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PRIME MINISTER

DEFENCE EXPENDITURE

Arithmetically and politically, it will be hard to achieve the required level of public expenditure cuts if the Defence Programme - one sixth of total central government expenditure - remains exempt. The CPRS are right to suggest that Cabinet will wish to review the exemption, but they are, of course, unaware of the delicacy of any review given the position which Francis Pym adopted in the aftermath of the October discussions. We cannot duck the issue, but in view of its sensitivity, I think it right to consult you before tabling any proposals.

2. The figures which I proposed, and Cabinet accepted, in October:-

<u>1980-81</u>	<u>1981-82</u>	<u>1982-83</u>	<u>1983-84</u>
8062	8250	8450	8650

were framed to meet the NATO target in cost terms in each year, and to provide for an average 3 per cent increase in volume terms over the five years from 1978/79. The subsequent private understanding with Francis Pym could raise these figures to:-

<u>1980-81</u>	<u>1981-82</u>	<u>1982-83</u>	<u>1983-84</u>
8062	8304	8553	8810

i.e. the straight 3 per cent volume progression to which he attached so much importance.

13. In considering



3. In considering what reduction in these figures we could sensibly make, I have identified two courses:-

(a) We could make use of the provision for derogations in the case of economic difficulties which is written into the NATO target. The deteriorating economic forecasts, and the problem of our Community contributions - which is exacerbated by the rising cost of BAOR - would be sufficient reason for imposing a moratorium on increases in Defence spending in 1980/81: for that year we should keep for volume planning purposes the same figure as in the October <sup>White</sup> written paper (Cmnd 7746) for 1979-80. I believe that our position would be understood, especially if we reverted to the 3 per cent volume progression after 1980-81. The figures would then be:-

<u>1980-81</u>	<u>1981-82</u>	<u>1982-83</u>	<u>1983-84</u>
7824	8062	8304	8553

(b) Alternatively, we could maintain a 3 per cent volume progression, but build it on the lower base-line provided by the Ministry of Defence's latest forecast of their expenditure this year in volume terms, which is some £100 million less than the figure tabled in the October discussions, and published in Cmnd 7746. The progression would then be:-

<u>1980-81</u>	<u>1981-82</u>	<u>1982-83</u>	<u>1983-84</u>
7966	8205	8451	8705

4. Obviously, I prefer course (a). Compared to the figures which Cabinet agreed in October, as modified by the subsequent understanding with Francis Pym (the second line of figures in paragraph 2 above), it would yield savings of:-

238	242	249	257
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whereas course (b) would produce only:-

96	99	102	105
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5. OD recognised on 3rd December that we must cut our defence coat according to the cloth we can afford. With Defence's share of GNP growing rapidly, we shall have to fall below the NATO target at some stage. There is much to be said for doing the job quickly and cleanly, and confining it to one year. We would not be alone: the Germans, for example, have failed to provide for a 3 per cent increase in 1980.

6. But course (a) would be much more difficult for Francis Pym, I would not press for it if you thought that the savings under (b) would constitute a sufficient contribution from defence to the present cuts exercise, and that Cabinet would agree. Not knowing of the subsequent understanding with Francis Pym, most of our colleagues would recognise only the much smaller savings against the October figures (£96m in 1980-81, and £45m in 1981-82, offset by a £55m increase in 1983-84).

7. Any cuts in defence involve re-opening the private understanding. Either of the courses proposed would eliminate the need for separate provision from 1981-82 for Polaris replacement costs to maintain 3 per cent annual volume growth in those years.

8. I think we have to grasp this nettle. I understand that Francis Pym is to attend the NATO meetings in Brussels in the early part of the week, which may make it difficult to arrange before Cabinet on 13th December, but I suggest that the best way to take things forward would be for you to take a meeting of Francis Pym, John Biffen and me. In preparation I could send him a note on the lines of this minute setting out the alternatives as I see them, but I should first like to know your views, both as to substance and as to procedure.

A handwritten signature in blue ink, appearing to be 'G.H.'.

(G.H.)

11 December 1979