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Treasury Chambers, Parliament Street, SW1P 3AG

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ms
14 October 1982

Dear Michael

DEFENCE SPENDING: NATO COMPARISONS

I understand that at yesterday's meeting with the Prime Minister, the Chief Secretary offered to comment on the table attached to Richard Mottram's letter to me of 8 October. *TAM*

As the Chief Secretary explained at the meeting, he sees good prospects of an amicable settlement to this year's defence PES bids and to avoid further controversy he had not intended to send an early response to Mr Nott. But he has asked me to send you the attached tables to demonstrate that there are different ways of comparing defence expenditure which are not nearly so unfavourable as the one chosen by Mr Nott.

Yours sincerely

J. Gieve

JOHN GIEVE
Private Secretary

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COMPARISONS OF DEFENCE EXPENDITURE IN NATO

1. There are differing ways of measuring real growth. The Annex to the letter from the Ministry of Defence of 8 October is based on figures calculated by MOD's internal price methodology. This has been found by the Unwin report to overestimate inflation and to understate "volume". Calculations based on the CSO defence procurement deflator show the UK's growth performance to be equal second to the US and are as follows:

| | 1979 | 1980 | 1981 (provisional) | average |
|---------|------|------|-----------------------|---------|
| US | 3.7 | 5.0 | 5.7 | 4.8 |
| *UK | 4.7 | 4.1 | 1.1 | 3.3 |
| France | 2.5 | 3.9 | 3.5 | 3.3 |
| Germany | 1.8 | 1.9 | 3.4 | 2.4 |
| Italy | 2.6 | 4.9 | 1.5 | 3.0 |
| ** (UK | 2.1 | 2.9 | 1.7 | 2.2) |

* CSO defence procurement deflator: financial year figures

** MOD price methodology: calendar year figures

2. In assessing our defence effort there are, however, factors other than the growth rate that should be considered. In absolute terms, UK defence spend is second only to the US. As a percentage of GDP, the UK is second; in per capita terms third:

| | total expenditure 1981 | | per capita expenditure US\$ |
|---------|---------------------------|-------|--------------------------------|
| | US\$ million | % GDP | |
| US | 167,800 | 5.8 | 730 |
| UK | 25,200 | 4.9 | 439 |
| France | 23,800 | 4.2 | 442 |
| Germany | 23,100 | 3.4 | 377 |
| Italy | 8,700 | 2.5 | 151 |

3. The 1977 NATO Resource Guidance (which formally recorded the 3% aim) recognised that what countries could achieve would depend on their economic circumstances. GDP growth of the principal NATO nations has been as follows:

| | 1979 | 1980 | 1981 | average |
|----------------|------|------|------|---------|
| United States | 2.8 | -0.4 | 1.9 | 1.4 |
| France | 3.3 | 1.2 | 0.3 | 1.6 |
| Italy | 4.9 | 3.9 | -0.2 | 2.8 |
| Germany | 4.4 | 1.8 | -0.3 | 1.9 |
| United Kingdom | 1.9 | -2.1 | -2.2 | -0.8 |

Source: OECD

4. In 1982-83, the defence budget provided for real growth of 3.7%. Lower inflation than expected should mean that the actual growth achievement could exceed that figure.

5. The calculations of course take no account of the defence expenditure incurred in connection with the South Atlantic which we have agreed should be additional to other expenditure. But anything spent there does increase the total claim of defence on our national resources.

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