

MR COLES *AK 15/10*
*h.a.*24 October 1983THE RISING COSTS OF DEFENCE PROCUREMENT

The Prime Minister will be discussing this subject with the Secretary of State for Defence tomorrow.

Since my note to you of 3 October 1983 the interdepartmental group on essential defence technologies has been making good progress and our final report will be available shortly. We shall be making a clear statement on technologies which require an indigenous capability. This will be an important development for future procurement decisions.

This outcome and the fact that the list will be extremely short reinforces our view that the Group should be able to make an important contribution to the additional questions suggested in my earlier minute

- would a more open system of defence procurement lead to better value for money for the defence equipment budget?
- how can greater collaboration and standardisation be achieved within NATO?

despite the Secretary of State's likely response that this is well-trodden ground.

Further study of the Secretary of State's paper indicates that more analysis of the Warsaw Pact's experiences with cost growth and their approach to defence procurement could help to answer these questions. For example, the paper compares the Soviet Union's defence burden (14-16% of GDP) with the NATO average of about 5%. But if, as I understand, defence spending in NATO is roughly equal to that in the Warsaw Pact why is the military balance so much in their favour? How much is this due to greater value for money through long production runs, to cheaper manpower or to a different trade-off between quantity and quality?

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In view of these comments, I enclose a revised version of my earlier minute together with a copy of the original in preparation for tomorrow's meeting.

DLP.

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THE RISING COSTS OF DEFENCE PROCUREMENT

The paper from the Secretary of State for Defence on Real Cost Growth in Equipment puts forward no new thinking on how to tackle the rising costs of defence procurement. It fails to acknowledge that:

- Advances in technology reduce unit costs in defence as elsewhere. Guided weapons achieve more hits at less cost than the systems they replaced. The real problem in defence is the growth of the threat, not the 'cost' of technology.
- Real rises in the cost of items of equipment are not peculiar to defence. They occur in industry, in the health service and in the utilities. Why should this argument make defence a special case?
- Of course, the Warsaw Pact has been spending a higher proportion of its GDP on defence. They have had to because their GDP lagged behind that of NATO. But if defence spending in NATO is now roughly equal to that in the Warsaw Pact, why is the military balance so much in their favour?
- The Warsaw Pact appear to get more equipment for their money than we do, through standardisation. Paragraph 7 refers to the fact that the Warsaw Pact achieve economies of scale and long production runs. Why don't we? It is ironic that the UK in particular and NATO in general fail to exploit the benefits of competition in the one area where our market philosophy should assist us most in our defence against the Soviet threat.
- Foreign competition is excluded from serious consideration in the paper (Paragraph 14). Similarly can we resolve some of the problems which prevent the potential benefits of collaborative projects being realised? Even though a collaborative project may be cheaper than a national project,

a foreign purchase may be cheaper still. Tornado probably cost twice as much as an F16, even allowing for hidden R&D costs and differences in capability.

It was in response to our apparent inability to contain the seemingly inexorable rise in the costs of defence equipment that our earlier papers to the Prime Minister suggested that more radical options need to be considered. This need will be reinforced by any decision to contain the growth in defence expenditure below 3% per annum in real terms after 1985/86.

Following the HARM v ALARM decision, an interdepartmental group with No 10 representation has been identifying those technologies in which an indigenous capability is essential for defence purposes. Our final report will be an important development for future procurement decisions. This outcome suggests that the Group could make an important contribution to some wider issues raised by the Defence Secretary's paper. We suggest that following completion of the current remit, the Group should be asked to consider two further questions:

- would a more open system of defence procurement lead to better value for money for the defence equipment budget?
- how can greater collaboration and standardisation be achieved within NATO?

We anticipate that the Secretary of State for Defence will advise that these questions are not new and are under continuous review. However, by assessing them together, by comparing the experiences of the Warsaw Pact and by looking at future prospects over a reasonably long time horizon, it should be possible to form a clearer idea of where Britain's best interests lie and how value for money in the defence equipment budget could be improved.

The covering note to the Secretary of State's paper also refers to the question of the co-ordination of Ministerial decisions on defence procurement. We suggest that it would be helpful for No 10 to receive copies of the Defence Equipment Policy Committee (DEPC) review of business expected in the following three months, and for the Policy Unit to attend DEPC as appropriate.


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