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cc: PS/Chancellor
Mr Bailey
Mr Anson
Mr Kemp
Mr C D Butler
Mr Kitcatt
Mr Turnbull
Mr Allan
Mr Gilhooly
Ms Seammen

CBA

Treasury Chambers, Parliament Street, SW1P 3AG

The Rt Hon Michael Heseltine MP
Secretary of State for Defence
Ministry of Defence
Main Building
Whitehall
London
SW1A 2HB

Mr M Williams
Mr Hoare
Mr Hansford
Mr Lord

30 October 1985

Dear Michael,

MOD RUNNING COSTS

I was disappointed to receive your letter of 18 October, since I thought we had already reached agreement in principle on the package set out in mine of 15 October and had only to insert the figures. Your letter, however, questions the principles of my package.

You refer me to your letter of 30 August to my predecessor, in which you expressed full support for effective controls of running costs but reserved your position on the defence block cash limit. Since then, of course, Cabinet has considered and endorsed on 3 October the arrangements proposed for establishing the limits for each department's running costs in this year's Survey. As forecast in my letter of 14 October to George Younger, I announced the decision on running cost limits, and the associated abandonment of a central pay assumption to the House on 22 October.

I understood your worry to be that you should not find yourself required to reduce Armed Forces manpower because of inadequate running costs provision, and I consider that my offer has removed this danger. I do not understand your reasons for now rejecting our decision in Cabinet and, as explained in my earlier letter, cannot accept the exclusion of MOD from the rules collectively endorsed.

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I have similar difficulty over your reasoning for a 7 per cent pay assumption for all MOD civilians, although I accept that this figure may not be unrealistic for next year's AFPRB award. In your minute of 17 April to the Prime Minister, at a time when a pay assumption of only 3 per cent seemed likely, you declared yourself content to absorb the excess cost of civil service pay awards. You now claim that you need more than twice as much.

In line with the Cabinet decision, most of our colleagues have now revised their bids and reached agreement with me on their running costs limits. Those agreements have been based on a range of departmental pay assumptions, but no department has a limit based on a pay increase of more than 5 per cent in 1986-87. As a result the aggregate increase figure has been reduced to below 6 per cent, but your proposal would push the rate of increase back above 6 per cent - which is clearly unacceptable in the light of our discussions in Cabinet. It would be markedly out of line with other departments.

You suggest that foreign exchange problems make 7 per cent necessary to cover your locally employed civilians abroad, principally in Germany. But comparable German pay inflation is running well below that of the UK and your department has publicly acknowledged that exchange rate factors have generally reduced overseas defence expenditure below forecast levels in recent years. I see no reason why an assumption of 5 per cent should not prove more than adequate for such staff.

These issues need to be settled very urgently in time for the report back to Cabinet less than two weeks from now. The question of Estimates presentation, upon which I wrote to you on 21 October, is equally pressing, and I hope you agree that our officials should meet urgently to discuss the way forward. Cabinet has decided that controls over running costs will in future be applied through agreed limits for each department. I would be willing to agree, along the lines set out in my letter of 15 October, to a limit of £5,215 million for your department in 1986-87 incorporating a 5 per cent increase for civilian pay. In the light of the assurances I have given, I hope that you will now be prepared to accept this.

Yours ever,
JM
JOHN MacGREGOR

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