

Prime Minister.

4



If it was as difficult as we believe to sell option 5 to Mr Pym, I doubt whether he will accept the Chancellor's compromise (paragraph 3).

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

In any case the Chancellor's compromise breaches his principle of going above the figures agreed by Cabinet and of not raiding the Contingency Reserve. But if he is ready to do that to the tune of £55 million, what basic agreement can he have to going up to £160 million and giving Mr Pym what he wants - bearing in mind the political dangers of not doing so?

PRIME MINISTER

DEFENCE EXPENDITURE

A.H.H.

24x.

In an effort to resolve the dispute with the Defence Secretary over defence figures for the later years, John Biffen and I have been considering possible modification to the proposals in C(79)35.

2. We should much prefer to stick to the figures which the majority of our Cabinet colleagues approved. They show a 3 per cent a year increase in cost terms over the last three years, add £700 million to the previous Government's plans, raise the Defence share of GDP from 4.9 per cent to over 5.5 per cent, and of total public expenditure from 11 per cent to 13 per cent. Furthermore, they also show an average increase of 3 per cent a year in volume terms over the whole of the 5 year period to 1983/84. If it would help, we should be ready to forego public presentation of these figures in cost terms, and to rely on the average annual 3 per cent volume increase. This would effectively accept the Defence Secretary's main premise that we should plan to meet the NATO target in volume not cost terms. It would also be consistent with your own support for the NATO target in your Luxembourg speech last week.

3. If nevertheless you felt that this would be insufficient to meet the Defence Secretary's demands, and would wish to



make a new financial concession to him if Cabinet colleagues agreed, then we have found a new formula for calculating his "entitlement" which would make it possible to make the proposition more attractive by offering some more money. Our original figures were based on an earlier forecast of the expected outturn for 1978/79. The latest provisional outturn is a little higher. We ought in logic to reduce that figure by the amount of the overspend which occurred. But by working from the adjusted figure to be published next week, and adding increases of 3 per cent a year compound over the five year period, it would be possible to raise the figure for 1983/84 from our proposal of £8,650 million by £55 million to £8,705 million. The figures for the previous two years could also be slightly raised. For convenience, I attach a table showing the various runs of figures and the percentage increases they would allow.

by £21M and
£35M

4. This option has the disadvantage (inescapable, if we are to go down this road at all) that it would increase the public expenditure totals. Nevertheless, it has certain real advantages. It would provide a firm run of figures. It would also mean that our acceptance of the NATO target in volume terms was on the basis of an annual average of 3 per cent rather than a year on year increase of 3 per cent, which could prove to be a costly commitment if projected into the future.

5. The third option, to which we see very serious objections, would be to publish the figures we proposed in C(79)35, but to allow limited increases in these figures at the expense of the contingency reserve, to provide for the cost of Polaris replacement. It would be essential to avoid an open ended commitment, and these increases should therefore not exceed the sums necessary to bring the growth rate for the years 1981/82 to 1983/84 up to 3 per cent a year in volume terms. This is not however a course which we could recommend. It



prejudices the normal principle that weapon system replacements are met within defence budget ceilings by dropping items of lesser priority - a discipline essential to the achievement of cost effectiveness. It would reduce the contingency reserve, and thus pre-empt for defence a growing share of resources which would otherwise be available to other programmes for their unforeseen and priority needs. But perhaps the main problem is that of presentation - how to explain to our Cabinet colleagues the reasons why we were giving defence more, effectively at their expense, and how to present the position publicly when the White Paper is published next January. In practice, the proposition (if it is not to be entirely open-ended - which is surely unacceptable) amounts to much the same thing in money terms as agreeing to the Defence Secretary's bid for 3 per cent volume increases in the last three years. It might be less damaging - though still difficult to explain to our colleagues - simply to agree to the latter.

Indeed. That is the point of this option.

6. None of these options is palatable. The third is not one which either of us feels disposed to accept. But if the first is regarded as un-negotiable, we should be prepared to live with the second. If you agree, you may wish to try it on the Defence Secretary yourself. As you will realise, any concession to him represents a serious erosion of our position. It is obviously all the more important that we should have the wholehearted support of all our colleagues on the public expenditure issues still outstanding.

G.H.

(G.H.)

24 October 1979

£m at 1979 Survey Prices

	1978/79	1979/80	1980/81	1981/82	1982/83	1983/84	Average % increase over 5 years
C(79)35 figures	7479	7824	8062	8250	8450	8650	
% increase (volume)	4.6	3.0	2.3	2.4	2.4	2.4	3.0
% increase (cost terms)	8.8	3.0	3.0	3.0	3.0	3.0	4.1
Defence Secretary's proposal	7479	7824	8062	8304	8553	8810	
% increases (volume)	4.6	3.0	3.0	3.0	3.0	3.0	3.3
Second option (partial concession to Mr. Pym)	7509	7824	8062	8271	8485	8705	
% increases (volume)	4.2	3.0	2.6	2.6	2.6	2.6	3.0