Prime Minister 2

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MINISTRY OF DEFENCE WHITEHALL LONDON SW1A 2HB

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3rd August 1982

Dear Geoffrey.

DEFENCE EXPENDITURE TO 1985/86

At Cabinet on 15th July we agreed that our aim should be to adhere to the public expenditure planning totals published in Cmnd 8494; and that Departmental Ministers' bids for additional provision should be discussed bilaterally with the Chief Secretary. Before this process starts I should like to set down the issues to which I attach importance for defence.

First, the Falklands operation. We have agreed that the costs of the campaign, of replacing equipment lost and of the future garrison will be met out of monies which will be additional to the 3% annual rate of real growth. I shall be bringing a paper to colleagues setting out the proposed size of the Falklands garrison - and a first estimate of the costs involved - in September. It is already clear that we shall need to acquire additional aircraft and ships, if our home defences are not to suffer a severe detriment. My officials are discussing with yours the Falklands bill as a whole and I shall give my colleagues by October an estimate of the total cash required.

Second, our basic defence commitments. There should be no illusion that these can be met without additional provision, as set out in my bids. The Prime Minister, the Foreign and Commonwealth Secretary

The Rt Hon Sir Geoffrey Howe QC MP

and I received last month a briefing on recent Soviet exercises; they showed a huge and widening gap in capability. We are committed in the clearest possible terms to planning to implement in full until 1985/86 the NATO aim of real increases in defence expenditure of 3% a year. This commitment was set out in last year's White Paper "The UK Defence Programme: The Way Forward" (Cmnd 8288) and repeated in Cmnd 8494 and in my recent Statement on the Defence Estimates. The 3% increase needs to be met "in full". And I cannot regard the extra cost of meeting the Government's published commitment as "an additional bid".

The provision for 1983/84 and 1984/85 that was published in Cmnd 8494 and forms the baseline for this year's Review does not, on any reasonable forecast of inflation, allow for real growth of 3% a year. On the basis of the Budget forecast of general inflation, the figures allow for growth of no more than about 1% a year. Even if inflation were in line with the cash factors used in constructing the figures, growth would be limited to 2.4% a year. It would require inflation to fall to little more than 5% in 1983/84 and 4% in 1984/85 for 3% real growth to be provided by the baseline figures. If the Government is to meet its 3% commitment, therefore, additional provision must be agreed as indicated in the PESC Report. There is no way round this: either we provide more money, or we renege on our commitment. I regard the latter as politically impossible.

However, the question is not simply one of the rate of general inflation. The 1982 Armed Forces Pay Award exceeds the 4% provision in 1982/83 Estimates. The carry-through effect of this in later years will have to be met (as it was last year) by additional cash provision to protect the 3% commitment. Furthermore, defence non-pay costs rise faster than general inflation and, if we are not to fall short of 3% growth, additional provision is needed to offset this relative price effect. I acknowledge, however, that this is an area in which precise predictions are difficult and I should be glad to talk to you or the Chief Secretary about how best to make allowance for it in our future planning.

I should also like to emphasise that, following last year's defence review and other action which we have taken to improve financial management such as cash profiles for firms, the programme is in better balance with the available cash in the current year, although we still face potential problems in 1983/84 and 1984/85. The difficulty is that if the consequence of our efforts to achieve a better balance and of showing a prudent caution in our plans is an underspending, under the present rules we lose the shortfall. To avoid this, we should have to over-programme with the risk of damaging last-minute cutbacks. This is why I believe end-year flexibility to be so important as a means for more efficient management. I am grateful for the Prime Minister's agreement that this should be discussed in October. There can be no argument for adding to the resource costs of defence by the continuation of a system which is costly and inefficient.

I am copying this letter to the Prime Minister, the Foreign and Commonwealth Secretary, and the Chief Secretary, and to Sir Robert Armstrong.

Yours ever

John.

John Nott

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GF4c - Mr. Gauthier

J R Rose Esq
Clerk to the Committee of Public Accounts
House of Commons
LONDON SW1

28 July 1982

Dear Mr. Rose.

PROJECT INFORMATION

When I appeared before the Public Accounts Committee to answer questions on Chevaline, I undertook to see whether it would be possible to provide the Committee on a regular basis with financial information on major defence projects.

2. Because of other preoccupations the assembling of information has taken much longer than I had hoped but I now attach 3 tables covering our largest sea, land and air conventional systems respectively.

3. The tables include 24 projects with authorised expenditure in excess of £200M. In each case the original cost estimates quoted are at the point in the project's life cycle at which they become firm government policy decisions (ie after project definition). Projects continue to be included as long as there is significant expenditure still to come in the current and future years.

4. In each project, production costs are separated from development and the following figures are given:

a. estimated cost as originally approved (price base identified in brackets);

b. (i) a. above revalued to present defence prices;

(ii) a. above revalued by the GDP deflator;

c. actual expenditure to 1.4.82;

d. c. above revalued to present prices;

e. estimated overall project cost at present prices for work currently authorised.

The figures in columns b., d. and e. are fully revalued. Column b(ii) has been included to show the difference between defence cost inflation and general inflation. This revaluation exercise is not yet complete but I thought it better to avoid further delay. We should let you have the missing figures as soon as possible.

5. As I mentioned in my letter of 4 March, these tables relate to expenditure formally approved rather than forecasts of the ultimate overall size of the project. The latter may fluctuate according to the exact quantities of the purchase assumed. Of course, even using approved expenditure, comparisons may sometimes be complicated by changes in the scale of the project.

6. Needless to say, much of this work involved breaking new ground. We hope to have substantially refined both the methodology and the coverage by next year. In particular I would hope to clarify the SEA EAGLE figures fairly soon. I hope nevertheless you will find this first attempt of significant value. We are assuming that with this new and more comprehensive information available you will not in future need the Ship Construction Accounts (the 'Blue Pages'). You may also like to consider whether the 'Pink Pages' relating to Dockyard work continue to fulfil any useful purpose.

7. I am writing separately about nuclear weapons projects.

Yours sincerely

Frank Cooper

FRANK COOPER