiority.

Research, Development and Production

6. A further manifestation of the problems we face shows up in our investment ratios. In each of the five years to 1979/80, we spent about £2.2 on production for every £1 spent on R&D. In preparing our forward programme there is a tendency to assume that the ratio will be more favourable particularly in the later years - for example, in LTC 74 the ratio in the first year was 2.3:1, and in the last year 3.9:1. As real time approaches, so too does the ratio fall - in LTC 1974 the ratio assumed for 1980/81 was 3.3:1 - by LTC 1980 it had fallen to 2.2:1. This clearly reflects greater realism both as to actual cost and cash restraints.

7. While it must be broadly true that a higher production to development ratio represents a better return on investment and is therefore a result devoutly to be wished for, it needs to be treated with some caution. The ratio tells us nothing about total procurement costs of particular equipments or the availability of off-the-shelf alternatives. High development costs aimed at reducing subsequent production costs could be advantageous; likewise a high production ratio can in some cases reflect unsatisfactory increases in production costs. Given these cautions, however, the ratio remains one which, if sustained, will lead us to bankruptcy.

Mitigating the Effects

8. We have survived with real cost escalation over the last 30 years mainly through a combination of:

a. reducing commitments overseas;

b. reducing numbers of equipment deployed (Annex A, but note that the Army pattern is distorted for a number of reasons, including the mechanisation of infantry battalions);

c. abandoning (or not proceeding with) some equipments which were beyond our means, eg Blue Streak, or had ceased to be cost-effective;

d. squeezing the so-called "tail" to release money for the so-called "teeth".

9. On a., we have effectively reached the limit of reducing commitments and we are having to talk about reducing roles within commitments. On b., there comes a point where reduced numbers no longer make operational sense. On d., the room for manoeuvre, while not exhausted, grows steadily smaller. On the other side, concentration on NATO for example has, if anything, put increased emphasis on sophisticated equipment.

10. The need for hard thought and action is compelling.

Initiatives

11. There are a number of relatively conventional initiatives which could be pursued more vigorously:

a. avoidance of over-elaboration in requirements, coupled with maximum use of commercial work and a willingness to forego the last few per cent of performance;

b. emphasis on collaboration with allies and/or UK industry where practical and advantageous;

c. greater attention to sales potential, in collaboration with industry; together with joint ventures and encouraging private speculation;

d. reducing through-life costs, through reliability and maintainability;

e. spending more on project definition to ensure optimum cost solutions;

f. tautening our relations with industry with tough negotiating stances, taking bad contractors to task and off the list, encouraging fixed price and incentive contracts when realistic;

g. exploiting stretch potential of existing equipments - probably one of the most profitable and practical lines to pursue.

Handling of Requirements

12. Views on whether our requirements are over-elaborate are strongly held either way. The evidence is not conclusive. In the last analysis, it is the potential enemy's equipment which determines the characteristics and basic minimum level of sophistication of our weapons. I have not yet seen convincing evidence that our equipment is more sophisticated than the threat requires. Contrary to what might be expected, the main contribution of the micro chip has been to enable designers to design cleverer weapons and so push up the cost of countering them.

13. Nevertheless, whatever the basic level of sophistication forced on us, we cannot seriously argue that in every aspect of every requirement our standards are as austere as they could be. By the very nature of things any good designer will seek to make his design as perfect as possible and every fighting man will seek to gain significant advantage in performance over his potential enemy. We must redouble our efforts to ensure tautness and maximum cost effectiveness. In particular:

a. there could be more sensitivity analysis of the implications of foregoing particular elements of a requirement;

b. we should beware of seeking to exploit all the benefits of new technology regardless of whether they are necessary or not;

c. our procedures should be geared to looking at "areas of capability" rather than looking at new equipments essentially on a "replacement" basis;

d. we should consider very carefully the wider use of a "design to cost" philosophy, wherever this seems appropriate;

e. a greater readiness to buy equipment already available and to forego if necessary the full military specification.

14. Do we actually need - let alone can we afford - all the things we set out to acquire? There is a spectrum of options - from maintaining balanced forces and capabilities at one end to cutting our coat to suit our cloth and buying essentially what is available off-the-shelf.

Collaboration and Sales

15. European collaboration has had its successes, its disappointments and its failures over the past 20 years. It has not proved a panacea for keeping down costs. The Euro-US package concept is a fragile plant still in its infancy. We have to recognise as a hard fact the overpowering effect of the US - both the sheer size and inventiveness of US industry and the effects of the vigorous US defence lobby. Giving our equipment wider sales appeal involves difficult judgments, both as to the level of sophistication which we have to have ourselves and on the likely customers. It is by no means the case that all Third World countries require less sophisticated equipment - consider Saudi Arabia, India, Pakistan, Iran under the Shah, Iraq, the Gulf States. Even so, continued pressure in all these fields of activity is essential if we want to secure reductions in production costs (or simply to keep factories partially filled), and obtain savings in our own development costs.

Through-Life Costs

16. We must study through-life costs more deeply at the stage of project definition and really look hard at the trade-off between

capital and support costs. The Public Accounts Committee has recently and rightly called attention to the same point.

Thorough Project Definition

17. We should not be afraid to:

a. devote substantial resources and time to Project Definition (PD);

b. carry PD to the point where industrial understanding of, and confidence in, a development programme can be expressed in a fixed price or incentive contract;

c. terminate programmes if PD shows the proposed solution not to be cost-effective, or alternatively, in such circumstances, proceed to further PD of a different solution (cf MBT 80 and the VJ 291 anti-armour weapon);

d. resist the temptation to go ahead, for so-called urgent reasons, when programmes have not been well defined.

Relations with Industry

18. We are making some progress with a range of initiatives aimed at reducing our procurement costs. The field includes encouraging competition both in project definition and for production contracts (although, all too often we now have only one major UK contractor in a particular area); enhancing industry's understanding of our requirements; prompting private speculation and joint ventures, and pressing hard for incentive and fixed price contracts instead of cost-plus. We must pursue all this vigorously.

Longer-Term, Radical Solutions

19. None of this is particularly new or revolutionary. Taken singly or together, it must be doubtful whether they can do more than slow down the rate of cost escalation. Are there more radical solutions, and, if so, what?

20. The first thing we could do is deliberately to reduce the range of equipments, and thus of our capabilities. We have done this in a number of areas over the years - but generally on an ad hoc basis as the result of a battle over resources for a particular new weapon system. Acceptance of the need to go further down this road as an act of deliberate policy would be a major step. Can it be avoided? Are there areas where we could do more - for example, by reducing the range of weapons in the anti-armour or anti-surface vessel spectrum and their modes of delivery?

21. Beyond that, there are the more radical solutions of specialisation, either industrial or military, or both.

22. Industrial specialisation could take two forms:

a. a deliberate UK decision to reduce and concentrate our industrial/technological base upon a limited range of weapon technologies - presumably high-value ones where we are already established such as electronics, GW and nuclear, although even this might be arguable;

b. agreement within NATO that individual countries or groups of countries should concentrate on developing and producing particular types of weapon, thus eliminating wasteful duplication.

An extreme variation of both a. and b. would be total or near-total dependence upon the USA as the primary arms supplier to NATO.

23. All of these solutions have basically the same objective - longer production runs with lower development and production costs per unit and more equipments. Other advantages such as common support arrangements and common training could follow. But they also have disadvantages. To a lesser or greater degree they make us dependent upon other people's judgment as to what the requirement is and the threat from the Soviet Union cannot be ignored.

24. Military specialisation could involve individual countries concentrating on certain military roles only, with the corollary that they would rely upon other countries to provide their defence in other areas. For example, in theory, the Dutch might concentrate exclusively on providing naval forces, leaving their air and land defence to others; conversely the Belgians might provide land forces and fighter aircraft but no naval forces. A more extreme example might be the UK agreeing to contribute only tank forces (although larger ones) - or no tank forces - to the Central Front. All this would mean taking a lot of things on trust and extremely long and complex negotiations. Is it a practical proposition?

25. Whether industrial specialisation necessarily needs to wait upon military specialisation, or whether the nature of a country's industrial specialisation must be linked to the nature of its military role, are open questions. What is clear is that the industrial, military and political problems are profound, not least in the transitional phase. They are likely to be insoluble as part of a grand design; what we may see instead is creeping specialisation as economic and industrial constraints bite. Indeed it could be said to be happening now with the smaller countries in NATO.

26. Specialisation particularly among the larger countries could introduce a new rationale for NATO in its second 30 years and a new cement. But it would take a long time to bring about. Ought we to be thinking harder about it? It can be argued that it is the most logical solution if NATO members are not to be overwhelmed by the relentless tide of the costs of advancing technology.

27. This paper is meant to provoke discussion. I suppose it is putting forward questions such as for how long can this country go on maintaining its present spectrum of equipment and capabilities? Can we change matters sufficiently to maintain our present numbers and quality? How might we carry forward our analysis? What possible initiatives might be pursued?

28. The Council may wish to have a preliminary discussion of these and other questions.

ANNEX A

	1950-1		1955-6		1960-1		1965-6		1970-1		1975-6		1980-1	
(a) Defence Expenditure £M (1980 Survey Prices)	7,316		11,320		10,304		10,667		9,542		9,424		9,550	
(b) Fleet Carriers/ASW Carriers	3	6	2	7	1	3	3	3	2	2	1	1	1	2
(c) Light Fleet Carriers/ Commando Ships	5	6	6	8	3	5	3	4	2	3	2	2	1	1
(d) Cruisers	16	26	10	24	5	10	2	6	1	4	2	2	-	-
(e) Destroyers/County Class/GMDs	52	111	32	90	23	52	17	26	7	15	10	10	10	12
(f) Frigates	42	165	52	167	51	100	56	63	57	67	51	61	38	54
(g) Submarines	32	62	43	57	34	53	34	43	21	27	16	20	11	16
(h) Nuclear (Fleet) Submarines	-	-	-	-	-	-	2	2	3	4	5	8	10	12
(j) Minesweepers/MCM Vessels	12	147	55	216	37	189	60	118	44	54	40	43	34	36
(k) Bombers and Strike Attack Aircraft	184		336		260		176		118		142		128	
(l) Fighter, Ground Attack, OS & Ground Support Aircraft	960		1,236		394		219		210		188		188	

/(m)

	1950-1	1955-6	1960-1	1965-6	1970-1	1975-6	1980-1
(m) Reconnaissance Aircraft (including photo and maritime)	213	290	169	151	87	82	82
(n) Transport Aircraft (including helicopters) and Tankers	120	150	200	291	242	168	122
(o) Tanks	1,148		772		758		791
(p) Armoured Cars, APCs and Scout Cars	2,041		1,791		2,242		3,614
(q) Light Artillery	450		357		225		266
(r) Medium and Heavy Artillery	64		164		156		157
(s) Army Helicopters	-		42		311		261

Notes

1. From 1965-6 onwards figures are for actual expenditure; actual figures for the earlier years are not available at constant prices and so the Estimates have been used. The figures take no account of changes in the definition of the Defence Budget.

2. In each ship category (columns (b) - (j)) the first figure is the strength of the Fleet including vessels engaged on trials and training; the second is this total plus vessels in reserve, on stand-by or undergoing long refit, modernisation or conversion.

3. Aircraft figures (columns (k) - (n)) are for Aircraft Establishments (AE) of Front Line Squadrons, adjusted where it is known that insufficient aircraft were available to meet the AE.

4. Figures for Army equipments relate to quantities employed only by Active (ie "mobile") units of the RAC, RA and Infantry. The figures for 1950 to 1970 represent war establishments.

File AH

Defence

10 DOWNING STREET

From the Principal Private Secretary

15 December 1981

BF

Dear Tom,

We have talked a number of times over the last few months about the Prime Minister's letter of 9 July 1981 to Mr Foot in which she invited him to be present at a classified defence briefing which Mr David Steel had suggested she should arrange.

When we last had a word at the beginning of November you told me that Mr Foot did not want to respond to the Prime Minister's approach until the Shadow Cabinet elections had taken place and he knew who his Front Bench defence spokesman was going to be. Since then Mr Silkin has of course been appointed to lead for the Opposition on defence matters, and I wonder therefore whether the way is now clear for Mr Foot to decide whether he wishes to take part in the proposed briefing or whether, perhaps, he would prefer Mr Silkin to attend.

Yours ever,

Clive Whitmore.

Sir Tom McCaffrey

AH

SECRET

Prime Minister.
4 xii
Mr Whitmore

2

43

CABINET OFFICE

70 Whitehall, London SW1A 2AS Telephone 01-233 8319

From the Secretary of the Cabinet: Sir Robert Armstrong KCB CVO

Ref: A06174

SECRETARY OF STATE FOR DEFENCE

Defence Expenditure

The purpose of this minute is to put on record the basis on which it was made possible for the Chief Secretary to report to the Cabinet that agreement had been reached on the figures to be included for defence expenditure in the public expenditure programmes for 1982-83, 1983-84 and 1984-85.

2. It is agreed that:-

(i) the defence cash limit for 1981-82 is to be increased by £300 million; this excludes adjustments already agreed to cover the 1981 Armed Forces pay award and to deduct the 1980-81 overspend, and is separate from agreed increases to cover the ROFs' financing needs and Service pensions;

(ii) for 1982-83 an additional £375 million will be provided: this does not include capital investment in the ROFs, for which an addition of £19 million is agreed, or carrying forward the effect of the 1981 Armed Forces pay award which had been agreed separately;

(iii) you will invite colleagues to consider and agree in the appropriate Ministerial Committee in January 1982 the detailed programme decisions required to give effect to these figures;

(iv) for 1983-84 an additional £325 million and for 1984-85 an additional £250 million will be provided in addition to the carry through of the 1981 Armed Forces pay award, on the understanding that the published programmes will on this basis be able to allow for the maintenance of the Government's commitment to a growth rate of 3 per cent a year in real terms for defence expenditure;

(v) you do not seek any further cash increases for 1982-83 or for any subsequent year on account of the relative price effect for 1982-83 and later years;

(vi) the Ministry of Defence will do its best to keep its expenditure within the cash figures resulting from this agreement, and there is no commitment to a mid-year review of the cash limit for 1982-83; but, if next year the prices of defence equipment rise by more than the general level of inflation, you reserve the right which any Departmental Minister has to approach the Treasury as to how to deal with the resulting problem in respect both of 1982-83 and of later years; the Treasury will consider the problem on its merits at the time, without commitment as to how it should be dealt with;

(vii) the figures now agreed for 1983-84 and 1984-85 are provisional as stated in the Chief Secretary's letter of 9th November 1981 to you;

(viii) there will be a joint review by the Treasury and the Ministry of Defence, with the assistance of suitable external advice, of the methodology of calculating movements in defence prices, on the lines proposed in your letter of 24th November to the Chancellor of the Exchequer; this review should also cover the possibility of devising arrangements which will enable the Ministry of Defence to live within cash limits without unacceptable consequences for the defence industries.

3. I am sending copies of this minute to the Prime Minister the Chancellor of the Exchequer and the Chief Secretary.

ROBERT ARMSTRONG

Robert Armstrong

2nd December 1981

2.

SECRET

Prime Minister. 42

Seen by the Lt. for many, if. MW 27xi

The Chancellor and Chief Secretary are meeting the Defence Secretary this morning to try to settle this. N Nott's position in this letter is back to where it was when I left Prime last night. fall 24xi

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

MO 8

24th November 1981

Dear Geoffrey,

DEFENCE EXPENDITURE

I have been thinking further about this very difficult problem.

I have already accepted the proposed figure of £275M in the defence cash limit for 1981/82.

For 1982/83 I am prepared to accept a figure of £400M to carry forward the effect of higher prices this year (excluding capital investment in the ROFs; and armed forces pay which we have agreed separately). Major cuts in the defence programme will be necessary to restrict expenditure within even this higher limit. They may have severe political and industrial as well as military consequences. I shall inform my colleagues in January of the measures I propose to take and seek their agreement for them.

For 1983/84 and 1984/85 sufficient cash must be provided to allow the annual growth of 3% in real terms on which we are all agreed. In the meantime I wish to propose an urgent joint review by the Treasury and my Department of the methodology of calculating movements in defence prices. I would like this also to cover arrangements which will enable us to live within cash limits without tearing industry to pieces each year. I would also welcome outside advice.

The Rt Hon Sir Geoffrey Howe QC MP

SECRET

I shall not press my claim now for a further cash increase on account of the relative price effect for defence goods in 1982/83 and later years. If I find that prices exceed the levels for which provision is made in the cash allocation, or I need more for armed forces pay, I shall make a claim for an increase in the defence cash limit in 1982/83 (and for a suitable adjustment in the planning figures for later years).

I am sending copies of this letter to the Prime Minister, the Home Secretary and the Chief Secretary and to Sir Robert Armstrong.

Yours ever

John.

John Nott

Prime Minister 41

Ref. A06055

PRIME MINISTER

Fair - put the proposition at X to the Treasury & see if they can reply with the MOD. The relationships are particularly non-equivalent.

Since receiving these papers (at 7.30pm) I've been trying to assemble some statistical material for you - eg the defence equipment price index: given the thin-ness of the material offered Alas! I have been unsuccessful.*

DEFENCE

I hope that the attached note goes some way towards explaining the apparent conflict of view between the Treasury and the Ministry of Defence about what has been happening to defence prices this year.

Should we set up a further meeting, on Monday afternoon?

MLS 20/11

2. If you want to try and reach a settlement before this comes before the Cabinet, there might be a way forward on the following lines:

*later I have got the attached defence RPE table

(i) So far as 1981-82 is concerned we know that the Defence Secretary would be prepared to accept the Treasury's offer of £275 million in the context of an overall settlement.

(ii) So far as the years 1982-83 and 1984-85 are concerned, the Defence Secretary has indicated that he might be prepared to drop his bid for a future relative price effect of 2 per cent which, as the note on defence prices suggest, is less well founded than the bid relating to higher prices in 1981-82 (sums involved: £169 million in 1982-83, £381 million in 1983-84, and £643 million in 1984-85).

(iii) The important year for the Defence Secretary is 1982-83 because a large part of his expenditure for that year is already

committed; it is also common ground that the figures for 1983-84 and 1984-85 are provisional.

3. We then have the following position:

	1981-82	1982-83	1983-84	1984-85
Treasury offer	275	250	250	225
MOD possible revised bid	275	455	466	477
MOD [illegible] bid (RPE)	400	624 (169)	847 (381)	1120 (643)
Compromise	275	350	250	250

It might just be possible to settle the matter by raising the Treasury offer to, say, £350 million in 1982-83, leaving the later years at £250 million or a little higher.

RIA

ROBERT ARMSTRONG

20 November 1981

not shown to PM

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
Telephone 01-~~930 7822~~ 218 2111/3

20th November 1981

Dear Michael,

DEFENCE PRICES

We spoke. Please find attached to this note a rather fuller description of the measurement of defence relative prices, and the so-called "defence" indices which you indicated might be helpful to you. Since you mentioned to me the subject of "lags" I am also attaching a note which was prepared sometime ago in the Ministry of Defence following our growing concern that the cash limit in 1981/82 was not providing, in practice, us with 11% over the actual prices paid last year, but only for about 8%. I hope this is helpful on the subject of lags, but a glance at the note does I am afraid show that this is a very difficult area and I should make it clear that although this has been discussed with the Treasury, and our methodology has not been convincingly challenged, it is still an area in which there is no full agreement between ourselves and the Treasury.

Yours ever

(D B OMAND)

M Scholar Esq

THE DEFENCE NON-PAY RELATIVE PRICE EFFECT (RPE)

1 The defence relative price effect (RPE) is the change in defence prices, relative to the change in prices in the economy generally. If defence prices rise by 12%, whilst general inflation is 10%, then the defence RPE is (12% minus 10%), that is, 2%. It is distinct from the "equipment multiplier", which measures the change in real cost between successive generations of equipment.

2 Defence prices can be measured by:-

(a) the "Pay and Prices Index", prepared annually by DS1, using information from the Vote-holders;

(b) the price index of the Defence Equipment Vote (and recently of Defence Procurement), compiled monthly by Stats(G), and widely circulated within the MOD, and to the Treasury;

(c) the index of prices of "Defence non-pay" prepared by the CSO, each quarter, in the preparation of the national income accounts.

3 General prices can be measured by various indices or "deflators", all prepared by the CSO:-

(a) Retail Prices (RPI) or the Consumer Price Index,

(b) Total domestic or total final expenditure,

(c) The gdp (Gross Domestic Product) deflator.

4 In the review of the 1981-82 cash limit, MOD and Treasury officials have measured the defence RPE primarily by the relative movement of prices of "Defence non-pay" and the gdp (market price) deflator (ie 2c/3c above). The gdp(mp) deflator measures wages, profits, indirect taxes, per unit of all output produced in the UK. It excludes import prices, since imports do not form part of gdp.

5 The CSO's index of "Defence non-pay" prices refers to defence goods and equipment, and is composed as to about 30% of prices paid by MOD and as to about 70% of the costs of input (eg materials, parts and labour used by contractors). Because of the changing nature of defence equipment it has proved difficult to produce an index of prices analogous to, say, the index of agricultural prices, where barley, milk, beef, etc are much the same from one

year to another. Furthermore, using the CSO index means assuming that profit margins on defence equipment change proportionately with input costs. This is necessarily an arbitrary assumption, which may affect the accuracy of the index as a measure of price movements.

6 Over the last 10 or 15 years taken as a whole the defence RPE, measured by trend rates, has risen by about 2% per annum on average. It has varied a good deal from one year to another, and in the 3 years 1978-1980 was actually slightly negative on average (See Table attached).

7 It is high when:-

(a) manufacturing productivity is improving rapidly. Non-defence producers can then cut their prices more than defence producers who, with limited production runs, have less scope for economies of scale; and also when

(b) import prices are rising relatively to domestic costs. Defence goods have an import-element, but import prices do not contribute to the gdp deflator. Thus the fall in relative import prices, when sterling was rising, helps to explain the negative RPE in 1978-1980.

8 The fact that the defence RPE is on average positive does not imply inefficiency in defence industries or weak contractual negotiation by MOD. As explained above, the coverage of the gdp deflator differs from that appropriate to defence prices. The RPE in part reflects this difference and in part derives from the different economic circumstances of defence procurement in comparison with industry generally (eg relatively limited production runs). In practice, of course, it is unlikely that any particular sector of economic activity will conform in detail to the norm for the economy as a whole.

9 The defence RPE is likely to return to at least its trend rate of 2% in the financial years 1982/83, 1983/84, and 1984/85, both because manufacturing labour productivity seems set for a sustained rise, and because the £ is more likely to fall than to rise, as the UK's external account swings back into deficit. The Treasury have expressed scepticism, but have not produced a reasoned response.

The way the cash limit was fixed originally at the end of last year and the calculation we have now carried out showing an uplift of 8% rather than 11% follow different methodologies. There have been gaps of this kind, although smaller ones, in previous years.

2. The cash limit calculation was carried out as follows:

a. take the Cabinet figure of £9753M for 1981/82 at 1980 Survey Prices (ie autumn 1979). Deduct non-cash limited expenditure;

b. inflate to autumn 1980 spot prices (LTC 8% prices);

c. inflate by the cash limit factors (6% pay and 11% non-pay) but allowing for 'lags'.

'Lags' take account of the fact that in the equipment area, for example, the prices ruling at one point in time are not reflected in the bills we pay until, on average, three months later. The mid-point of the financial year is end-September. Bills paid at end September reflect prices prevailing at end June. Therefore, end-June spot prices should, other things being equal, be average prices for the year. The cash limit therefore needs to provide for 9 months inflation from September to June and not for a full 12 months. On this basis the 11% uplift for non-pay becomes 8% after lags.

3. The more recent calculation works out how much money we would have this year to buy last year's outturn on the basis of known factors. The steps are:

a. take last year's cash outturn for non-pay;

b. deflate to 1980 Survey Prices using price variations as established in the final outturn;

c. inflate to LTC 81 prices using the factor derived for agreeing the 1981/82 budget at this price level;

d. inflate again using the factor derived from the difference between published Estimates and the LTC 81 figure for 1981/82;

e. compare the result with 1980/81 cash outturn and compute the percentage increase.

4. The Treasury argue that the year on year cash limit increase put by MOD at 8% is more apparent than real and is caused by distortion of the deflators that are used to move through the various price bases by other factors, viz:

a. changes in the mix of the programme from one year to another;

b. variations in the profile of expenditure and the uneven movement of exchange rates through the year, and

c. the change in repayment services charging policy which would have increased our receipts and thus reduced the year on year percentage increase.

The Treasury assert that if the figures were amended to take account of these factors then the year on year increase would in fact be 11%. However, the mix of the programme, eg the proportions of various types of equipment and purchases changes little from one year to the next; our own examination of the expenditure profile and of foreign exchange rates suggests that their effect on the figures is insignificant; and the largest estimate of increased receipts due to the

revised policy on charging puts them at £30 - £40M which would have reduced the year on year increase by less than 0.5%. Our own view is that whilst the above factors may have marginally contributed, the main cause was that the traditional three month lag (ie the time between work being costed and the bill being paid) was not fully realised in 1980/81. This meant that instead of the normal nine months (twelve months less three months lag) inflation between September 1979 prices and average 1980/81 prices it was much nearer to a full twelve months thus invalidating the assumptions on which our 1981/82 cash limit was based.

SECRET

HDA

Ref. A06053

PRIME MINISTER

Defence Prices

At last night's meeting to discuss defence expenditure it was agreed that the Cabinet Office, in consultation with the Treasury and Ministry of Defence, should urgently look into the explanation and justification for the higher prices of defence equipment. In the time available our objective has been to provide you and the other Ministers who were at last night's meeting with a short note agreed by the Treasury and the Ministry of Defence which sets out the problem as dispassionately as possible.

2. It is common ground that there is a genuine difficulty in deciding precisely how to translate the volume decisions of last June into cash on a realistic basis. It is also common ground that there should at least be some transitional addition to the defence budget in the current year and throughout the period 1982-83 to 1984-85. The question of how large that addition should be depends on the last analysis on the balance to be struck between the Secretary of State for Defence's wish to avoid further major cuts of a controversial nature and the very difficult issues arising from other expenditure programmes and the overall position.

3. I am sending copies of this minute to the Chancellor of the Exchequer, the Secretary of State for Defence and the Chief Secretary, Treasury.

ROBERT ARMSTRONG

(approved by Sir R Armstrong & signed on his behalf)

20th November, 1981

SECRET

U

DEFENCE PRICES

Note by Officials

1. We were asked to review the evidence relating to the Ministry of Defence's claim for increases in the defence budget due to higher prices for defence equipment, goods and services. There are two separate questions -

a. the movement of prices in 1981/82;

b. the relative price effect (RPE) in future years - ie the difference in the movement of prices for defence goods compared with prices of goods in general.

Defence Prices in 1981-82

2. The Ministry of Defence's (MOD) latest monthly forecast of the outturn of expenditure for the year is that it will exceed the cash limit by £300 million. All of this is in their view attributable to higher prices including those attributable to the fall in sterling in 1981, than were allowed for when the cash limit was fixed. They also forecast a volume shortfall resulting from the measures already taken to control the programme under the cash limit.

3. The MOD's methology which has been used to prepare the volume figures published in previous Public Expenditure White Papers, distinguishes between the volume of goods purchased and the price level of those goods. This distinction cannot, however, be wholly objective. In a few cases MOD can compare the actual contract price paid for an item this year compared with last; in other cases they judge the price increase by reference to indices appropriate to the industrial sector concerned, eg electronics, aerospace and shipbuilding. MOD statisticians prepare an overall defence equipment price index. The movements of this during 1981-82 do not support the MOD's view of the actual movement of prices. The defence equipment is, however, merely an index of the cost and price movements in those sectors of industry from which the MOD purchase equipment and does not reflect actual purchases by the MOD. If for example the prices charged by the relevant sectors of industry to buyers other than MOD have risen by less than the average, the index will not accurately reflect the actual prices paid by the MOD. In any

case it is often difficult to distinguish that element of price changes which reflect a quality improvement. Conclusive evidence is consequently not available to prove either the MOD's contention that above-average price rises have been occurring or the Treasury's view that the existing cash limit allowance of 11 per cent for price rises (other than pay) is adequate.

4. Under the new system of cash planning introduced this year, whatever figure is agreed for price rises in 1981-82 would have to be added to the base line figure for the programme for 1982-83 and the succeeding years if a volume squeeze is to be avoided. If excessive allowance is made for price rises, the consequence is that the defence budget will be over-provided; if, on the other hand, insufficient allowance is made, the volume of the defence programme will have to be cut.

1982-83 and Succeeding Survey Years

5. MOD point out that over the last 10 years the prices of defence goods have increased faster than prices in general by an average of 2 per cent per annum. Their analysis is that defence costs, other than the pay of MOD employees, will rise faster in 1982-83 than the allowance of 9 per cent for non-pay factors agreed for public expenditure as a whole. Their reasons are that much defence procurement is of highly sophisticated items where comparable gains in productivity cannot be achieved. In addition, many items of defence ~~for~~ equipment produced in this country have a high import content, both in materials and components, whose prices are higher when sterling falls. If sterling falls MOD's overseas costs could rise in sterling terms. MOD, as a large consumer of oil, is vulnerable to erratic fuel prices.

6. The Treasury maintain that to incorporate into the Government's plans provision for a positive RPE would permit defence contractors to agree to high wage payments and would reduce pressure on the MOD to limit costs. The MOD strongly disagree: pressure on supplies to limit costs is already intense. Since 1978, the defence RPE has been negative, but it is inevitably a matter of judgment as to whether this pattern will be repeated over the next few years.

20 November 1981

DEFENCE PRICES

Note by Officials

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Leave out some of the contracts

(Moolcraft of M.O.D. have been taken for a ride but the private sector has been charged!

case it is often difficult to distinguish that element of price changes which reflect a quality improvement. Conclusive evidence is consequently not available to prove either the MOD's contention that above-average price rises have been occurring or the Treasury's view that the existing cash limit allowance of 11 per cent for price rises (other than pay) is adequate.

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1982-83 and Succeeding Survey Years

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! They were lower last year!

6. The Treasury maintain that to incorporate into the Government's plans provision for a positive RPE would permit defence contractors to agree to high wage payments and would reduce pressure on the MOD to limit costs. The MOD strongly disagree: pressure on supplies to limit costs is already intense. Since 1978, the defence RPE has been negative, but it is inevitably a matter of judgment as to whether this pattern will be repeated over the next few years.

20 November 1981

The Defence Non-pay RPE

Annual percentages

1971	-1.6
1972	+4.4
1973	+4.2
1974	+6.5
1975	-2.3
1976	+6.3
1977	+0.4
1978	-0.7
1979	-0.1
1980	-2.3

Measured as: CSO's index of prices of defence non-pay ÷ gdp(market price) deflator.

SUBJECT

40

NOTE OF A MEETING HELD AT 10 DOWNING STREET ON THURSDAY 19 NOVEMBER 1981 AT 6.45PM TO DISCUSS PUBLIC EXPENDITURE ON DEFENCE

cc Master Set

Present

The Prime Minister
Chancellor of the Exchequer
Secretary of State for Defence
Chief Secretary, Treasury

Sir Robert Armstrong
Mr P L Gregson

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The meeting had before it the annex on Defence Expenditure to the Home Secretary's draft paper on the work of MISC 62 circulated by the Prime Minister's Private Secretary on 13 November and the Secretary of State for Defence's minute to the Prime Minister of 18 November.

The Chief Secretary, Treasury said that the question at issue was how to translate realistically into cash the decisions which the Cabinet had taken on defence in June. The Ministry of Defence had argued that there were special price factors, but the Treasury had not been able to find evidence to justify this. The Treasury had however accepted that there should be some transitional adjustment to ease the pressure on the defence budget as the Government's plans for re-shaping the defence programme were put into effect. MISC 62 had therefore proposed that there should be additions in 1981-82 of £275m and further additions in the three succeeding years of £250m, £250m and £225m respectively.

The Secretary of State for Defence said that the MoD was in the midst of unprecedented radical change - for example the CDS reorganisation, the cutting out of three of the five dockyards, the reduction in civilian numbers, and putting the defence budget onto a cash basis. It would be damaging to disrupt that process by a further round of cuts. He wanted to see a realistic cash provision for the defence programme over the survey period which would provide a basis for firm planning and tight control. The additional provision which he was seeking was necessary if he was not to be forced into some major changes in the defence programme, additional to those agreed last June, of a kind which were unlikely to be politically acceptable.

The Prime Minister, summing up the discussion, said that, at this stage, it was not possible to reach agreement. A major consideration was the difficulty of

finding an adequate explanation and justification for the higher prices of defence equipment. This should be investigated urgently by the Cabinet Office in consultation with the Treasury and the Ministry of Defence.

The meeting -

took note of the Prime Minister's summing up.

20 November 1981

39

P.0587

PRIME MINISTER

Public Expenditure: Defence

Annex B(i) of the Home Secretary's note summarises the position reached by MISC 62 and in correspondence up to 9 November. The Secretary of State for Defence's letter of 12 November to the Chief Secretary adds little; his letter of 18 November is of more substance.

Clay E
Clay F

2. The gap identified in the Home Secretary's annex is made up as follows:

		1981-82	1982-83	1983-84	1984-85
	MoD's bids				
i.	higher prices	400	436	462	484
ii.	2 per cent RPE	-	169	381	643
iii.	ROFs	-	19	4	[- 8]
iv.	Total i.-iii.	400	624	847	1,120
v.	Treasury offer	275	250	250	225
vi.	Gap	125	374	597	895

i. is for higher equipment prices in 1981-82 carried forward to the later years (paragraph 2 of annex)

ii. is for MoD's view that there should be a 2 per cent additional allowance for the relative price effect of defence equipment by comparison with the general price factors (paragraph 3)

iii. is for the Royal Ordnance Factories; it is being dealt with separately and you will not need to discuss it

v. is the Chief Secretary's offer endorsed by MISC 62, to ease the transitional problems for Defence of the move to cash planning.

3. There will be reference to Cabinet's decisions on 18 June on the Defence Budget (CC(81)24th Conclusions, Item 4). The key points in your summing up were:

Key c

> "The Cabinet agreed that the highest priority must be given to the defence programme, and accepted that that entailed lower priority to other expenditure programmes ..... approved the general thrust of the Secretary of State for Defence's proposals as set out in C(81)31 .... . Like every other programme the defence programme should be expressed in cash terms, not in volume terms. The Cabinet agreed that there should be a realistic translation of the defence programme up to 1985-86 from volume to cash terms; but in taking account of relative price effects for defence expenditure it would be important not to countenance excessive increases in overhead rates and wages of the kind which some defence contractors had recently been seeking to apply. The cash figures for defence, like those for other programmes, would be for review and final settlement at the conclusion of the current Public Expenditure Survey."

The question at issue now is what 'realistic translation' to cash means. The Secretary of State for Defence argues that unless special provision is made to recognise the relatively high costs of defence equipment it will be impossible to honour the Government's commitment to increase defence expenditure in real terms by 8 per cent between the Election and the end of 1981-82 and by 3 per cent in each of the three subsequent years. The Chief Secretary argues that there is no evidence to justify a special allowance for higher prices for defence equipment and that use of the general inflation factors will not therefore represent a cash squeeze on the defence budget.

4. In summary Treasury Ministers are likely to argue:

Key b

i. If there is to be any chance of getting near to an acceptable outcome to the present public expenditure exercise the enormous Defence bid has to be eliminated, or at least very substantially reduced (the Chancellor of the Exchequer's minute of 13 November to you on public expenditure).

ii. MoD's claim for a 2 per cent RPE from 1982-83 onwards is unproven: it is based on annual averages over the last ten years, but for the last three years the RPE for defence equipment has been negative and there is no evidence that it will be positive in 1981-82.

iii. To make provision for the possibility of higher defence prices would be to absolve MoD from the cash disciplines now applying to all other programmes.

iv. It would take the pressure off MoD's Procurement Executive to negotiate lower prices and, in turn, off their contractors to hold down wage settlements in their industries.

v. The transitional offer (line v. above) will help, provided it is understood that any deal for 1982-83 cannot be re-opened later in the year; the figures for 1983-84 and 1984-85 will be provisional anyway and subject to review in the next annual Survey.

vi. Apart from the Americans, no other ally is likely to meet its NATO target.

5. The Secretary of State for Defence, in his minute of 18 November, now judges that he needs the full cash figures for which he has bid if there are not to be drastic cuts in his programme, notably in aerospace and shipbuilding; there would be practical difficulties in 1982-83 where 80 per cent of the equipment programme is already contractually committed. He summarises the problem, as he sees it, in his paragraph 9. The Treasury will dispute that (their factor for defence prices in 1981-82 is 5 per cent low) and will argue that the other difficulties identified should have been apparent at the time of the Summer defence review. It seems that the Secretary of State has now abandoned arguments about the RPE in favour of a simple claim that he needs the money to maintain as much as possible of the volume of expenditure envisaged in the Summer.

6. MISC 7 will meet on 24 November to discuss the Trident programme. So far as the period up to 1984-85 is concerned, the cash flow for the bigger Trident now proposed is likely to be less than earlier assumed and so, to that extent, does not affect the present argument. But since the total costs of Trident have risen substantially (largely because of improvements which would be necessary whichever version we go for) the cuts in conventional forces and programmes in the later years which will be necessary will be criticised both by industry and by our NATO allies. The criticism will be greater if such cuts have to be combined with a squeeze resulting from the present public expenditure exercise.

7. The Treasury seem to be on strong ground in arguing that the case for higher defence prices is unproven. You will wish to press the Secretary of State for Defence hard on this and to establish whether the reality is that his assumptions in the summer were wrong so that he is now having to ask for more cash to minimise the disruption to programmes which he then thought were practicable.

8. You might then examine the possibility of a compromise on the following lines:

i. If the Treasury offer of £250 million in 1982-83 (where there is the problem of contractual commitments) were to be increased by, say, £50 million, could MoD live with that and seek to close the gap by further economies and, perhaps, by seeking to check the speed of deliveries?

ii. For the later years could the Secretary of State accept the Treasury figures on the understanding that they will be reviewed in the 1982 Survey when further evidence on defence equipment prices will be available?

9. Whether or not you are able to record agreement on the figures or to identify a remaining gap, it would seem right that the report to Cabinet should draw attention to the cancellations and deferments which seem likely to arise anyway. The Secretary of State for Defence will need to discuss these in more detail with the Secretary of State for Industry and with other Ministers concerned.

PG

P L GREGSON

19 November 1981

cc A Walters
A Duguid
J Vereker

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Prime Minister

The Chief Secretary is not going to reply going over all the old ground again: you may wish to refresh your memory of the Treasury case (Play A and B) MCS 18/11

MO 8

PRIME MINISTER

PUBLIC EXPENDITURE

We meet on Thursday to discuss the Defence Budget. It may assist you if I set out the latest position, based on MOD's provisional Estimates for 1982/83, which have become firmer in the past week.

2. I hope that we can avoid disagreement about the facts of the June Cabinet decision. It was a decision taken in volume terms, with the agreed proviso that there should be realistic translation into cash. The difference now is about how that translation should be made. As the Home Secretary's draft paper shows, for 1982/83 we are £374m apart; and the amounts widen thereafter.

3. In June I offered two options for getting expenditure back onto a more stable basis, in relation to available resources (1) a crash programme which involved 3% volume increase until 1985/6 plus £200m volume a year extra or (2) a gradualist programme involving a 3% volume increase until 1987/8 without any addition in the early years. The Cabinet decided on a 3% volume increase, but restricted the commitment to 1985/6. Cabinet chose the gradualist approach, for good political, industrial and employment reasons. The Treasury's proposals assume we could carry out the crash programme of reductions but without the cash to pay for cancellation charges and redundancy payments: an impossible problem.

4. But that is history - the reality is as follows.

5. MOD can tackle the problems of those Votes which are comparable to other Departments' expenditure, even although we have had to cut back Services' activities and works programmes in order to deal with the volume squeeze - and you will recall that the inflation factor chosen by Cabinet last month has already been shown to be inadequate - which will produce continuing difficulties particularly in relation to oil purchases.

6. The problem now overwhelmingly concerns Vote 2 - defence equipment - and in particular the Air and Sea Systems area. Tornado, the greatest single difficulty, exemplifies the situation. Production is now flowing in accordance with pre-arranged tri-national plans fixed years ago. Annual programme costs amount to over £1 bn. Ship deliveries amount to nearly £500m. Deferment pushes added costs into later years, and beyond a certain point involves paying compensation which increases costs in 1982/3 as well.

7. As we approach 1982/83 I find that of the total Vote 2 equipment budget about 80% is already contractually committed. Not all of the residue can be readily cut, since, for example, some spares have to be provided to keep equipment serviceable. The gearing is such that to cut back on uncommitted funds would involve quite disproportionate damage to our weapons programme, and such new projects as have survived the Defence Review.

8. Our Defence Review was meant to achieve a better balance between expenditure on platforms and expenditure on weapons, sensors etc, and the enhancement of our hitting power and staying power.

Having trimmed our plans for platforms (eg the reduction in the size of the surface fleet), we should be foolish now to degrade our defence capability by failing to provide the desperately needed weapons for our remaining ships and aircraft. Similarly, we cannot go on as has happened year after year, robbing war stocks and running down our combat capability. Each year's deferments have increased the following year's problems. We are now down to an essential minimum - and in some areas we are below NATO minima (which are themselves pathetically low).

9. My judgement after reviewing the whole position again is that I require the full cash figures set out in the draft MISC 62 paper. My study of the Defence Estimates, reinforced by the meetings of the Service Boards which have taken place this week, reinforces my view. Anything less will be unsustainable in Parliament. In broad terms the three Services Estimates were initially £1300M above the financial remit I had given them for next year - and this was before revaluation to 1982/83 prices and without any provision for the Relative Price Effect. This staggering excess can broadly be broken down into three categories:

a. an estimated under provision of more than £500M of cash. The Treasury factor for defence prices this year is 5% low. Included in this are Exchange rate variations amounting to up to £300M. This is the effect of applying a cash squeeze before Estimates are compiled;

b. a very significant strengthening of the Block Adjustment relating to industrial activity, amounting to £500M. This is a factor which seeks to offset the <u>speed of deliveries</u> from

the contractors. The recent Reeves Report recommended lower margins, and the likely condition of British industry next year requires this.

Both factors a. and b. above are new this year; and having to adjust the long established volume programme within a 5 month period is just impossible.

c. slippage of programmes, primarily deferments to meet demands for "savings" in earlier years, together with some real cost growth, amounting to about £300M excess. Until we have closed the dockyards, completed the Service redundancies, worked through existing contracts etc, hopefully by 1985/86, each year's "savings" aggravates the succeeding year.

10. We have already subjected the Estimates to the closest scrutiny in order to bring the cost of the programme down to a provision of £14333M (my figure) next year. This will involve us in any event in major cancellations and deferments. I am being faced here for instance with the disposal of Dreadnought (a fleet nuclear submarine), slowing down the Sea King helicopter replacement reducing the Army ammunition and vehicle programmes (including the major new combat vehicle project), cancelling the collaborative SP70 self-propelled gun, reducing funding for future tank development, deferring various weapons programmes and stopping all new Army works commitments; and cutting Tornado deliveries to the RAF from 52 to 44 a year and foregoing the conversion (mentioned as a possibility in Cmnd 8288) of the last 20 Tornado GR1s to the F2 air defence role. These are hard decisions which could bring job losses running into thousands

rather than hundreds. The impact on BAe, on BS, on Vickers and Guest Keen and on the West Midlands will be marked. But in my judgement we can get the package through Parliament, without abandoning Cmnd 8288.

11. I see no hope on the other hand of removing the remaining £374M gap without taking measures which would totally undermine our declared defence programme, and have severe military, industrial, and political effects. I believe we should have to cancel the AV8B, Sea Eagle and the conversion of 3 Nimrods to the maritime role and of the Hawks for air defence; cancel Wavell and Bates and the Gervantes mortar locating radar; cancel destroyers and frigates in the yards on contract; defer the new Type 23 and the new Fleet Minesweepers; dispense with the new conventional class of submarines; cancel the kinetic energy round required to pierce the frontal armour of modern Soviet tanks; withdraw from European/US collaboration on the air-to-air missile package; and significantly reduce effort on weapon sights, thermal imaging and electro-optics. Even this whole list would not close the gap completely.

12. The cumulative effect of these measures on British industry would be acute. Shipbuilding could lose 10,000 or more job opportunities in addition to the rundown of 14,000 already planned to take place by 1985. Associated industries would also be hit. Cancellation of the RAF requirement for AV8B would lose some 5,000 job opportunities, and put at risk BAe's full participation in the US order and the prospects of collaboration with the US on advanced short take-off and vertical landing aircraft (STOVL). Cancellation of Sea Eagle and withdrawal from the US/European air-to-air missile

package would cause over 1,000 redundancies and loss of about 1,900 job opportunities; BAeD could not remain a major contractor for air-launched guided weapons or play a reasonable role in future European collaborative arrangements. There would be serious industrial implications for Shorts (Belfast). Major reductions in ammunition and other programmes would seriously damage the Royal Ordnance Factories, which are already underloaded. The electro-optics industry would suffer substantially: the UK's excellent thermal imaging capability would be threatened, we could lose most of our image intensifier work to the US.

13. There is no conceivable way in which I can get such a package through the House - and for the sake of the sums at issue between the Treasury and myself it would be madness to attempt it.

14. I must stick, therefore, to my position. In June I delivered maximum savings in the middle and long term which I believed to be politically sustainable. I will do the same now, although the going will be rougher. The Chancellor needs every pound that he can find. But it would be irresponsible of me to offer the £300-£400M of extra savings next year when I cannot deliver them.

15. The position remains, therefore, as follows:

	1981-82	1982-83	1983-84	1984-85
My proposal	12754	14333	15816	17317
MISC 62 proposal	12629	13959	15219	16422
Gap	125	374	597	895

16. I am copying this minute to the Home Secretary, the Chancellor of the Exchequer, the members of MISC 62, and to Sir Robert Armstrong.

Ministry of Defence
18th November 1981

Private Secretary for

J N

(approved by the Secretary of State and initialled in his absence)

37 DSG

cc: HMT
HO
CSO, HMT
CO

10 DOWNING STREET

From the Private Secretary

13 November 1981

bc: Mr. Duguid

BF 18.11.81

Dear David,

PUBLIC EXPENDITURE

As you know, the Prime Minister has decided to hold a series of meetings with Ministers to discuss the public expenditure items which remain disagreed following the conclusion of the work of MISC 62.

The meeting on defence is planned for Thursday 19 November at 1830 hours. Apart from the Prime Minister and the Defence Secretary, the Chancellor, Chief Secretary and Home Secretary will also be present. The Prime Minister thinks that it would be helpful for the meeting to have before it, as a basis for discussion, the attached note on defence expenditure, which is extracted from the Annex to the draft paper which the Home Secretary is preparing for circulation to Cabinet on the work of MISC 62.

I am copying this letter to John Kerr (HM Treasury), John Halliday (Home Office), Terry Mathews (Chief Secretary's Office, HM Treasury) and David Wright (Cabinet Office).

Yours sincerely,

Michael Scholar

David Omand, Esq.,
Ministry of Defence.

SECRET

DSG

DEFENCE

£ million

	1981-82	1982-83	1983-84	1984-85
Cmnd 8175 revalued	12270	13624	14881	15625
Secretary of State's proposals	12754	14333	15816	17317
MISC 62's proposals	12629	13959	15219	16422
Gap	125	374	597	895

The Government is publcily committed to increase defence expenditure in real terms by 8 per cent up to the end of 1981-82 and by 3 per cent in each of the three subsequent years. The Cabinet has agreed that those volume targets should be translated realistically into cash and that the defence programme should then be expressed in cash terms. The question at issue, for the next three years, is what realistic translation into cash means. There is a related question concerning the cash limit for the current year.

2. The Secretary of State for Defence proposes that, in addition to the increase in the 1981-82 defence cash limit which has already been agreed to cover the 1981-82 armed forces pay settlement, the limit should be increased by a further £400 million to allow for increased prices of defence equipment; and that this increase should be carried forward into further years (£436 million in 1982-83, £462 million in 1983-84 and £485 million in 1984-85).

3. The Secretary of State also argues that planned expenditure on defence should allow for a 2 per cent Annual increase in the future relative price of all defence expenditure other than pay, on the grounds that defence procurement involves the purchase of sophisticated equipment whose prices

typically increase more rapidly than the general price level. The cost would be £169 million in 1982-83, £381 million in 1983-84 and £643 million in 1984-85.

4. The Chief Secretary, Treasury argues that the evidence of recent years supports neither the case for an increase in this year's cash limit specifically to take account of higher prices nor the assumption of a positive relative price effect for defence equipment in future years. He points out that since 1977 the relative price effect for defence equipment has been either minimal or negative; and that the Ministry of Defence's own index of defence equipment costs shows a rise of only about 10 per cent over the last 12 months, compared with the 11 per cent factor used for non-pay items in drawing up 1981-82 cash limits. He contends that to incorporate into the Government's plans provision for a relative price effect for whose recent existence the evidence was so weak would permit defence contractors to agree to high wage demands and would remove pressure on the Ministry of Defence to limit costs. In bilateral discussions with the Secretary of State for Defence he has however accepted that there should be a special transitional addition to the 1981-82 cash limit to ease the pressure on the defence budget as the Government's plans for reshaping the defence programme are put into effect.

5. MISC 62 concluded that it would not be appropriate to translate the Government's plans for defence spending into cash terms other than by using the general expenditure planning factors unless a higher figure could be clearly and precisely justified. Nonetheless the Group recognised the special problems of the defence budget. The Group proposed that the special transitional addition to the 1981-82 cash limit should be £275 million; and

that there should be further special additions to planned expenditure in 1982-83, 1983-84 and 1984-85 of £250 million, £250 million and £225 million respectively. The Group invited the Secretary of State for Defence to consider whether he could agree to this approach.

6. In his minute of 3 November the Secretary of State for Defence has replied that he could settle on the £275 million addition to this year's cash limit, which the Group proposed, but that to do so would leave a risk of overspending; that it is unlikely that the 1982-83 figure can be settled until December, when he will probably wish to put before Cabinet difficult proposals for savings in defence expenditure which will probably be necessary anyway; and that for 1983-84 and 1984-85, he cannot accept MISC 62's proposals without colleagues' knowing of the consequences for the Government's defence effort, which will not be clear until early in the New Year.

7. The Chief Secretary, Treasury in a letter of 9 November has asked the Secretary of State for Defence to consider accepting the MISC 62 proposals as an overall package covering the four years 1981-82 to 1984-85. The offer for 1982-83 is conditional on there being no in-year review clause and no relative price effect allowance, and an agreement to plan to keep within the resulting cash provision. It is recognised that the Public Expenditure White Paper figures for 1983-84 and 1984-85 will be provisional.

Prime Minister
This will be for discussion in the defence expenditure meeting which is proposed.
Defence
MCS 12/11

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MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

MO 8

12th November 1981

Dear Leon.

MISC 62: DEFENCE EXPENDITURE

Thank you for your letter of 9th November. I have already agreed to settle on the Home Secretary's compromise figure of £275m proposed for this year. I put in my winter Supplementary Estimate on this basis but you have not accepted it.

I have never sought to disguise the fact that the defence programme has been and continues to be "substantially overheated" in the next year or two. The defence programme review in the summer dealt with this problem in the middle and long term: but I made it very clear to Cabinet in the summer that grave short term problems remained. The Cabinet agreed in the summer to provide sufficient cash to sustain the volume decisions taken in July.

I accept that defence like other programmes will be managed in cash in the future but this means using cash as a tool of management - not setting wholly unrealistic limits which are seen to be unobtainable before the year begins. I stand on the policy set out in Cmnd 8288, and the corresponding figures set out in line 1 of the attached table.

The Rt Hon Leon Brittan QC MP

I am of course ready to talk further about this matter at the convenience of the Home Secretary and yourself.

I am copying this note to the recipients of yours.

Yours ever

John.

John Nott

		Real Growth to date	Annual Growth 1982/83	1983/84	1984/85	6 years 1978/79 to 1984/85
a.	Published Figures (Defence Review White Paper, July 81, Cmnd 8288)	+8%	+3%	+3%	+3%	+18%
b.	Implications of Chief Secretary's proposals	+6.1%	nil	+2.1%	+1.7%	+10%
c.	Implications of Compromise MISC 62 proposals	+7.1%	+0.7%	+2.0%	+1.5%	+12%

	1978/79	1981/82	1982/83	1983/84	1984/85
Published figures	9026	9750	10050	10350	10660
Chief Secretary's proposals(1)		9574	9565	9768	9938
Compromise MISC 62 proposals(1)		9670	9739	9929	10074

(1) Volume equivalent of Chief Secretary's and compromise MISC 62 proposals based on MOD's latest forecast of prices; on the assumptions that the 1982 non pay cash factor of 9% will be inadequate by 1% (para 19 of C(81)51) and that there will be a positive RPE of 2% each year. Also assumes that Armed Forces pay will, as necessary, be compensated by cash uplifts and that MOD will not be required to pay a "fine" in 1982/83 for any overspend in 1981/82.

RESTRICTED

Defence

C.F.
Please do this

MCS 10/11

Treasury Chambers, Parliament Street, SW1P 3AG

The Private Secretary
Secretary of State
Ministry of Defence
Main Building
Whitehall
London SW1A 2HB

10 November 1981

Dear Private Secretary,

MISC 62: DEFENCE EXPENDITURE

I should be grateful if the following correction could be made to the Chief Secretary's letter to Mr Nott of 9 November;

Page 2, paragraph (a), penultimate line: delete "supportive", insert "separate".

I am copying this letter to the Private Secretaries to the Prime Minister, the Home Secretary, other members of Misc 62 and Sir Robert Armstrong.

Yours sincerely

MISS J M SWIFT
Assistant Private Secretary

A

Treasury Chambers, Parliament Street, SW1P 3AG

Rt Hon John Nott MP
Secretary of State
Ministry of Defence
Main Building
Whitehall
London SW1A 2HB

9 November 1981

Dear John

MISC 62: DEFENCE EXPENDITURE

I have carefully considered your minute of 3 November to the Home Secretary.

This does I think confirm my fears that the defence programme has been and continues to be substantially overheated, but these deep-seated problems cannot be solved by simply adding to my existing offer of additional cash; the problems will become even more difficult in subsequent years.

It is, I think, now generally accepted that expenditure programmes must in future be planned and controlled in cash terms. Cmnd 8288 specifically reaffirmed that "Defence, like other programmes, will now be managed in cash terms". The objective must be to fit the programme to the cash likely to be available.

Paragraph 4 of your minute suggests a rather different approach. I certainly would not say now that there will be no defence RPE next year. But I am sure that there would be if it were planned for in advance. The discipline of cash control must be used by all Departments as a limiting factor on the prices of the goods and services they procure.

We all recognise that the present climate - partly because the PSBR is too high - is not an easy one for UK industry. Our economic strategy - which depends partly on restraining public expenditure - will help ease its burden. But I have less sympathy for defence firms who are apparently complaining that their excessive aspirations are not being met in full. In 1981-82 MOD will be spending with industry some £300 million more than was originally announced. Defence business in the current year is greater, not smaller, than industry should have been led to believe. If the defence industry has false expectations these should be corrected.

My MISC 62 offer was a package covering four years (not four individual offers). It was conditional upon there being no RPE addition or reopening clause. I am restating it below and in the attached table in the hope that you will be willing to look again at it positively.

(a) 1981-82

The £275 million figure was to be an overall adjustment (AFPRB, 1980-81 overspend, and ROFs apart) to the 1981-82 defence cash limit. It was part of a package which includes later years and which recognised the transitional problem of adjusting an overheated programme. I have subsequently been made aware of an extra £23 million needed for Service pensions. I am prepared to allow for this separately from the £275 million offer increasing the defence programme total in 1981-82 to £12,629 million. However, adjustments to the estimates cannot be made until we have reached agreement on the package. It is now too late to take provision in the Winter Supplementaries and that will have to wait for the Spring, although a supportive statement can be made about the cash limit increase when this is agreed.

(b) 1982-83

The 1982-83 part of the offer was conditional on there being no in-year review clause and no RPE allowance. It was also conditional on your firm agreement to plan to keep within the resulting cash provision.

(c) 1983-84 and 1984-85

Although the £1 billion offer over the four years was a package, I recognise that the PEWP figures for the later years will be provisional.

Table ... & comp

I attach a table in cash terms. The proposals are consistent throughout with the revaluation factors agreed by Cabinet and the commitment to plan to implement the 3% aim.

I hope that on reconsideration you will now be prepared to accept this package. We cannot delay much longer settling the 1982-83 figures.

I am copying this letter to the Prime Minister; to the Home Secretary and the other members of MISC 62; and to Sir Robert Armstrong.

Yours ever, Leon

LEON BRITTAN

THE DEFENCE PROGRAMME

	1980-81	1981-82	1982-83	1983-84	1984-85
(a) Cash baseline: Cmnd 8175	-	12270	13624	14881	16105
(b) MISC 62 proposed additions(1)	-	359	335	338	317
(c) Proposed provision	11179*	12629	13959	15219	16422
(d) Annual increase		+13.0%	+10.5%	+9.0%	+7.9%
(e) Revaluation factors agreed by Cabinet					
pay		6%	4%	6%	5%
non-pay		11%	9%		

* outturn

(1) based on 1981-82 offer of AFPRB (£82m) minus overspend (£64m) plus £275m plus ROFs (£43m) plus Service pensions (£23m); and offer for future years of AFPRB flow through, plus £250m, £250m and £225m respectively.

PRIME MINISTER

Meeting with the Chancellor : Tuesday 10 November at 1630

So far there are two issues for your regular meeting with the Chancellor, one of which is being raised by the Chancellor and one which you wish to raise:

i) Pay Review Bodies The Chancellor's minute of 30 October proposed that there would be advantage in you and he meeting Chairmen of Review Bodies, as you did before they produced their 1981 report. This would give you the opportunity to put pressure on the Chairmen, in particular to urge them to take account of the likely level of pay settlements in the economy over the coming months, and of the ease with which those on whom they report can be recruited and retained. You commented that you cannot do this year after year, and that it seemed to you more a matter of the evidence given by the Government.

ii) Public Expenditure The Chancellor wants to talk about the progress (or lack of it) in the MISC 62 discussions of public expenditure. In particular I understand that he wishes to talk over with you how best to handle the issue of defence expenditure. You may find it useful to glance at John Nott's recent minute; and at the same time at the paper by Treasury's DM Division which offers a different account from Mr. Nott about how to achieve savings on the scale required.

MCS

9 November 1981

Defence 35

Mr Scholar MO
Mr Whitmore KHW
Prime Minister

MO 8

This is the minute the Chancellor mentioned this evening.
KHW.

HOME SECRETARY

MISC 62: DEFENCE EXPENDITURE

At our meeting yesterday I did not accept, but nevertheless said I would consider, your compromise proposal of an addition of £275m to this year's defence cash limit, £250m of which would be carried forward into 1982/83, with £250m in 1983/84 and £225m in 1984/85, with no RPE allowance. This was against the MOD assessment that £400m additional cash would be needed this year with £624m next year and £847m and £1120m in the two succeeding years to meet the volume decisions taken by the Cabinet in June - and the NATO 3% volume target. I attach a revised version of the table which I produced yesterday.

2. Let me start with this year's cash limit. Many months ago I ordered stringent "savings" to be made. But until the books are closed we shall not know how successful these efforts have been, particularly in reducing cash flow to industry. Certainly from the growing volume of Parliamentary complaints it is biting hard on industry - particularly on small firms. I could settle on £275m now - and if that is what you want, I will agree to do so - but that will leave a risk of overspend and I may have to take further provision in a second Supplementary Estimate in the Spring - something that I had hoped to avoid since it weakens cash discipline in the MOD.

3. But the harder I try to hold down expenditure this year, the more problems I push into next year. This year's "savings" are creating an even larger bow wave in front of us pushing items forward,

adding to total costs and compounding our problems in subsequent years. I explained at MISC 62 that the first scrutiny of my Estimates indicated a volume excess next year of about £1000m (partly created by "savings" in earlier years) even if I assume no cash squeeze. But the fact is that your compromise proposal will add a cash squeeze, which in my judgement would be about £250m. Although I am determined to drive down the volume excess, I do not see, at the moment, how I could avoid being left with a significant cash overrun at the start of the next financial year.

4. Defence prices next year present an additional problem. The evidence is pointing to a strong positive defence RPE of up to 5% - but if Cabinet accepts the Chief Secretary's view that this will not happen then I shall leave RPE out of account in planning the programme for next year. If the Chief Secretary is wrong, of course, then inevitably we will overspend next year and we will have to take a major Supplementary Estimate; in backing the Treasury judgement on RPE, that is the risk we take.

5. Given the problem which I have described I would be misleading my colleagues if I were simply to accept the compromise figure of £250m for 1982/83. At this juncture it seems likely that I will need to come forward to Cabinet in December with some difficult proposals, the main part of which seems likely to involve a major curb on the programme of British Aerospace and its sub-contractors, since this is where the main problem lies. Until we reach that point we cannot regard the matter as settled. It goes without saying that I cannot accept your proposal for 1983/84 and 1984/85 without colleagues knowing of the consequences for our future defence effort: I hope this will be clearer early in the New Year.

6. In the meantime, I have instructed the Department not to sign a number of major contracts which we should complete in the next few weeks. The Marconi heavyweight torpedo negotiations will not be concluded; lightweight Sea Wolf and Sea Eagle will be left in abeyance with renewed uncertainty as to their funding; and there must now be the gravest doubts about going ahead with a contract for a satellite (BAe and Marconi) which would mean we were not able to bid for the NATO satellite. We cannot expect industry to remain silent about this.

7. I quite understand that there is a yawning credibility gap; no-one believes the MOD - or is it me? I am convinced that only four months after the Defence Review we now face a very difficult political choice: either more cash or more cuts.

8. I am copying this minute to the Prime Minister, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, the Secretary of State for Industry, the Secretary of State for Scotland, the Chief Secretary, the Chief Whip and to Sir Robert Armstrong.

SN

Ministry of Defence
3rd November 1981

		Real Growth to date	Annual Growth 1982/83	1983/84	1984/85	6 years 1978/79 to 1984/85
a.	Published Figures (Defence Review White Paper, July 81, Cmnd 8288)	+8%	+3%	+3%	+3%	+18%
b.	Implications of Chief Secretary's proposals	+6.1%	nil	+2.1%	+1.7%	+10%
c.	Implications of Compromise MISC 62 proposals	+7.1%	+0.7%	+2.0%	+1.5%	+12%

	1978/79	1981/82	1982/83	1983/84	1984/85
Published figures	9026	9750	10050	10350	10660
Chief Secretary's proposals(1)		9574	9565	9768	9938
Compromise MISC 62 proposals(1)		9670	9739	9929	10074

(1) Volume equivalent of Chief Secretary's and compromise MISC 62 proposals based on MOD's latest forecast of prices; on the assumptions that the 1982 non pay cash factor of 9% will be inadequate by 1% (para 19 of C(81)51) and that there will be a positive RPE of 2% each year. Also assumes that Armed Forces pay will, as necessary, be compensated by cash uplifts and that MOD will not be required to pay a "fine" in 1982/83 for any overspend in 1981/82.

CONFIDENTIAL AND PERSONAL

Prime Minister B (2)

Some very interesting material here.

MCS 5/11

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

2 November 1981

M. Scholar, Esq.,
10, Downing Street

Dear Michael,

DEFENCE PROGRAMME

You sent me a copy of your letter of 27 October to David Omand, reporting that the Prime Minister had decided that, since the MISC 62 Group had been set up, it would be right for the defence issues to be discussed there.

The Prime Minister had of course already seen the Defence Secretary's minute of 16 October and the Chief Secretary's comments of 19 October on it. It has occurred to the Chancellor that the Prime Minister might also like to see the attached further note by Treasury officials commenting on the measures which the Defence Secretary claimed that he would have to take in 1982-83 if his bids for additional money were not met in full.

I am sending a copy of this letter and enclosure to Terry Mathews only.

Yours ever,

John Kerr.

J.O. KERR
Principal Private Secretary

DEFENCE PROGRAMME: NOTE BY THE TREASURY

Treasury officials have considered the list of project cancellations and other measures which, Mr Nott claims in his minute of 16 October to the Prime Minister, would be necessary in 1982-83 if his additional PES bids are not met in full.

2. The MOD are better placed than the Treasury to judge where adjustments to the Defence programme can least painfully be made. We cannot conduct a defence review for the MOD, but we would not accept that all of the items in the MOD annex represent the most obvious choices. MOD have always tended to exaggerate the potential damage when the Defence Budget is threatened. Mr Nott himself points out in his minute that in his review earlier this year he was able to find savings without major direct effects on British industry; the problem now is that it is becoming apparent that he did not do enough earlier this year to get his programme back on the rails, particularly in the Survey years.

3. There is no doubt that MOD officials are in some difficulty in matching the defence programme for 1982-83 with the resources likely (even on the most optimistic assumptions) to be available. The defence programme has been and continues to be substantially overheated. For the last three years actual expenditure on Vote 2 (the equipment defence procurement vote) has exceeded original supply by £m 245, 180 and 634 respectively. This pattern is continuing in the current year (the latest forecast suggests an excess of some £300m over original supply) and shows every sign of being repeated in 1982-83. These difficulties do not stem from miserly provision; the Government has accorded defence the highest priority in its annual expenditure plans. The fundamental problem is a chronic tendency to over-programme, and a repeated reluctance to take a realistic approach to the degree of trimming needed to recover financial control: too little too late. MOD persist in using the technique of block adjustment cutting the estimated cost of the programme instead of the programme itself.

4. It is mainly because of these overprogramming difficulties that the sort of measures that appear in the annex to the minute to the Prime Minister can be instanced. But it would be ingenuous to accept

/this

this annex at face value. These measures cannot represent the lowest priority operational areas in the MOD. Some of them might be impracticable in any case. And the savings figures shown should be regarded with great circumspection because of, for example, the impact of cancellation charges. In short, the MOD budgetary outlook may be tight, but it is unlikely to be as desperate as is suggested.

5. These considerations however underline the risks that would necessarily attach to any Treasury attempt to table an alternative list of defence cuts measures. Some would be impracticable or, because of cancellation costs, would in practice yield little in the short term; others might even be planned already as part of internal MOD exercises to get down to their starting point. All would be likely to incur operational and/or industrial penalties.

6. Nevertheless we have compiled from the information available to us a very quick list, which is attached (Annex A). It is notable that some relatively large savings possibilities are not mentioned in the MOD annex - deferral of Trident £60m; deferral of the heavyweight torpedo £25m; cancellation of the Sea King replacement £30m; adjustment of Tornado programme £35m. It cannot be claimed that any of these measures would be painless. Thus the Treasury list should be viewed with much circumspection. It should be regarded as illustrative of the wider possibilities which have not been mentioned rather than as any prescription of specific measures. But it should be recognised that some of the weapons mentioned above or in the MOD annex, such as Sea King replacement or the Type 42 destroyer, are widely regarded in MOD as of questionable operational value.

7. It is relevant that all civil departments are being asked, as part of the Chief Secretary's proposals to Cabinet, to accept a 2% cut in their administration and staff costs. MOD will not have to surrender this provision, and would normally be allowed to use administrative savings to benefit other parts of the Defence Budget. The additional sums generated by the Chief Secretary's proposal would amount to some £50m in 1982-83 - a substantial contribution in lieu of equipment cuts.

8. This line of thinking can be taken further. There is evidence that MOD have not squeezed the tail hard enough in their quest for economy. It may be significant that the MOD annex makes no reference to savings from the support area. Yet:

- over £1000m is spent annually on Service training

/- MOD

- MOD are subsidising Servicemen's food by over £40m in 1981-82, excluding the extra costs of messes, cooking, stewards etc
- the average cost per recruit in 1981-82 - despite lower recruiting targets and higher unemployment - will be twice what it was in 1980-81.

In addition

- the three Services each have their own medical service
- 40% of the beds in MOD hospitals are occupied by NHS patients without benefit to the Defence Budget
- the three Services each have their own dental service
- the three Services each have their own legal service
- opportunities whereby Services could share training facilities (musicians, dog-handling, catering) have been ignored
- Rayner studies in, eg, research establishments support indicate that there is still substantial scope for further savings in administration.

9. MOD will have arguments against most of the above suggestions. They will say that some of the areas are already under review, or would contribute relatively small savings. But the Defence Budget has supposedly been under pressure for many years. It is not clear - except for the "too little too late" syndrome - why these areas should be effectively protected. It is arguable that the current situation is indicative of too relaxed an attitude towards support areas at the expense of the front line; that until this situation is rectified Treasury cannot accept that savaging equipment projects is the only means of matching the defence programme with its resources.

10. This appraisal suggests that if the MOD bids for additional cash are substantially accepted, this would simply sustain both the overheated defence programme and the processes which have led to the present situation, leading in all probability to a recurrence of cash problems in subsequent years. If this danger is to be avoided, it seems essential that MOD must think and plan at all levels in cash terms in future; the defence programme plans should be reshaped to fit within the cash likely to be available; the outmoded volume concept should be abandoned; and MOD methodology for determining price changes should be radically overhauled.

Some Treasury alternatives to the measures in Annex A of Mr Nott's minute of 16 October.

	£m 1982-83
Chief Secretary's 2% administration savings proposal	50
Stretch Trident programme (under consideration but not mentioned by Mr Nott)	60
Cut Sea King replacement programme	30
Adjust Tornado production schedule	35
Defer Sea Wolf improvements	15
Cuts to RN sonar and electronic projects	20
Defer heavyweight torpedo	25

CONFIDENTIAL

File A/H Defence

CCS HO D/I
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Tsy - ChEx
Tsy - Ch. Secy
SO

10 DOWNING STREET

From the Principal Private Secretary

27 October 1981

Dear David,

DEFENCE EXPENDITURE

We had arranged for your Secretary of State and the Chief Secretary to meet the Prime Minister next week to discuss the outstanding points on defence expenditure which were raised in your Secretary of State's minute of 16 October and discussed in the Chief Secretary's minute of 19 October.

That exchange of minutes took place and the arrangements for the meeting were made before the Cabinet agreed to set up MISC 62. The Prime Minister has decided that now that that Group has been set up, it would be right for these matters to be considered in the Group; and she thinks that the Foreign and Commonwealth Secretary should be invited to attend the meeting. It may well be convenient for the meeting to take place at the time the Prime Minister's meeting was to have been held, given that the Foreign and Commonwealth Secretary is available then.

I am sending copies of this letter to the Private Secretaries to the Home Secretary, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, the Secretaries of State for Scotland and Industry, and the Chief Secretary, Treasury; and to Sir Robert Armstrong.

Yours ever,

Clive Whitmore.

David Omand Esq.,
Ministry of Defence.

CONFIDENTIAL

SECRET

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Ref. A05823

MR. WHITMORE

Defence Expenditure

Thank you for your minute of 26th October.

2. I think that the Prime Minister's decision would be best communicated in a letter from you to the Secretary of State for Defence's Private Secretary. I attach a draft herewith.

D. J. Wright

ROBERT ARMSTRONG

(dictated by Sir R Armstrong and signed on his behalf)

27th October, 1981

SECRET

Agreed.

SECRET

DRAFT LETTER FROM C.A. WHITMORE TO D.B. OMAND, PS TO SECRETARY OF STATE FOR DEFENCE

Defence Expenditure

We had arranged for your Secretary of State and the Chief Secretary to meet the Prime Minister next week to discuss the oustanding points on defence expenditure which were raised in your Secretary of State's minute of 16th October and discussed in the Chief Secretary's minute of 19th October.

That exchange of minutes took place and the arrangements for the meeting were made before the Cabinet agreed to set up MISC 62. The Prime Minister ~~thinks~~ has decided that, now that that Group has been set up, it would be right for these matters to be considered in ~~that~~ the Group; and she thinks that the Foreign and Commonwealth Secretary should be invited to attend the meeting. It may well be convenient for the meeting to take place ~~when we had arranged for~~ at the time was to have been held the Prime Minister's meeting, given that the Foreign and Commonwealth Secretary is available then.

I am sending copies of this letter to the Private Secretaries to the Home Secretary, the Foreign and Commonwealth Secretary, the Chancellor of the Exchequer, ~~and~~ the Chief Secretary, Treasury; and to Sir Robert Armstrong.

the Secretaries of State for Scotland and Industry

SECRET

SECRET

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10 DOWNING STREET

From the Principal Private Secretary

Sir Robert Armstrong

Defence Expenditure

The Prime Minister has seen your minute A05803 of 23 October about the minutes from the Defence Secretary and the Chief Secretary about defence expenditure.

She thinks it would be right for the question of defence expenditure to go first to Misc 62; and she would like the Foreign and Commonwealth Secretary to be invited to attend the meeting.

There remains the question how we communicate the Prime Minister's decision to the Treasury and the Ministry of Defence. No reply has yet gone to Mr. Nott's minute of 16 October, and we could tell him and the Chief Secretary in a letter from me to his Private Secretary that the future levels of the Defence Budget are to be considered in the Home Secretary's group. Or you may prefer to pass on the Prime Minister's decision through Cabinet Office channels. Perhaps Mr. Wright would let me know what you would like to do.

C. A. WHITMORE

26 October, 1981.

SECRET

Prime Minister.

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Do you want defence expenditure to go first to the Whitelaw group? Or to an ad hoc meeting chaired by you (can have a time provisionally fixed for Monday 2 November)?

Agree that Carrington should be present at whatever meeting takes the matter?

23/x.

Ref: A05803

I think it should go to the MISC group first - or should it be referred to Cabinet?

SECRET

PRIME MINISTER

Defence Expenditure

attachment.

You have seen the Secretary of State for Defence's minute to you of 16th October and the Chief Secretary's comments in his minute to you of 19th October. The issues at stake here are important both for defence policy and for the overall public expenditure totals (£600 million in 1982-83 rising to £1.1 billion in 1984-85). You will wish to consider how best to make progress in settling these differences before public expenditure comes back to the Cabinet.

2. It had been assumed both by the Secretary of State for Defence and Treasury Ministers that the next step would be for you to take a small meeting yourself, and their minutes are written in this sense. Now that the Home Secretary's Group (MISC 62) has been set up, you will wish to consider whether the matter should be taken there.

3. Some other spending Ministers may think that the Secretary of State for Defence should be put on the same footing as other spending Ministers who cannot reach a settlement with the Treasury, and should be expected to go to the Home Secretary's group and not enjoy the unique favour of a bilateral with you and the Chancellor. Against that, it is unlikely that either the Secretary of State for Defence or the Chief Secretary would give ground in the Home Secretary's group. If that is right, requiring the group to consider this would simply take up time; and MISC 62 already has more than enough to do. If MISC 62 could not agree, the matter would in any case be referred to you to hold a small meeting later, unless you ruled that it should go straight to the Cabinet.

4. However the matter is handled, you will wish to consider whether the Foreign and Commonwealth Secretary should be invited to the discussion. In the case of MISC 62, where the spending Minister will be expected to make his case without supporting colleagues this would be unusual; but an exception could be made, if you thought fit, on the grounds that the Secretary of State for

Defence's case is argued partly in terms of our relations with our allies. If the Foreign and Commonwealth Secretary is to be involved, the discussi on, whether taken by you or in MISC 62, will have to be held on 2nd November because of his trip to Saudi Arabia and the public expenditure timetable.

5. The decision turns largely on the political question, whether you mind being seen apparently to discriminate in favour of the Secretary of State for Defence. If you do not mind, it would make sense for you to hold a meeting, and not to attempt a prior discussion in MISC 62. In that event, I would suggest that the invitees should be the Chancellor of the Exchequer, the Chief Secretary, the Secretary of State for Defence and the Foreign and Commonwealth Secretary.

RCA

Robert Armstrong

23rd October 1981

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Prime Minister

To note at this stage - for decision later in the Public Expenditure discussions.

MCS 19/10

PRIME MINISTER

DEFENCE EXPENDITURE

Geoffrey Howe will not be back from Luxembourg until later tonight. In his absence I send you this quick comment on John Nott's minute of 16 October to you.

attached -

2. I agree with John's view that we should have an early word about how to handle the problems he has outlined. I cannot however accept the solution he proposed, which is in effect to underwrite the defence programme with substantial cash additions both this year and over the next three years, regardless of the implications of this for our public expenditure strategy and our plans for the adjustment of the economy. I attach a note spelling out the objections in more detail.

3. Geoffrey and I have discussed these matters with John on several occasions recently. We have offered him a substantial increase in his cash limit this year to help him over the transitional problem of adjusting the defence programme to the lines of the proposals the general thrust of which Cabinet endorsed. We are not now seeking to reopen the Cabinet decision on 3% p.a. real growth as John alleges. We cannot accept his implied view that cash planning and cash limits are different for defence than for other programmes, and that the defence figures should be enhanced by the use of special and favourable price factors which apply only to defence.

4. By any criteria the cash additions John is seeking are substantial: £600 million in 1982-83 rising to £1,100 million in 1984-85. This would imply a defence programme in cash terms in 1984-85 of some £5 billion (40%) higher than the original 1981-82 baseline.

5. The proposals for defence in my Cabinet paper are consistent with the NATO 3% target. The underlying real growth endorsed by Cabinet would be sustained, since the cash provision would be determined by the price factors Cabinet have approved for general application.

6. We have seen no convincing evidence that defence prices are rising and are bound to rise in future faster than prices generally. The indices of defence procurement prices available to the Treasury do not indicate that defence prices are moving faster than prices in general this year, nor have they done so for the past three years. There is no justification for the proposition that the trend rate of RPE of 2% said to have been experienced on average over the last 10 years should be assumed to emerge again during the survey period. Indeed, as the economy picks up and industry takes on more non-defence business, the reverse may apply.

7. As indicated above, enormous sums of money depend on the view taken of defence prices. To accede to John's suggestion would jeopardise our approach to other public expenditure programmes, the PSBR and the tax position.

T. Mattaus

for LEON BRITTAN
[Approved by the Chief Secretary
and signed in his absence]
19 October 1981

The Tory have expressed their commitment to the MoD and Cabinet agreed.

KW
21/X.

TREASURY COMMENTS ON MR NOTT'S MINUTE OF 16 OCTOBER TO THE PRIME MINISTER

Treasury Ministers are not seeking to overturn the June Cabinet decision; the proposed provisions fully reflect 3% real growth enhanced by the general revaluation factors agreed by Cabinet. Cabinet accepted that there should be a realistic translation of the Defence programme up to 1985-86 from volume to cash but confirmed that, like every other programme, the Defence programme should be expressed in cash not in volume, with the figures for review and final settlement at the conclusion of the current public expenditure exercise. The figures quoted by Mr Nott (Appendix J of C(81)31) were explicitly illustrative; were clearly indicated as such in the Cabinet paper; and were calculated on a different basis from the proposals he now puts forward.

2. Mr Nott's proposals for future years are very substantial; £600m in 1982-83 rising to £1100m in 1984-85 above the baseline revalued.

3. The Treasury remains unconvinced that there is any case for these additions. There is no evidence that so far this year defence prices have been rising faster than prices generally but Treasury Ministers acknowledging the pressures on the Defence Budget have offered a transitional increase of £250m for this year only.

4. The defence case for future relative price effect provision of 2% per annum above the general cash factors for non-pay items is related to the annual average over the past 10 years and a claim that defence suffers a positive RPE when productivity is increasing. The past trend is distorted by a few very high figures. For the last 3 years the RPE has been negative. In any case the pattern has been erratic and past trends give no reliable indication for the future.

5. Treasury economists reject the MOD forecasting techniques as unsound. There is no convincing evidence to support MOD's claimed link between productivity and RPE, nor have MOD tried to separate out the effect of excessive wage increases in the defence industries.

6. If advance provision is made for higher price increases in defence,

/there

there would be every incentive for defence contractors to accede to high wage settlements and no pressure on MOD to contain these costs.

7. Cabinet envisaged in June that any increases in defence spending would have to be met by adjustments to other public expenditure programmes; such reductions in other programmes do not now seem possible. To accept the MOD bids would be to jeopardise the approach to public expenditure in general and to increase the PSBR or taxes (or both). The defence programme cannot be increased regardless of the implications for public expenditure strategy and Government plans for the adjustment of the economy.

Prime Minister. 30 ①

You should read this before you see Mr Natt. He took it before he decided to ask whether he could have a word with you over the week-end.

I suggest that you avoid committing yourself when you see him tomorrow. You must get the Chancellor's view. I think that you should tell Mr Natt that Cabinet will have to carry over its discussion on public expenditure to its meeting on 29 October. Let him, given his absence on 20 October, the defence budget in particular that he left over till the later meeting.

tell Mr x.

MO 9

PRIME MINISTER

I have been considering whether I should after all return for Cabinet next Tuesday, given the importance of your public expenditure discussions or whether I should stick to my plan to run the opening session of the NATO Nuclear Planning Group in Scotland. Somewhat reluctantly I think it really is in all our interests that I should be in Gleneagles to support Caspar Weinberger given the great importance of the nuclear issues we will be discussing and our own unique role in interpreting the Americans to the Europeans and vice versa. If I am not to be at Cabinet however I must let you know that I do not accept the proposals in the Treasury papers as they affect defence.

2. When I put our new defence policy to Cabinet (C(81)31) I was putting forward major adjustments in the defence programme which will put defence on a sustainable basis in the longer term, given reasonable resource allocation meanwhile. Cabinet endorsed my proposals (see C(81)24th conclusions), which provided for an increase in defence expenditure in real terms of 3% per annum up to 1985/86. Cabinet acknowledged the need for realistic cash provision, including the defence relative price effect which I specifically dealt with in cash terms (appendix J to C(81)31) and Cabinet authorised me to enter into conversation with our Allies on this cash basis. The Cabinet accepted that this decision would have implications for other public programmes.

3. I cannot therefore accept that the defence position is as the Chief Secretary describes in his latest paper. We settled on all this in June and I am not now making any extra "bids". The position of the defence programme cannot be reopened by the Treasury in this way without another major defence review, something which is quite clearly impossible in current circumstances.

4. It was agreed with my predecessor that this year's cash figures would be subject to review and adjustment in the light of defence price movements. I have discussed the latest pay and price information with both the Chancellor and the Chief Secretary. At our last meeting the Chief Secretary offered an adjustment of £250M after taking account of Service pay and of my agreement to pay a "fine" of £64M for last year's overrun and to be "fined" a further £40M for the programme cuts which colleagues were reluctant to make last January. Even on the basis of £300M, however, I shall need to take at least an additional £100M off defence expenditure with industry, having already this year clawed back £200M from the Tornado, shipbuilding and other programmes.

5. £300M is needed to achieve the published defence figure for this year; and you and I have been consistently on record in public as saying that defence expenditure would grow by 8% in our first three years of office - and 3% per annum thereafter. This is the basis on which our programme was planned and announced and it cannot now be changed four months before the end of the financial year.

6. If I agree to anything less than £300M the MOD is bound to overspend. I see no gain to the MOD, the Treasury or the Government for us to be involved in two supplementary Estimates, one now for a lesser figure than £300M and one later. This would represent the negation of cash discipline for my Department.

7. I am certain that the consequences of decisions on this year's cash limit must in turn become the base from which next year's Estimates are calculated, and which we have already agreed should represent a 3% volume increase. The Chief Secretary's proposals recognise this in the case of Armed Forces Pay, but make no provision for carrying forward the consequences of this year's final cash limit in respect of other expenditure. The new system of cash planning simply will not work if it does not start with a fair base from which to calculate the following year's figures - all logic demands this. To do otherwise would make it impossible to honour the Cabinet's decision to provide for 3% annual real growth in defence expenditure up to 1985/86.

No

8. If we assume that this year's cash limit is settled on the basis of the £300M I referred to above, my present calculations suggest that if this is not taken into the base line for next year, and on the Chancellor's assumption about prices generally, then the planned and announced 3% growth in the defence programme in 1982/83 will be reduced to almost nil. If there is no allowance for defence relative prices then the programme will actually shrink in volume. Every 1% of RPE represents about ½% off growth. Under the normal conventions all these effects would be cumulative in subsequent years (though I presume that the Chief Secretary's proposed further substantial cuts in 1984/85 cannot apply to the defence programme on which we have taken decisions up to 1985/86.)

9. I am quite clear that although defence prices relative to general prices do fluctuate from year to year, there has been a positive trend over the last ten - and indeed 15 - years at an annual average rate of 2%. Economic analysis in MOD suggests that it will be positive over the next few years as we come out of the recession, and forecasts for next year indicate that it could be substantially higher than 2% - perhaps 5%. However, I would put more confidence in the trend rate and I would be prepared to stick by the figure of 2% which was what I presented to Cabinet prior to agreement on the new defence programme.

10. In my defence review I avoided hammering British industry, by finding savings by contracting the size of the surface fleet, closing two Dockyards with the loss of 11,000 jobs, by reducing service manpower by 19,000 and by cutting MOD civilians by 15-20,000. I believe this was the right course particularly given the severity of the current recession. Indeed it would have been impossible then to get major cuts in the aerospace and high technology industries through Parliament. It would be even more difficult now. In the attached Appendix however I have set out what could be needed to meet the cuts that are the consequence of the Treasury proposals in the papers under discussion next week. The only way of living within those cash provisions would be to reduce the defence programme before the start of the year. I shall be scrutinising my Estimates as they are compiled towards the end of next month, but it is already clear that a significant cash squeeze cannot be accommodated without measures of the kind described in the attached list.

11. I would much rather that we embarked on next year's defence programme with a firm cash limit to which my Department is required to work. Last year we started the year with a cash limit which was recognised to be inadequate and which had to be subject to review. The events leading up to this had become the subject of public disagreement. Our defence review was designed to put an end to all that. We only just got the results of the defence review through Parliament, the Party and our Allies. We cannot embark on such a course again. The answer must be to give the Ministry of Defence a cash limit which is realistic but which requires tight cash discipline, and which reinforces rather than undermines the new cash planning system.

12. Although I would of course be prepared to return for next Tuesday's Cabinet should you wish it, there is the danger that this would be portrayed by the defence correspondents at Gleneagles as a crisis move. I hope, however, that it will be possible to have an early word with Geoffrey and you together on my return about how we handle the tricky problems I have outlined in this note.

13. I am sending copies of this to Geoffrey Howe and Leon Brittan and to Robert Armstrong, but to no-one else.

SN

Ministry of Defence
16th October 1981

ANNEX

	Savings in 1982/83 (£M)
MARITIME TASKS	
Cancel 3 of the 6 Type 42 destroyers now under construction (at Camell Laird, Vosper Thorneycroft and Swan Hunter) and defer the Type 23 frigate for one year: destroyer/frigate numbers declared to NATO would fall below the figure of 50 referred to in Cmnd 8288	20
Cancel ARK ROYAL, under construction at Swan Hunter	10
Cancel recently announced Marconi/British Aerospace communications satellite with serious industrial consequences and effects on British space capability	30
Cut fleet activity by 25% to save fuel: would mean withdrawal from NATO exercises and reduced operational standards	20
Defer nuclear submarine programme and next generation of conventional submarine	10
Defer further purchase of Lynx ASW helicopter	10
Abandon land based maritime strike/attack role (currently Buccaneer)	20
Cancel Sea Eagle air-launched anti ship missile	25
Further reduce naval works programme	20
CENTRAL FRONT	
Cancel new kinetic energy round: Army would have no shell capable of penetrating Russian T62 and 72 tank front armour until 1987 at the earliest	30
Cancel Wavell and Bates command and control and artillery fire control systems: decision to proceed with Wavell highlighted in Cmnd 8288	3 (Bates only, Wavell savings in later years)
Cancel remainder of Clansman radio production and delay introduction of Ptarmigan with serious effect on BAOR communications	24

Reduce Army activity levels by up to 40% to save on spares, training ammunition and fuel: would mean cancellation of major NATO and other exercises	30
Further cut Army works projects, delaying implementation of BAOR restructuring plan outlined in Cmnd 8288	25
Defer Chieftain and Challenger tank sight improvements	7
Cancel SP 70 155 mm tracked gun jointly developed with Germany and Italy	(Savings in later years)
Reduction in support helicopter force (2nd Chinook Squadron)	10
Cut RAF flying activity by average of 10% below current levels, which would mean breaching NATO minima and withdrawal from NATO exercises	20

HOME DEFENCE

Abandon defensive mining capability stressed in Cmnd 8288	5
Cut in internal security and bomb disposal equipment with damage to Army's capability	5
Cuts and deferments in UK air defence radar improvements and in the RAF works programme	65
Reduce deliveries of Nimrod maritime recce and airborne early warning aircraft, with associated avionics: affects British Aerospace	10

PERSONAL AND CONFIDENTIAL

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
Telephone 01-~~930 7022~~ 218 2111/3

MO 35/1/1

15th October 1981

Dear Clive,

DEFENCE BRIEFING FOR THE OPPOSITION

As Brian Norbury implied in his letter to you of 24th August we are now under some pressure from the three NATO Commanders about whether we will require them to provide the defence briefing early next month. Our preferred date of 3rd November is now less than three weeks away and as I understand it we still have no response from Mr Foot. In those circumstances my Secretary of State suggests that we might now think of standing down the NATO Commanders and trying to arrange a later date which would be convenient to all the parties. Do you agree?

Yours ever,

David

(D B OMAND)

C A Whitmore Esq

PERSONAL AND CONFIDENTIAL

Speak Tom McCaffery — and ask him again — to get the Foot to give his Shadow Minister a reply. I said that we needed to settle one way or the other whether there was to be a briefing: a clear 'no' from the Foot to the P.M's invitation would be more than enough on its own, with NATO poised to give the presentation he never actually asks to. He said he can do what he liked. I then passed this on to Duncan Sandys

Mr Norbury's letter. I told him that there was no question of doing the briefing on any of the dates in November which had been suggested. If we get a 'no' from Mr Foot, we shall have to consider whether we arrange a briefing for Mr Foot alone.

23 x 81

Extract from meeting record between the Prime Minister & the Chancellor of the Exchequer on Wednesday 16 Sept, '81 - at 1715 hrs.

Defence

Top Copy: Govt Mach, Pt4
Future CSD/HMT.

(iv) Defence Cash Limits

The Chancellor explained that MOD were heading for an over-run of £300m - £400m, and that Mr. Nott was asking for an increase in the cash limit of about this amount. He was trying to get further explanation for the reasons for the over-run, and he hoped to be able to resolve the issue without troubling the Prime Minister further. But he thought the Prime Minister ought to be aware of what was happening. The Prime Minister said she was most unhappy to hear that, for the third year running, MOD were heading for a substantial over-run; she hoped that the Arthur Andersen report would lead to improvements in MOD's accounting practices which would reduce the risk of over-spend in future years.

NOTE OF A DISCUSSION BETWEEN THE CHANCELLOR OF THE EXCHEQUER, THE CHIEF SECRETARY, AND THE SECRETARY OF STATE FOR DEFENCE ABOUT THE REVIEW OF THE 1981-82 DEFENCE CASH LIMITS: 6.30 P.M. ON 15 SEPTEMBER, 1981

The Chief Secretary recalled that he and the Defence Secretary had agreed on 28 July that the cash limit should be:-

(a) increased by £82 million on account of armed forces pay;

(b) reduced by £64 million, on account of the 1980-81 overspend.

They had also agreed that the so-called "programme gap" should be closed without the provision of any additional cash to Defence. The outstanding issues now were:-

(a) the MOD claim for £9.5 million on account of service pay; and

(b) an MOD claim for some £300 million on account of actual and expected exchange rate changes.

He and the Chancellor thought it right now to settle the outstanding issues. The agreed joint report by officials recorded continuing disagreement on both: a political decision was required.

2. The Defence Secretary agreed. It would make sense to settle on a figure now. Such a figure must however be realistic, if the danger of having to seek Supplementary Estimates twice were to be avoided. On Vote II, he was heading for a £300 million overspend, £200 million of which originated in the Air Systems Control, and mainly on the Tornado project. On Vote I, the indications were

of a £50 million overspend, largely as a result of increased oil costs. Taking into account the need to show a deduction on account of the 1980-81 overspend (£64 million), he accordingly required a cash limit uplift of £414 million (gross) or £350 million (net). £300 million was the minimum for which he could settle. A £300 million uplift would ensure that defence spending in 1981-82 would be 8 per cent higher in volume terms than in 1978-79: this would be in accordance with the plans published in the 1981 PEWP. The Chief Secretary demurred: the conversion from cash to volume to which Mr. Nott had alluded must be on the basis, not accepted by the Treasury, of MOD predictions of inflation and exchange rates throughout 1981-82. Moreover the MOD argument based on these predictions - paragraphs 16/17 of the joint paper by officials - took no account of lower inflation rates, and therefore costs to MOD, in the FRG and the US.

3. The Chancellor asked whether the Defence Secretary was in fact making a different case from the one put forward in the joint paper. His argument now seemed to be based not on exchange rate movements, but on actual and expected price increases by defence contractors. The Defence Secretary confirmed that the fundamental problem was one of pay and prices in Vote II, and that his estimate of a £300 million Vote II overspend was based on evidence of what was actually being spent, and likely to be spent, with defence contractors. Exchange rate movements were important, because it might have been possible to cope with all or most of the problem but for the fall in sterling: the exchange rate point was however not the heart of the matter. He might just get by with a £300 million uplift: he could not settle for less, since any reduction on £300 million would entail a certain commensurate overspend.

4. The Chancellor did not believe that it could be feasible to validate inflation to the tune of £300 million. The Chief Secretary and he might be prepared to settle for £200 million: £300 million was just not on. The Defence Secretary said that actual outturn would be precisely the same whether the cash limit was increased

by £200 million or £300 million, or indeed £1 million: all sensible steps to check cash flow were already being taken. A second Supplementary Estimate for the residual £100 million, or a £100 million overspend, would be damaging to the system. Moreover, he warned that the position for 1982-83 seemed likely to be far worse than in the current year.

5. The Chancellor said that it was clear that there was no basis on which to strike an immediate deal. The Chief Secretary, agreeing, said that the difficulty was that the Treasury arguments, and indeed the joint paper by officials, discussed what the cash limits should objectively be, whereas Mr. Nott's new arguments about actual and expected pay and price movements on Vote II related to what it would have to be if an overspend were to be avoided. It was agreed that officials should be asked to conduct a further joint study, this time covering the evidence of actual pay and price increases.

6. The meeting ended at 7.15 p.m.

J.O. KERR

15 September 1981

Distribution:

PS/Secretary of State for Defence
PS/Sir Frank Cooper - MOD
J D Bryars Esq - DUS(P), MOD

PS/CST
PS/FST
Sir D Wass
Sir A Rawlinson
Mr Littler
Mr Barratt
Mr Hansford o.r
Mr Bridgeman
Mr Wilson

PERSONAL AND CONFIDENTIAL

Defence

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
Telephone 01-~~930 7822~~ 218 2111/3

MO 35/1/1

24th August 1981

Mr Foot's office will leave a note for Ian McCaffrey about this - see Clive's note on Norbury's letter of 27/7. McCaffrey returns on 1 Sept. I have spoken to MOD.

MAP 28/8

Dear Clive,

DEFENCE BRIEFING FOR THE OPPOSITION

One of the files I am today happily handing over to David Omand is the one concerned with the above and I wondered whether there was any advice you could give David yet about whether any of the dates - 3rd, 4th or 9th November - suggested in my letter to you of 27th July was likely to prove a starter? I ask because (predictably enough!) the three Major NATO Commanders are getting concerned about their own programmes, and one, CINCHAN, has been invited to call on The Queen of the Netherlands on 9th November. I am sorry to press!

Yours ever.
Brian

(B M NORBURY)

C A Whitmore Esq

PERSONAL AND CONFIDENTIAL

Defence

Civil Service Department
Whitehall London SW1A 2AZ
01-273 4400

The Rt Hon John Nott, MP
Secretary of State for Defence
Main Building
Whitehall
LONDON SW1A 2HB

18 August 1981

Dear John,

REDUNDANCY TERMS FOR SERVICE PERSONNEL

In my letter of 21 July, I asked colleagues to agree to your proposal that the 1975 compensation terms should apply to Service personnel made redundant as a result of the new defence programme, without waiting for the outcome of the wider review of public service redundancy terms which H Committee has asked for.

You will have seen that both Mark Carlisle and Michael Heseltine are content for you to go ahead. No one else has commented so I am writing now to let you have formal agreement to the use of 1975 terms for the impending rundown.

I am sending copies of this letter to those who received my earlier letters.

Yours ever

Christopher

SOAMES

CONFIDENTIAL

VLB

Defence

10 DOWNING STREET

From the Private Secretary

11 August 1981

Review of Defence Cash Limits

The Prime Minister has read the Chancellor's minute of 5 August, and has noted that the Review of the Defence Cash Limits is being deferred until September. She has offered one comment - she hopes that the figures for increased equipment costs will show how much these are accounted for by pay increases.

I am sending a copy of this letter to Brian Norbury (Ministry of Defence), Terry Mathews (HM Treasury) and David Wright (Cabinet Office).

T. P. LANKESTER

Peter Jenkins, Esq.,
HM Treasury.

CONFIDENTIAL

Prime Minister 2

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

PR
5/8

PRIME MINISTER

REVIEW OF DEFENCE CASH LIMITS

As you know, officials have been reviewing the case for adjusting this year's defence cash limits. Leon Brittan and John Nott discussed the problem on Tuesday but because of the uncertainties involved they considered it better not to seek to agree on the size of any net adjustment to the cash limits at this stage but to defer the decision until September.

2. There remains a wide gap between the Treasury and MOD on the major point of disagreement - the assessment of the likely increase in defence prices this year. Deferment of the review until September will provide the opportunity to collect and assess more information on current price movements to validate the forecasts one way or the other. John Nott has already had some success in cutting back his forecast overspend. He has agreed to take additional corrective action now further to reduce the risk of overspend this year. MOD have been asked to resubmit their case for adjustment, with supporting evidence, as early in September as possible. I will keep you informed of progress.

3. I am copying this minute to John Nott, Leon Brittan and Sir Robert Armstrong.

May we also know the pay increases associated with wrecked equipment costs? MT

Jim Rutter
pp (G.H.)
5 August 1981

(Approved by the Chancellor of the Exchequer and signed in his absence)

Pm. un 3/8

Defence

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
Telephone 01-~~930 7022~~ 218 2111/3

MO 14/3

27th July 1981

(2)

Prime Minister

Dear Brian,

The American Defense Secretary has taken up a suggestion my Secretary of State made to him during the course of his re-examination of the defence programme, and proposes to come to London for a day of talks, on Friday 21st August.

I should be very grateful if the enclosed letter Mr Nott has accordingly written to Mr Weinberger could be despatched to Washington. Our officials will obviously be in touch about the briefing for the visit; and I think that ours will be asking yours to arrange for a probe in Washington on the precise motives that lie behind Mr Weinberger's slightly surprising desire for talks so early.

I am sending copies of this letter to Michael Alexander (No 10) and David Wright (Cabinet Office).

Yours sincerely
Brian Norbury

(B M NORBURY)

B J P Fall Esq

MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

TELEPHONE 01-218 9000
DIRECT DIALLING 01-218 2111/3

27th July 1981

Dear Cap.

Many thanks for your letter of 22nd July. I should be delighted to welcome you to London next month to continue our discussions. I am only sorry that I shall be away from London on 10th August, which I know was your suggested date, but I understand that our offices have been in touch and have suggested an alternative of Friday 21st August. This would suit me very well, and I look forward to meeting you again then.

I suggest that our staffs now get together to make the necessary arrangements.

With best wishes,

John.

John Nott

The Honorable Caspar Weinberger

Defence

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
Telephone 01-~~XXXXX~~ 218 2111/3

MO 35/1/1

27th July 1981

To have ready in case for a reply from Mr Foot to the Prime Minister's letter of 9 July. Sir T McCaffery says we can be sorting now.

Dear Clive,

DEFENCE BRIEFING FOR THE OPPOSITION

Thank you for sending me copies of the Prime Minister's letters of 9th July to the Leader of the Opposition and the Leader of the Liberal Party. We have now made inquiries of SACEUR.

We understand that the three Major NATO Commanders, led by SACEUR, and with Mr Hughes from Washington, could give a briefing on 3rd, 4th or 9th November (it seems over ambitious, for a variety of reasons, to aim for a date earlier than November).

The basic structure proposed for a briefing is that the three Major NATO Commanders should speak for about 40 minutes; that there should then be a briefing, again for about 40 minutes, from Mr Hughes; and that there could then be a question and answer period.

Given particularly the length of this briefing my Secretary of State would now like to suggest that only one is given for the Opposition leaders (desirably, in the case of Mr Foot, with Mr Healey, if Mr Foot so determined) but with in attendance also members of the Cabinet, and with perhaps also, if the Prime Minister so decided, other Privy Councillors in the Government. It is not likely that much additional classified material could be made available for a briefing confined only to the Government, although, clearly, the restriction of attendance to Government Ministers might lead to a more open discussion.

C A Whitmore Esq

If the dates suit, and if the above proposals commend themselves to the Prime Minister, she might like to write again to Messrs Foot and Steel on the lines of the attached draft.

My Secretary of State believes that it would be appropriate for a Government only lunch to be given to the Major NATO Commanders either before or after the briefing; he would propose to arrange this himself unless the Prime Minister would like to offer lunch.

I am sending a copy of this letter to David Wright (Cabinet Office).

Yours ever

Bob

(B M NORBURY)

DRAFT FOR PRIME MINISTER TO WRITE TO THE RT HON MICHAEL FOOT MP/ RT HON DAVID STEEL MP

I am writing further to my letter of 9th July concerning a classified defence briefing to enquire whether it would suit you if I were to arrange this briefing on 3rd, 4th or 9th November.

If one of these dates would suit you I will be in touch with you about the precise time and arrangements. As I have said I envisage that the briefing should be on Privy Councillor terms, and I have it in mind that members of the Cabinet should join us to hear the presentation from the NATO team.

Perhaps you would also let me know whom you would like to bring with you?

If the date is inconvenient I will see what are the alternative possibilities: it is a little difficult to get together at any one time the three of the Major NATO Commanders who would all usefully be present.

I am writing similarly to David Steel/Michael Foot.

2.

Prime Minister.

The Chancellor proposes this in Ottawa, but it has only just reached us. He thought you should have it in case John NOTT tries to nobble you. No need for you to do anything at this stage.

MCL 24.viii

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DEFENCE CASH LIMITS REVIEW

Aide Memoire for the Prime Minister

1. November 1980 Cabinet decision that the 1981-82 Defence cash limit should be reviewed, taking account of:-

(i) the reduction required to offset the 1980-81 overspend (75 million pounds);

(ii) the cost of any pay increase beyond the 6 per cent already provided (this is put at 80-90 million pounds); and

(iii) any change justified by the movement of defence prices in relation to the 11 per cent already provided for.

2. It was agreed in restricted meetings earlier this year that the last tranche of cuts required by the November 1980 decision on the volume of defence expenditure should also be settled in the context of this review.

3. Urgently necessary to complete the review - before the Recess.

4. Ministry of Defence cash limit managers are expecting increases on account of (i) and (ii) in para 1 and also an increase of 295 million pounds on account of higher defence prices (which they attribute to a continuing fall in sterling and to high pay settlements in the defence industries). They also want exemption (cash cost 42 million pounds) from the last tranche of volume cuts. Total addition 427 million pounds.

5. Treasury calculate that defence prices will increase by only 9½ per cent, which would imply a reduction of 92 million pounds. Allowing for higher service (but not civilian) pay, and offsetting last year's cash limit overspend, this implies a total reduction of 99 million pounds.

/6

6. Essential to stick to last year's volume decision, and to normal cash limit discipline that overspends must be offset. Defence cash limit must not be infinitely adjustable. Other cash limited programmes had to find ways of containing cash so as to keep within the limits. Defence should not exaggerate difficulties; last year's overspend only 75 million pounds as compared with 300 million pounds threatened earlier.

7. If Defence are to take timely action, decisions needed now. May be necessary to resist pleas by Defence Secretary to wait for more evidence on prices. Officials preparing joint report on facts, and issues for Ministerial decision.

19 July 1981

Defence

Civil Service Department
Whitehall London SW1A 2AZ
01-273 4400

21 July 1981

The Rt Hon Mark Carlisle QC MP
Secretary of State for Education and Science
Elizabeth House
York Road
LONDON
SE1 7PH

LM 23/7

Dear Mark,

REDUNDANCY COMPENSATION TERMS FOR SERVICE PERSONNEL

Thank you for your letter of 7 July about John Nott's proposal that the 1975 compensation terms should apply to Service personnel made redundant as a result of the new defence programme.

As you know, at its meeting on 14 July, H Committee agreed with your suggestion that we should take a general look at our policy on payments to those made redundant in the public sector. I have been asked to produce a paper with the aim of ensuring a common approach so far as that is possible. As a first step, my officials will be discussing this with officials of other interested departments on 31 July. Their aim will be to identify for us the areas where a common approach would be useful and practicable and those where we could justify different treatment. We shall, of course, need to consider very carefully the financial implications of any proposed changes in the present redundancy terms.

Allowing for these discussions and the Summer Recess, it may be some weeks before I can put my paper to our colleagues. In the meantime I hope we could agree to accept John Nott's proposals for the Armed Forces. What he is proposing is the continuation - without improvement - of an existing scheme. And though the scheme is in some respects generous, it reflects the particular circumstances of a service career. Politically, it would be very difficult to cut back on those terms for members of the Services made redundant as a result of the latest defence review.

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Michael Heseltine has already recorded his agreement. If you and our other colleagues are also content, I would see no objection to accepting John Nott's proposal. I think he would find it helpful to have an early decision as the question is likely to be raised before long both publicly and in discussion with the Services.

I am copying this letter as before.

Yours ever

Christopher

SOAMES

Defence

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
Telephone 01-930 7022

MO 21/8/16

16th July 1981

MOAGA
Any comment?
MAP 16/VII

No.
17/7

Dear Mike,

HOUSE OF COMMONS DEFENCE COMMITTEE: GOVERNMENT OBSERVATIONS ON THE SECOND REPORT ON THE STATEMENT ON DEFENCE ESTIMATES 1981

The House of Commons' Defence Committee's Second Report was published on 15th May and I enclose a draft of the Observations which, subject to comment, my Secretary of State would propose should be published next week.

The Observations are essentially uncontroversial; Mr Nott proposes that they should be sent, following last year's precedent, as a memorandum which the Committee could have printed as a Special Report if it wishes rather than be printed and presented as a Command Paper.

I am sending copies of this letter, with the draft Observations, to David Heyhoe (office of the Duchy of Lancaster), Murdo Maclean (Chief Whips Office) and the Chief Press Secretary at No 10. Perhaps I could assume no comment if I have received none by close of play next Monday, 20th July?

Yours ever
Brian Norbury

(B M NORBURY)

M A Pattison Esq

D R A F T

HCDC 140/15

GOVERNMENT OBSERVATIONS ON THE SECOND REPORT FROM THE DEFENCE COMMITTEE SESSION 1980-81 HC 302

STATEMENT ON THE DEFENCE ESTIMATES 1981
Observations by the Secretary of State for Defence

1. The Second Report from the Defence Committee was published on 15 May. The Government welcomes the Committee's support for the continued improvement of the information given in the annual Statements as a basis for better-informed public debate.

Low Cost Summary Version

2. The Committee invited the Ministry of Defence (paragraph 2) to consider publishing an additional low-cost summary version of the White Paper in the future.

3. This is an attractive idea. The present White Paper is expensive and copies do not reach a very wide audience. The cost of producing a summary version must however be weighed against the number of people likely to be interested in having it. A summary version could be justified only if it reached a much wider audience.

4. A version for new, non-specialist, readers would have to be brief and reasonably attractive. This would be expensive to produce in quantity but would need to be either free or very cheap to attract a substantial new public. Special distribution arrangements might also have to be made. A considerable MOD financial subsidy would then be needed. A less attractive version, perhaps on a more

restricted distribution, would be cheaper but would have correspondingly more limited appeal.

5. It is therefore regretfully concluded that a summary version would be ineffective or expensive, and possibly both. The aim of sharing the contents of the White Paper with as wide an audience as possible is probably best achieved through debate in the House of Commons, and with the help of the mass media, with whom the Ministry of Defence works closely to help ensure that the public are given an accurate and interesting picture of the White Paper's contents.

Standardisation of Tanks, Guns and Ammunition

6. In paragraph 9 of its Report the Committee referred to the prospects for collaboration on tanks. The Ministry of Defence accepts that the gun and ammunition represent one of the areas where greater interoperability among NATO tank fleets would be advantageous. The Committee has already noted that this will not be attainable in the near term, since CHALLENGER will have a rifle-bore gun firing separated ammunition whereas our allies are committed to smooth-bore technology and one-piece ammunition for the generation of tanks now entering service. However, we recognise the benefits of interoperability and have no preconceived ideas about the gun and ammunition for a future tank. We will examine every possibility for collaboration to produce tanks in the 1990s, taking into account operational, financial and industrial factors.

Defence Sales to the United States

7. The Ministry has submitted a separate note on the steps taken to promote the Searchwater radar in the United States (paragraph 13 of the Report). These include arrangements by EMI for Lockheed cooperation in installing and evaluating the radar in the P3 Orion. The importance of securing industrial as well

as official cooperation when promoting the sale of defence equipment in the United States is fully appreciated. The Ministry will continue to encourage British firms to seek industrial cooperation where appropriate.

The Chevaline Programme

8. The Committee asked that the current state of the Chevaline programme should be made clear to the House as soon as possible. As the Secretary of State has already told the Committee, the estimate of the cost of the Chevaline programme remains at about £1 billion. There has been no significant cost escalation in real terms since the end of 1977, although there had been major increases in the earlier stages of the project. Information concerning the precise in-service date is classified, but as the White Paper makes clear the programme is far advanced. The Government does not plan to make any further statement on Chevaline at this stage.

Aircrew for Civilian Transport Aircraft in Reinforcement Plans

9. The Committee asked (paragraph 17) for consideration to be given to the introduction of a reserve to provide crews for the civilian transport aircraft in contingency plans for reinforcement. The Ministry of Defence remains confident that the civil air transport organisations can be relied upon to honour the obligations incurred under Letters of Agreement and that volunteer support will be forthcoming. The Ministry will however continue to keep under review the adequacy of the existing arrangements.

Manpower

10. The Ministry of Defence shares the Committee's view of the importance of maintaining adequate Service manpower levels,

(paragraph 19) and accepts the need to explain in next year's White Paper what action is proposed to deal with the decline in the size of the recruitment age group.

11. The Committee recommended (paragraph 20) that in subsequent White Papers the financial savings from reductions in civilian manpower should be quantified. The Ministry will try to do so, but powers are widely delegated throughout the Department and special arrangements will be needed to collect the information. While the bigger blocks of work should present little difficulty the large number of smaller-scale efforts to streamline may make exact and reliable assessment difficult. Moreover where sub-contracting is involved it may be necessary to preserve the confidentiality of contract prices by presenting figures in aggregated form, for example as net savings.

CONFIDENTIAL

Defence

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

14 July 1981

The Rt. Hon. The Lord Carrington, KCMG MC
Secretary of State for Foreign and
Commonwealth Affairs

NBPM

Dear Peter

DEFENCE PROGRAMME - GIBRALTAR

Thank you for sending me a copy of your minute of 9 July to John Nott.

You say in your second paragraph that our obligation to support Gibraltar would not necessarily come to an end if Spanish restrictions on the border were lifted. Nevertheless, as you also point out, our commitment flows from the existence of those restrictions, and I cannot accept that we would have any such continuing obligation after they had been lifted. This is not to say that we might not then choose to continue to support Gibraltar, but that is a different question.

You suggest to John that any extra aid which would be needed to fulfil our commitment in the event of the closure of the dockyard might be financed by a transfer from Defence Votes. I am concerned that the savings in public expenditure resulting from the closure should be preserved intact, and so any extra aid should be found from within existing programmes, and not offset against those savings. I would like my officials to have a chance to discuss with yours the financing of any extra aid and the amounts of money involved, which you estimate at about £30 million.

I am sending copies of this letter to the Prime Minister and to the Secretary of State for Defence.

Yours

Geoffrey

GEOFFREY HOWE

CONFIDENTIAL

010

THE RT. HON. DAVID STEEL, M.P.

HOUSE OF COMMONS
LONDON SW1A 0AA

file:
TL.
14 vii

13th July 1981.

Dear Private Secretary,

Mr. Steel has asked me to acknowledge with his thanks The Prime Minister's letter of 9th July about a classified defence briefing.

He notes that she will be in touch with him again shortly.

Yours sincerely,

Tessa Horton

(Miss T. Horton) Private Secretary.

The Private Secretary,
10 Downing St.,
London SW1.

F.S.

Prime Minister

(2)

FCS/81/97

SECRETARY OF STATE FOR DEFENCE

10/7

MT

Defence Programme: Gibraltar

1. In response to Geoffrey Howe's letter to you of 24 June, I can confirm that, in telling the Chief Minister of the White Paper commitment to "support the economy of Gibraltar", the Governor said that no detailed undertaking could be given as to how it will be discharged. The Governor was reminded that the commitment itself flowed from the Spanish restrictions.

2. Your plans for the dockyard are one of the details of the defence programme which remain to be discussed and perhaps brought to OD. It is unrealistic to think that we shall be able to wash our hands of Gibraltar and give no further assistance from the day the frontier opens. To say that we would then recognise no obligation to support Gibraltar goes too far.

3. I understand that the first estimates of savings to the defence vote from closing the dockyard and giving up the airfield are over £30m per annum. (I assume that in the circumstances of dockyard closure or major reduction, the costs of "re-provisioning" as may be necessary will be met by MOD.) The aid necessary to get both going again as civil undertakings will, I hope, be a good deal less than that. But I cannot accept that the extra aid to Gibraltar (which will undoubtedly be needed if the dockyard is to be closed as you wish) should be found from within the

/existing

existing Aid Programme. I believe that in the circumstances there is a very good case for some support from Defence Votes. Transfer of surplus MOD land to the Gibraltar Government without charge would go some way to ameliorating Gibraltar's problem. But clearly we shall need to do more than this. A PESC transfer from your Votes to my ODA Vote seems not unreasonable if the cutback you propose is to be achieved and our commitment to the people of Gibraltar honoured. The required transfer to the Aid Programme could very well be of the order of £9m annually, reducing as civilian enterprises become viable. This process may be quite fast once the Spanish restrictions are lifted but we do not know. Alternatively to provide a firmer budgeting figure and to avoid an open-ended commitment on your part, we might consider a total transfer of £30m, divided over four years from 1982-83 as £5m, £10m, £10m and £5m. Thereafter we should have to consider any continuing need for aid in the content of the PESC provision and the Aid Framework at the time. This would still show a substantial net saving to public funds if the £30m a year estimate is anywhere near the mark.

4. I have not yet seen the record of Tuesday's debate, but I understand that Gibraltar did not figure significantly. In particular, the difference in treatment of Chatham and Gibraltar in your statement on 25 June seems not to have been used to cause us political embarrassment. Given the financial facts as well, you may, therefore, think that there is some scope for modifying your original Gibraltar proposals. For instance I understand that withdrawal of the Army battalion from Gibraltar might save some £13m annually. We should, of course, need to take into account the effect of the withdrawal of the army units on the Gibraltar economy in

/the

the context of our commitment to "support and sustain". But our preliminary view is that the need for remedial measures would be substantially less than in the case of the measures affecting the dockyard and the airfield.

5. If this is not an acceptable alternative, there seems, at the very least, to be a case for adjusting the timing of your proposals further. Some flexibility would allow alternatives to the dockyard's role in the Gibraltar economy to be put in place before it closes.

6. I am sending copies of this minute to the Prime Minister and the Chancellor of the Exchequer.

C

(CARRINGTON)

Foreign and Commonwealth Office

9 July 1981

B

file

CP

10 DOWNING STREET

cc MOD
Cabinet Office

THE PRIME MINISTER

9 July 1981

Dear Michael

David Steel has suggested to me that there would be advantage if I arranged a classified defence briefing similar to the one which Jim Callaghan arranged for the Opposition in 1976.

I agree with him that such a briefing would be useful. I think that it might best be given by a team from NATO, and it would of course be on Privy Counsellor terms. I will seek to arrange it as soon as possible after the Summer Recess.

I very much hope that you will be able to be present at the briefing. If you would like to attend, my office will be in touch with yours shortly to discuss possible dates.

Yours sincerely

Margaret Thatcher

The Right Honourable Michael Foot, M.P.

B

CUMOD
Cabinet Office

10 DOWNING STREET

THE PRIME MINISTER

9 July 1981

Dear David,

I am sorry not to have replied before to your letter of 3 June suggesting a classified defence briefing.

I think that this is a very good idea and I have asked John Nott to see what could best be arranged. I think that the briefing, like the one we had in 1976, should be given by a team from NATO and should be on Privy Counsellor terms.

I am afraid that the briefing cannot be fitted in before the Summer Recess but I will be in touch with you shortly to discuss possible dates in the autumn.

I propose to invite Michael Foot to attend the briefing and I am writing to him accordingly.

Yours sincerely

Margaret Thatcher

The Right Honourable David Steel, M.P.

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1A 2HB
Telephone 01-218 2111/3 (Direct Dialling)
01-218 9000 (Switchboard)

MO 9

8th July 1981

Dear Clive,

Thank you for your letter of 6th July about the proposed defence briefing for members of the Opposition.

My Secretary of State will aim to put a specific plan to the Prime Minister by the end of this month. Meantime I enclose the drafts of possible letters from the Prime Minister to the leaders of the Liberal and Labour Parties.

Yours ever
Bill

(B M NORBURY)

C A Whitmore Esq

DRAFT FOR PRIME MINISTER TO WRITE TO RT HON DAVID STEEL MP

I am sorry not to have replied before ~~this~~ to your letter of 3rd June suggesting a classified defence briefing.

I think that this is a very good idea and I have asked John Nott to see what could best be arranged. I think that the briefing, like the one ~~to which you refer~~ we had in 1976, should be ~~a~~ given by a team from NATO ~~one~~ and should be on ~~a~~ "Privy Counsellor" ~~basis~~ terms. ~~I believe that I should extend an invitation to~~ Michael Foot, and I am writing to him accordingly.

~~I do not think~~ I am afraid that the briefing ~~could be~~ cannot be fitted in before the Summer Recess but I will be in touch with you shortly to discuss possible dates in the Autumn.

DRAFT FOR PRIME MINISTER TO WRITE TO RT HON MICHAEL FOOT MP

David Steel has suggested to me that there would be advantage ~~in my arranging~~ it's arranged a classified defence briefing similar to ~~that~~ the one which Jim Callaghan arranged for the Opposition in 1976.

I agree with ~~David~~ him ~~that~~ that ~~this~~ would be ~~a~~ useful ~~idea, and~~ I ~~have proposed to him that it should be a NATO briefing~~, and one ~~given~~ of course be on "Privy Counsellor" terms. I will seek to arrange it as soon as possible after the Summer Recess.

~~I thought that I should ask you whether you would - as I hope you will - like to attend.~~ If ~~so, I~~ you would like to attend, my office will be in touch with ~~you~~ yours shortly to discuss possible dates.

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DEPARTMENT OF EDUCATION AND SCIENCE

ELIZABETH HOUSE, YORK ROAD, LONDON SE1 7PH

TELEPHONE 01-928 9222

FROM THE SECRETARY OF STATE

WM 23/7

Rt Hon Lord Soames GCMG, GCVO, CH, CBE
Lord President of the Council
Civil Service Department
Whitehall
LONDON SW1A 2AZ

7 July 1981

Dear Christopher,

REDUNDANCY TERMS FOR SERVICE PERSONNEL

PEG.

Your response to John Nott's letter of 19 June recognised the importance of redundancy compensation for various groups of employees. At this stage I would like to add that I support the idea of an across-the-board look at the difficulties facing our several Departments, in the hope that we can move towards a common approach or agree on differences in treatment which can be defended. I would therefore favour discussion in a Cabinet Committee, perhaps starting from a note summarising the arrangements, present and proposed, in our various fields of responsibility.

I am sending copies of this letter to the recipients of yours to John Nott.

Yours ever

Mark.

MARK CARLISLE

CONFIDENTIAL

MINISTRY OF DEFENCE
MAIN BUILDING WHITEHALL LONDON SW1
Telephone 01-~~XXXXXXX~~ 218 2111/3

MO 9

6th July 1981

NBPM

Dear Clive,

DEFENCE DEBATE

I enclose the latest draft of a speech with which my Secretary of State proposes to open the Debate on Command 8288 tomorrow; a further passage on Trident is under consideration here.

I am sending copies of the draft, with this letter, to John Wiggins (HM Treasury), Brian Fall (FCO), Ian Ellison (Industry), David Heyhoe (Office of the Chancellor of the Duchy of Lancaster), Richard Dykes (Employment), David Edmonds (Environment) and Murdo MacLean (Chief Whip's Office).

Yours ever,

Brian

(B M NORBURY)

C A Whitmore Esq

The first duty of any British Government is to safeguard our people in peace and freedom. Peace requires will, it demands vigilance and it does not come cheap.

[Peace is expensive - but it is nowhere near as expensive as war.]

No-one can doubt the capacity of the British people to respond to a national crisis in time of war; but history warns us that it is less easy to ask them to pay a heavy premium to insure against war in time of peace.

But for 35 years under successive Governments we, with the other members of NATO, have paid that premium and as a result Europe has enjoyed, and still enjoys, peace.

No-one can be certain whether the rt hon Gentleman the Member for Leeds North East was correct, when on the 7th May, Col 285, he said that the tensions in Europe since 1945 would in any other period of world history have led to war. But it seems sensible to give him the benefit of the doubt. Security is not an area of policy where there is anything to be gained from taking risks. If deterrence has worked, it would indeed be an odd moment to diminish it, by lowering our guard against the threat.

For the international scene is in many areas unsettled and even turbulent. Soviet conventional military power already massive continues to grow in size, quality and reach - and the Soviet leaders continue to demonstrate their readiness to use it brutally.

At another level - nuclear weapons exist; they cannot be disinvented, or wished away. Each week another Soviet SS20 nuclear missile is targetted on our cities, and whether we renounce our nuclear deterrent or whether we do not, there are 9 or 10 non-nuclear countries who could become capable of developing nuclear weapons in the next decade. None of them would be remotely influenced by a unilateral gesture on our part.

However much we may share a sense of horror about these weapons and work for non-proliferation and disarmament it would be a strange moment to choose (nuclear) defencelessness for ourselves.

I believe that the British people generally are prepared to face the task of keeping the peace in an increasingly violent world; and in asking them to fund a real increase in defence expenditure of 3% for the next 4 years, we are, of course, asking them to forego other benefits of a more visible kind.

But, whilst I have no doubts about the readiness of the British people to make some additional sacrifice for security there seem to be faint hearts in high places less ready to meet the challenge. Perhaps the greatest danger which we face is from a failure of will, a creeping demoralisation in the face of the seeming hopelessness of it all, and a loss of confidence in our ability to preserve our fundamental values in the face of a world which seems increasingly doomed to violence.

Those who undermine and demoralise our defences with defeatist and neutralist talk can unwittingly become a cause of war. I would not be so foolish as to suggest that those who hold genuine pacifist views are in the pay of some international conspiracy, but whatever motives they too sing the Kremlin's song.

For unwittingly they lead the Soviet leadership to believe that the West has no longer the will to resist. The huge campaign now being conducted from the Kremlin against the modernisation of our nuclear deterrent is evidence enough of their determination to break our will.

Consider only that for the last 3 years the Soviet Union has been deploying long range theatre nuclear missiles of enormous accuracy on targets throughout this country whereas all the UK possess is a force of ageing Vulcans increasingly difficult to keep maintained and flying in the air, let alone capable of penetrating Soviet defences. Is it seriously suggested that we can cease the modernisation of our deterrent and freeze the position as it is - leaving their existing SS20's in their place?

I quoted a Russian Admiral in my last speech to the House. At the risk of arousing anxiety about my bedtime reading I would now like to quote from a Russian General. General Yapishev, Head of the Political Directorate of the Soviet Army has said:

> "Nuclear weapons in imperialist hands threaten mankind: in the hand of the Soviet Army they serve to defend peace and the foremost social system in the world."

Whatever hon Gentlemen below the gangway may propose, I doubt if the vast majority of our fellow countrymen are prepared to put their future in General Yapishev's hands but that is precisely what the CND would seek to do; what the renunciation of all civil defence preparation implies and what those who seek to turn the Labour Party into what Mr Sydney Weighell has recently described as a Bolshevik-style organisation, paving the way to physical confrontation on the streets.

The Way Forward, to use the words of the White Paper, is not an easy one. In times of economic difficulty we are having to ask our people to contribute significantly more to defence; we are asking members of the Armed Forces and their supporting civilian staff to accept quite radical change, - and most painful of all, having to reduce jobs in our Dockyards by 1984 - in order to provide the resources to keep our front line strong.

Mr Speaker,

In 1981 we have to be prepared for war at three distinctive levels at the level of subversion and terrorsim; by intervention, directly or by proxy, in non-aligned countries, as with the Soviet invasion of Afghanistan; and finally by direct military conflict. First at the level of armed terrorism and subversion. Every day we read of outrages by gun and bomb. We cannot compromise with this threat. We must maintain law and order in Northern Ireland. We will continue to make preparations to combat terrorism and subversion here at home, or against our vital oil and gas installations off the coast. And if we have to act, as in the seige of Princes Gate, we will act decisively.

Second, in reviewing our defence programme the Government has had to look far beyond the confines of our small corner of Europe. For we must recognise the threat to our peace and prosperity which comes from the other side of the globe. Soviet leadership will, mark my words, follow Lenin's dictum:

> "Probe with bayonets. If you find mush - proceed; if you encounter steel - withdraw."

Soviet oil production may well peak in the next two or three years although her consumption will continue to increase. She may find new areas of production such as the Barents Sea and she may compensate for her lost oil export earnings by supplying natural gas to Western Europe. But Eastern Europe may be forced to buy large quantities of oil from the OPEC countries of the Middle East, with little prospect of finding the hard currency earnings to pay for it.

In one area, at least, therefore - the Middle East - Soviet political, strategic and economic interest all point in the same direction. The dangers are clear.

The Government fully recognises that the security and stability of third world countries are in the first place matters for the states themselves, and it is in this spirit that we do everything possible through military training, assistance and the supply of equipment precisely to help them build up their ability to defend themselves.

But we have a role to play by a presence, albeit modest in scale, in out-of-area deployments. That is why we have made special provision in the defence review to enable Royal Naval ships, whether with a Carrier group or with a group of frigates to resume deployments for visits and exercises beginning

in the next financial year. We are also continuing with the plans to build up a stockpile of essential equipment for such tasks. The designation of a command structure, the conversion of our Hercules aircraft for assault parachute tasks in an emergency and other preparations have all been maintained in the programmme. With this modest plan we envisage being able to make a contribution to operations by the United States and other Allies, should we be called upon to protect the interests of friendly local states, and or of wider Western interests in strategic regions.

Third I turn nearer to home, to Europe. Is direct military conflict likely here? Certainly I do not believe, at present, that the Soviet leadership seek a direct military confrontation with Western Europe - and that, in itself if you like, is proof of the success of the Western Alliance.

But in a single party state, with the Soviet leadership in the possession of overwhelming and still growing military power who can be certain of the future? Who can tell what problems will come for their successors with popular discontent inevitable over living standards, with a disintegrating Empire, with demographic problems - a steep increase in the birth-rate of the non-Slav peoples especially the 50 million Moslems in Central Asia - and all this held together by a repressive bureaucracy and supplied by a heavily over-centralised and inefficient economic system?

Can we disregard totally even the possibility in years to come of a disintegrating Soviet Empire; with as an act of desperation the dying giant lashing out across the Central Front?

If - and this is only speculation - such circumstances were ever to arise what would be the Soviet's objectives. The Warsaw Pact superiority is 2.3:1 in tactical aircraft, 2.5:1 in armour and 2.8:1 in artillery. Moreover on top of this the tremendous military resources of the Western military districts of the Soviet Union could quickly be brought to bear as reinforcements on the Central Front - and let us not forget that the Soviet Union has immense geographical and logistic advantages in any conflict in Europe.

The United Kingdom as a principal reinforcement base for NATO would in my view be a first and immediate target, together with West Germany. The aggressor would have to deal with both countries quickly. If the Soviets attempted to smash a way through on the Central Front with their overwhelming conventional superiority there might be a war which was nasty, brutish and short - for we should remember that today's conventional weapons are far more destructive than those used in any previous war.

So deterrence must begin for us in Europe. If the British Isles cannot be defended against Soviet special forces, if the Central Front does not hold, then no reinforcement from the United States would be possible over the succeeding months. The forward defence

of Germany is the forward defence of the United Kingdom itself and these islands are - leaving the question of nuclear weapons entirely on one side - the overriding first target given our key role as a reinforcement base for NATO.

In the Defence Review, therefore, we looked first at our ability to hold such an attack - as well as to deter it. If it ever came, it would be a Blitzkrieg of immense conventional force. And the Channel would not protect the UK Base, for instance from the highly trained Soviet special forces, in the same way as it did in 1940.

The first essential, therefore, is to strengthen the combat effectiveness and in particular the staying power of our land/air capability on the Central Front, and the air defence of the United Kingdom. Not only is this essential, if reinforcement is to have any part to play at all, but it also raises the nuclear threshold.

[Some commenters have concluded that because we have no choice but to modernise our strategic nuclear deterrent, as the previous Labour Government did before us with the Chevaline programme we have in some way lowered the threshold. That is nonsense.]

I will not list again the substantial enhancement of our land/air and UK air defence capability above present levels set out in the White Paper. But I would like to stress that we gave particular attention to an increase in war stocks and ammunition - to the extent that I estimate we shall be increasing the staying power of 1 BR Corps by around 20 to 30%. I repeat that this raises the nuclear threshold in the most cost-effective way open to us.

It would, of course, have been more glamorous and indeed welcome to British Industry - to have announced new orders for tanks and aircraft but, if we were to be able to afford to maintain most existing procurement programmes - as indeed we have done - the best way of increasing combat endurance was by enhancing war stocks.

I do not have any doubt that leaving aside the more ambitious plans and aspirations of the Department we have substantially

increased the effectiveness of our land/air capability above its existing levels.

This brings me then to our maritime air capability. I must first emphasise here that, so far as I can judge, we have not made a major shift away from our maritime air capability in the Atlantic. These things are difficult to calculate and involve many difficult judgements of where to allocate resources but I estimate that there may be a minor but only a minor shift to our land/air commitment.

The Sea Systems Procurement Vote will increase by 11% in real terms in the next 4 years, against the existing plan of a 13% increase. The reduction in what is misleadingly described as, the Royal Navy's share, when in fact we are not talking about shares but capability, comes in fact from the Dockyard Vote which will fall by 25% to 30% against a planned increase of 11% over the next 4 years.

Of the three main tasks in the Atlantic, first, the covering, as best we can, of the Greenland/Iceland/UK gap and other choke points against Soviet submarines; second, the prosecution of anti submarine warfare generally in the Atlantic and third, the protection of reinforcement shipping, I am confident that we are enhancing our capability in the first two.

Our decision to continue unabated with the nuclear and conventional submarine programme, the enhancement of our Nimrod II conversions, the procurement of Sea Eagle and Sting Ray and the running on of the Buccaneers are all a major plus.

This brings me then to the third area which has been the principal point of controversy, namely reinforcement by sea. I have already made the point that if we lose on the other fronts reinforcement is irrelevant - it would be too late. The manpower reserves will come by air and we must protect the air lanes in the first days of a war. We must preposition as much heavy equipment as we can in Europe,

but I have always recognised, first, that no one can predict the course of any future conflict and secondly that massive reinforcement of heavy equipment by sea will be essential if we succeed in holding the first aggressive thrust.

Naturally I would have wished to increase our escort frigate and destroyer numbers above their present level. I recognise the important role of the surface fleet in times of peace and war. I recognise too that we can never be sure that a future conflict might not start with deliberate naval brinkmanship by the Soviet Union.

But we have to assess priorities in the 1990s and beyond, not least in the light of the latest class of Russian submarines which are now equipped with anti surface ship cruise missiles with a range of 250 missiles - outside the range of even the Sea King Replacement helicopter. And our resources are not infinite.

In a genuine desire to afford, within our budget, both a new shipbuilding programme and a reasonably sized surface fleet I was much influenced by the Dockyard Study prepared under the chairmanship of my hon Friend the Member for Ashford. In Annex I which is available for study in the House of Commons Library, there is a most useful analysis on the cost-effectiveness of the policy of refitting surface ships. The Select Committee on Defence is examining the position at the present time. If we are prepared to accept the painful employment changes for the Dockyards which I have proposed, then we will be able to release substantial resources in this supporting area.

I do not claim any originality in identifying these changes for they have been the subject of continuous arguments and study within the Royal Navy for very many years.

As the House knows we are proposing a reduction in our NATO declaration from 59 escort ships at present, of which some are in the Standby squadron - and many others are under major modernisation - to a figure of about 50, of which 8 will be in the Standby squadron but with of course fewer ships in a low state of readiness in Dockyard refit.

It is for this reason, as Annex I points out, that a short-life destroyer frigate fleet without expensive midlife modernisation will have a higher availability of about 12% than a long life fleet of the same size. It shows that a smaller short-life fleet of equivalent operational availability will be marginally cheaper, though considerable reductions in dockyard load will be possible, and that the military worth of a short-life fleet will be slightly higher since ships will be more modern.

My hon Friend would immediately remind me that the conclusion against short-lifing reached by his study were based on the assumption that the size of the surface fleet must be kept at its planned level, and that the resources must be made available to build new ships under the new policy.

But I believe we can build new and cheaper ships and I have made provision for an acceleration of the building programme of the new Type 23 frigate.

I believe we can get the design settled and orders placed faster than has been the case in the past with new ships, and I shall be taking a personal interest to ensure that the Navy Department and British Shipbuilders work together to get the orders into the yards as quickly as humanly possible.

But accepting a rather smaller surface fleet, we should be able to obtain the benefits of higher availability and slightly greater military worth, outlined in the Report, at a very great saving in dockyard support.

The next genuine matter of concern has been expressed to me by my hon Friend the Member for Faversham and other of my hon Friends; It concerns the question of capacity in Devonport and Rosyth to carry forward the larger nuclear submarine refitting programme envisaged in my Statement.

Experience of the performance and durability of submarine equipment and materials, and the introduction of longer life cores for their reactors now make it possible to plan for the extension of refit intervals by 10% for older boats and 20% in the new Swiftsure class of submarine. In addition one of the three intermediate dockings for the nuclear submarines is being discarded although there will be intermediate docking periods for testing and examination to ensure that the highest standards are maintained.

It is not possible to judge the feasibility of the new plan by simple arithmetic based on the number of so-called "streams" available in Devonport, Rosyth and Chatham. Having two streams does not mean that submarines enter the refitting complex two by two like animals entering the ark.

Prior to the dfence review Devonport's programme provided for an accelerating SSN refit with start dates initially at 16 months closing gradually to 12 months, down to 10 months. The options for a rephasing of the nuclear refit programme have been restricted to a relatively small expert team in the Ministry of Defence in London and in the Dockyard Department in Bath.

But I am assured that with the new facilities already available at Devonport as a result of expenditure already made of £85M, and further support facilities already in the pipeline, the increased workload can be handled in Devonport and Rosyth. It will however need an increase of numbers at Devonport of about 1,500 people, some of whom will be transferred from Chatham or Portsmouth.

I must ask the House to accept that the Government - and I personally - will do all that we can to ensure that these changes are effected with the minimum hardship. They are to be implemented over a number of years. There will be redundancies among the civilian force (and also in the Services) but they will be kept to the minimum. The Ministry of Defence, and other Government Departments, will take all possible steps . . . .

I have drawn the attention of my rt hon Friends in other Departments to the needs of the situation, and proposals put to me, for example in respect of the relase of land at Portsmouth, are under urgent consideration by my rt hon Friend the Secretary of State for the Environment and myself. As soon as I can be more specific, I undertake that I will put forward proposals.

Mr Speaker, I have spent some time on the dockyard re-organisation because it affects so many of my honourable Friends, and in a most distressing way for their constituents and themselves. In general criticisms which I have received from my honourable Friends, with only one or two exceptions, are not directed at the overall strategy. I think it is broadly accepted that we could not pull any bricks out of the supporting arch of NATO by withdrawing from our present commitments on the Central Front. Some of my honourable Friends think we should have spent more money - going beyond the 3% increase. But generally it is specific aspects of my proposals to which my honourable Friends have directed their attention.

But I have to say this, with the increasing costs of defence equipment which have been accelerating far faster than the general level of inflation and beyond the increase of 3% in defence expenditure, it was necessary to look to major savings in manpower, both Service and civilian, at all levels.

If we were to avoid massive redundancies in the defence industries by a wide-spread cancellation of existing programmes, there was nowhere else to look but in the supporting infrastructure. And quite apart from the dockyards, we have proposed substantial changes in the infrastructure of the Army; the savings in the headquarters

of the British Army of the Rhine will amount to 20% and we will withdraw a divisional headquarters; the training and general management and support organisation of the Army is also too large when related to its present front line strength.

Thus, whilst I am sensitive to the employment consequences of what we have to do to underpin the improvements we are making in our front line capability and in our hitting power, it is not a charge that I am prepared to take from the front bench opposite. They know very well, even if they do not say so, that their defence policies if implemented would lead to a massive reduction in jobs in the defence sector beyond anything that I could even contemplate.

Nor is the soundness of a defence policy to be judged solely on the extent to which it improves employment prospects although, as I have already made very clear, the interests of British industry and therefore of employment, have been taken into the fullest possible account by my Department in deciding upon the balance of the equipment programme and the placing of new orders.

Finally I come to Trident . . .

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File AH Defence

10 DOWNING STREET

From the Principal Private Secretary

6 July 1981

Dear Brian,

Thank you for your letter of 30 June 1981 about the proposed defence briefing for members of the Opposition.

I have consulted the Prime Minister again, and she agrees with Mr Nott that we should offer a NATO briefing in, say, October.

She thinks it a good idea that Ministers, besides your Secretary of State and herself, should also receive the briefing but she has reservations about including them in the briefing for members of the Opposition. She thinks that to do so might reduce the usefulness of any question and answer or discussion period which will follow the briefing. She would therefore like to have two separate briefings on the same day, one for members of the Opposition at which she and Mr Nott would also be present and the other for a number of senior Ministers. She would be grateful if Mr Nott would now go ahead and make the necessary arrangements.

Finally, is there any reason why the Prime Minister should not now reply to Mr Steel letting him know it is proposed to arrange a NATO briefing for him and Mr Foot in the autumn and saying that we will be in touch later about the details ? She will need to write to Mr Foot at the same time letting him know what is proposed and inviting him to attend the briefing.

Yours ever,

Clive Whitmore.

Brian Norbury Esq.,
Ministry of Defence.

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PRIME MINISTER

Intelligence Briefing for Opposition Members

When Mr. Nott let you have advice on Mr. David Steel's request for an intelligence briefing, you agreed that the briefing should be on Privy Councillor terms, and that it should be given by a NATO team rather than a national one. You also said that you would prefer the briefing to take place this month rather than leave it over until the autumn.

I subsequently consulted the Ministry of Defence to see whether they could assemble the NATO briefing team in July, and this has produced the attached letter from Mr. Nott's office. This reports that if we want the NATO team, the briefing will have to be after the Summer Recess.

Mr. Nott is also recommending that the audience for the briefing should be widened to include not only Mr. Foot and Mr. Steel, but also a number of Ministers. I must say that I have some reservations about this proposal. I can see the merit of killing several birds with one stone, but I should have thought that it might make for a pretty awkward question and answer or discussion period after the briefing itself if we had both Mr. Foot and a number of Ministers there (an objection which I don't think applies if the Government was represented by only you and Mr. Nott).

Agree that the briefing should now be held in October? Do you wish to have Ministers besides you and Mr. Nott present?

Agree Autumn

It is a good idea to invite Ministers but for the record Lo-expert, Ched. Fab briefing should be done separately. Possibly the same day

MT

3 July, 1981.

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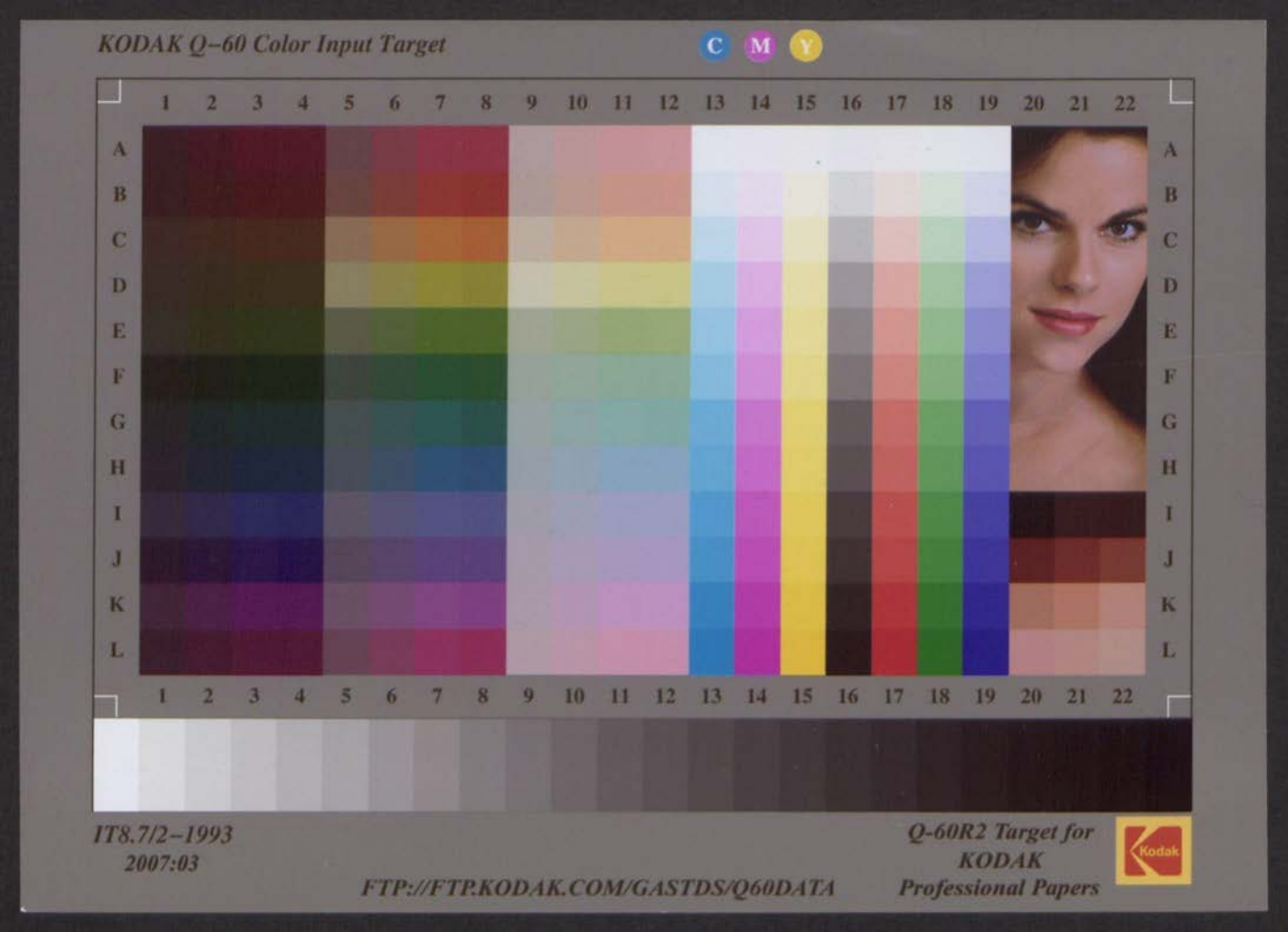
PART 6 ends:-

MOD to CAW 30.6.81

PART 7 begins:-

CC (81) 26th Item 2 2.7.81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