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26.9.03



HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

PRIME MINISTER

MINISTRY OF DEFENCE BUDGET

We have a serious problem because the Ministry of Defence has lost control of its cash spending. The issue concerns the MOD's core budget. This is entirely separate from the funding of our operations in Iraq. None of the issues that follow have any bearing on the special arrangements the Treasury has agreed with MOD for the funding of Operation Telic and which the Treasury is committed to continue.

2. It has emerged in the last few days that the MOD has lost control over its cash spending. We agreed in SR02 that MOD budgets would increase in cash terms as follows:

£ million	2002-03	2003-04	2004-05	2005-06
Cash spending	24,196	25,579	26,479	27,389

We also agreed that the MOD could have an additional £500 million in 2002-03 to help meet in-year pressures. Taking this into account, the cash profile we agreed in the spending review grows by **3.6%** between 2002-03 and 2003-04, and by 3.5% and 3.4% in subsequent years. Given the size of the MOD budget, this was a critical component of our fiscal planning.

3. MOD is now operating on the basis that its budget (excluding the extra resources we are providing for Iraq) will increase this year by **9.1%** in cash terms, instead of 3.6%. The implication of this is a requirement for an extra

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£1,152 million of cash this year, with broadly corresponding sums in 2004-05 and 2005-06.

4. Until a fortnight ago, Paul Boateng was discussing with Geoff Hoon whether it was acceptable for up to £490 million of non-cash headroom in the MOD's resource budget to be redeployed as cash spending. Paul and I recognised that these were legitimate questions about the way the new resource accounting and budgeting system works, although we had serious concerns about the impact of what was proposed on the fiscal position, and none of the offsets that MOD were proposing seemed to represent genuine improvements in the use of assets that RAB was designed to deliver. As a result, Paul wrote to Geoff on 20 August and met him on 15 September.

5. **However it has now become clear that we are dealing with an issue of a completely different scale, which is being driven by a complete lack of budgetary control in MOD. MOD's unforeseen requirement for £1,152 million of extra cash represents a very serious failure.** This is not a RAB problem, it is a basic control problem. The new Resource Accounting and Budgeting framework introduces new aggregates to improve the accounting and management of assets, but as the guidelines always made clear cash remains an essential element of the financial framework. It is the basis for our fiscal rules, is the key determinant of what we must raise in taxes or borrowing, and requires parliamentary approval. Despite this, MOD appears to be operating an internal control regime in which cash is completely uncontrolled.

6. When we agreed last year an extra £500 million for the MOD this was on the explicit understanding that MOD would examine how the problems had arisen and how efficiency might be promoted further. The 9.1% year-on-year increase in cash spending represents their failure to tackle these problems. It is **essential** that MOD management takes action to address the underlying issues and to refocus its efficiency programme onto relieving these cost pressures.

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7. We must now take action to regain control over the public finances. I am anxious these changes will not affect the special arrangements the Treasury has agreed with MOD for the funding of operations in Iraq and I will make sure that this funding continues. But cost increases in the core defence programme on this scale are unacceptable.

8. Given the gross loss of control by MOD, I must disallow immediately any flexibility for MOD to move resources between non-cash and cash. This is a serious step but it is essential. We need to have full confidence in MOD's cash control arrangements. I must therefore also impose on MOD a fixed cash control total to ensure it remains within the SR02 settlement. Planning for next year should be done on the same basis. Paul Boateng will be writing to Geoff Hoon to follow this up.

9. In the meantime, I require an urgent externally led review of MOD's financial control arrangements, and assurances that the MOD will immediately increase its focus on cost control including through ensuring that its efficiency programmes are focused on this objective. Again, Paul's letter to Geoff Hoon will give more detail. If that review provides assurances that the relevant controls are in place and operating effectively, I would be willing to review the MOD control system in the run up to SR2004.

I am copying this minute to Geoff Hoon, Paul Boateng and Sir Andrew Turnbull.

Gordon

[GB]

26 September 2003

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