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FROM: CHIEF SECRETARY
DATE: 19 October 1990

PRIME MINISTER

1990 PUBLIC EXPENDITURE SURVEY: DEFENCE

Unfortunately I have been unable to reach agreement with Tom King on the provision for Defence. I believe that it is both practicable and politically desirable to make reductions beyond what he has so far been willing to offer.

2. The spending plans Tom proposes would show spending rising by £2 billion over the next three years. At a time when the public are expecting significant reductions in the Defence Budget, and when we will be seeking to convince the markets that we have kept control of public expenditure, I believe that the outcome Tom proposes would be politically difficult and economically damaging. People would certainly contrast a rising Defence budget with plans for Employment and Industry that are broadly flat or falling.

3. I should stress that I fully understand the need not to do anything to put our defences at risk at this moment. For this reason I have already agreed with Tom arrangements for handling the Gulf costs this year. We have also agreed that for future years any further costs will be handled separately once we know how much they might be. It is largely because of the sensitivity of the Gulf that my proposals for savings have focused mainly on the third year of the Survey.

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BACKGROUND

4. Leaving potential Gulf costs on one side, the starting point for the Survey was Tom's Statement to the House of 25 July. As OD had agreed, he made it clear that the cost of the Defence Policy Options "will, of course, be within the expenditure plans published in the last Public Expenditure White Paper". This set a ceiling on our discussions of:

				£million
90-91	91-92	92-93	93-94	
21400	22821	23500	24289	

Subject to some qualification about transitional costs and the "provisional" nature of the 1993-94 figure, Tom subsequently agreed to live with these figures.

STATE OF PLAY

5. My approach has been to look for savings and efficiency gains, consistent with OD's policy decisions, which will enable us to get well below this ceiling. These savings should build up to a significant sum by 1993-94. Indeed this will be expected since we have announced plans to reduce manpower, military and civilian, by 18% by 1995. My initial proposals therefore implied savings (against the agreed ceiling) of:

			£million
91-92	92-93	93-94	
521	1275	2139	

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6. In contrast Tom has argued that the bulk of the savings he can offer as a result of the Options exercise will be swallowed up by the substantial gap between his present estimate of the cost of the Defence programme and the cash provision he and I agreed last year. This is not an acceptable argument. This continuing gap arises essentially because, despite assurances to the contrary, MOD have failed to align their internal planning assumptions with the published cash plans approved by Cabinet. They now claim that this can be largely attributed to increases in inflation. I do not accept that this is the case - in my view MOD's internal planning has been the root cause of the problem. In any event the Government operates a system of cash planning to which all departments, including MOD, must conform.

7. After a number of meetings with me, Tom offered to settle at:

	fmillion		
	91-92	92-93	93-94
	22770	23400	23400

However these figures are not necessarily what they might seem - Tom made his offer subject to the condition that he would be able to bid for up to 80% of transitional redundancy costs to be met from the Reserve. I am not at all sure that a significant number of redundancies will prove necessary. But, if I were to accept this arrangement the figures put forward by Tom's officials suggest that it could effectively put expenditure in 1993-94 up to £23700 million - an increase of £2.3 billion on the current year, and a saving of less than £600 million against the ceiling (paragraph 4 above) for the last year of the Survey.

8. I firmly believe that the 1993-94 total should be no more than £23,000 million. Nevertheless, earlier this week in the interests of reaching a bilateral settlement I made Tom a final offer, which agreed to his formula on any redundancy costs and proposed published totals in the 1990 White Paper of:

22720	23300	23150
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9. Tom has not been able to agree to this, though he has told me that he would be prepared to move by £100 million more in either the second or the third year.

THE CASE FOR FURTHER REDUCTIONS

10. If we are to demonstrate to colleagues that the significant sacrifices they have made during this most difficult Survey have been matched by the MOD; if we are to convince the public that by 1993-94 the announced Defence reductions will provide any financial benefits and, perhaps most important of all, if we are to give MOD a budget which imposes financial discipline, I believe that there is a very strong case for making cuts that are much larger than those implied by my final offer.

11. In reaching this judgement I have taken account of the possibilities for savings, identified by the Treasury. These are listed in the table annexed. Together they far exceed what would be needed to achieve a cash total of £23 billion by 1993-94. The main points are as follows:

- **Efficiency Savings:** you have approved a target for efficiency savings averaging 2½% per annum over the next 4 years. Achieving the targets would generate savings rising to £1 billion by 1993-94.
- **Inflation:** MOD have kept non-pay price increases below the GDP deflator in recent years. We should plan on the basis that this good performance will be maintained, not that defence prices will rise faster than the GDP deflator, particularly at a time when defence suppliers are competing keenly for work. This could yield £¼ billion by 1993-94.
- **Equipment:** MOD are still not planning any significant fall in the equipment budget over the Survey period, despite a planned reduction in manpower of nearly a

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fifth by 1995. We need to cancel some of the multiplicity of planned weapons systems not indulge in salami-slicing. Savings could amount to more than £½ billion.

- **Research and Development:** the current plans should be tailored much more closely to MOD's real needs. By 1993-94 we may be able to make savings of £¼ billion.

These potential savings take no account of the possibility of further savings from Army restructuring within the ranges agreed by OD. However, this is not something that Tom and I can settle bilaterally. The savings I am proposing do not require further policy changes.

PRESENTATION

12. We must consider carefully how the totals finally agreed will look when they are published. Tom's proposals - before allowing for the extra £100 million - would lead to the forthcoming Autumn Statement showing increases in the published defence budget for 1991-92 of about £450 million and £50 million for 1992-93. While much of this can correctly be explained by technical changes and by payments to war widows, it would be clear to the public that there was no saving on previous defence expenditure plans in these two years. Such an outcome would be extremely difficult to present. It would also be extremely difficult to convince the markets that the overall Public Expenditure Survey had indeed been a tough one, if the revised plans included increases for Defence.

13. Even my own proposals imply rising cash totals for the next 2 years, and no real decline in defence spending until 1992-93. This compares with real terms falls in 5 of the last 6 years. These are modest reductions by any standards, and certainly by comparison with plans in the United States and, to judge from press reports, many major European countries.

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CONCLUSION

14. I recommend that we should publish totals for Defence (subject to the addition of their share of the agreed additional bids for the Intelligence Agencies) of

<u>22670</u>	<u>23100</u>	<u>23000</u>
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15. These figures would represent a ceiling on the Defence budget, subject only to the possibility of additional bids for the Gulf and, within the agreed formula, for any necessary transitional redundancy costs. I will want to review in the 1991 Survey the scope for reducing this ceiling further.

16. My proposals would have no effect on our operations in the Gulf. They are consistent with the decisions taken by OD in July. They represent the minimum defensible response in terms of public expenditure plans to our announced plans for reductions in defence capabilities. And they would provide MOD with a very necessary discipline on their resource planning and a spur to achieving their efficiency targets.

17. I am sending a copy of this to Tom King and to Sir Robin Butler.

NORMAN LAMONT

Treasury estimates of possible savings

The Treasury do not accept MOD's costing of the post Options force structure and have identified the following main possible reductions in it:

	91-92	92-93	93-94
1. Efficiency	460	710	1,000
2. Inflation assumptions	280	480	790
3. Equipment (exc R&D)	180	370	590
4. Research & Development	130	270	240
5. Profile of rundown	0	140	260
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Total	1,050	1,970	2,880

These savings would contribute both to offsetting the excesses of £700 million a year by which MOD claim they are currently over the ceiling and to savings below the ceiling.

Main Figures

	1990-91	1991-92	1992-93	1993-94
OD Ceiling		22,821	23,500	24,289
Tom King's final offer (1)		22,770	23,400	23,400
My final offer	21,400	22,720	23,300	23,150
My recommendation		22,670	23,100	23,000
My initial position		22,300	22,225	22,150

(1) Before the final £100m off either 1992-93 or 1993-94.

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1990 Autumn Statement would show:

	1991-92	1992-93
Previous plans (ie PEWP adjusted)	22360	23440
Mr King's proposal (after adding agencies)	22805	23485
Change on previous plans	+445	+45
- of which		
1. switch	+200	-200
2. MOD offer	-50	-100
3. widows	+116	+117
4. agencies	+35	+85
5. rates etc	+144	+143
	<u>445</u>	<u>+45</u>

The Chief Secretary's proposal would increase the peace dividend line (2) to:

-100 -200

leading to changes on previous plans in the AS of:

+395 -55

*1/ i.e. be
CST's
"final offer";
not his
"recommendation"*

*"OD ceiling" = Previous Plans
+ switch
+ widows
+ rates etc*

*"Proposed changes" = [OD ceiling + Agencies
- proposed savings] less Previous Plans*