

# Comment: Defence Inflation

In our edition of October 2008, Professor David Kirkpatrick examined the oft-quoted, but wholly neglected, subject of defence inflation. This raised great interest and has been quoted in the sessions of at least two Defence Select Committees of the UK Parliament. It also brought comment from four acquisition experts in our last edition. Now David Faddy says that he doesn't find debates about defence inflation very helpful.

**From: David Faddy**

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In your most recent issue of *RUSI Defence Systems* (June 2009), you included as a bone of contention several interesting articles on defence inflation. In most debates about defence, participants seem keen to use numerical measures. But the fundamental problem is that the output, or value, of defence expenditure cannot be measured in numerical terms, any more than can that of the National Health Service.

Of course, one can have the impression that there has been an improvement, but a convincing quantitative measure is absent. For example, the MoD may claim, as Professor Chalmers reports, that it has achieved "cumulative annual efficiency gains totalling £3.1Bn on an annual budget of £33.5Bn", but what that means in terms of its effect on output is unknown. We are expected to accept that defence output, undefined though it is, is unchanged.

As is well known, the Treasury demands efficiency savings from every government department every year and MoD responds as quoted, but the basis on which these so-called savings are compiled is not at all clear; nor is it clear whether they really relate to efficiency as it is defined in a dictionary. As always, the reader is expected to accept that inputs can be used as surrogates for outputs. In my view, we have to accept that the only measure of defence output is whether society as a whole feels more secure than before – and that is a qualitative measure and an intensely subjective one at that!

## Measuring Inflation

For this reason, I don't find debates about whether defence inflation exists or not very helpful. There must be an element of inflation somewhere in the total defence budget, since, apart from the equipment budget (36% of the total), defence is manpower intensive (military and civilian) and wage costs rise faster than GDP or RPI. However, there have been so many changes in policy and size over the years that I doubt whether an attempt to measure the inflation specific to defence is useful. Of course, debate about whether we need to spend more or less on defence and where the emphasis should lie, is important, but it is, to say the least, doubtful whether the concept of defence specific inflation – if it exists – and its relation to inflation in other parts of the economy as seen by the man in the street, is relevant.

All we know of inter-generational cost escalation is that it has been a persistent feature of the past and has prompted revolutionary changes to defence policy. Often this has been because, as Philip Pugh has pointed out, it has either made further improvement to a particular type of equipment unaffordable or because a potential adversary has found a devastatingly effective counter. There is no reason to believe that this type of cost escalation won't continue in the future as it has for at least a thousand years (Professor Kirkpatrick points out that Professor Chalmers makes the mistake of comparing actual outturn costs with current forecasts in order to claim that inter-generational cost escalation is reducing).

## Two Certain Facts

There seem to be only two certain facts about defence spending. The first is the persistence of inter-generational cost escalation and the second is the phenomenon termed by the Treasury as the 'conspiracy of optimism'. As a solution to the latter the Treasury advocates that, wherever the data is available, initial estimates for future systems should be based on a statistical analysis of experience with previous systems of similar types.

The MoD possesses abundant numerical evidence of the outturn costs of previous generations but seems reluctant to use it, believing that the past is no guide to the future in regard to costs. However, the stages by which any engineering project reaches service use have remained unchanged since time immemorial. Thus, at the very least, if the estimated cost and timescale of a proposed project is radically different from the trend established for previous projects, there should either be a convincing explanation, or its cost and timescale should be reconsidered. Thus, it seems to me that, rather than frequently indulging in reforms of the management process, it might be more useful for MoD to concentrate on improving the forecasting process that it uses at the early stages of project procurement.

## Nomenclature

Finally, and as something of an aside, may I plead for a change in nomenclature? It seems to me that it would be clearer if the term 'escalation' was reserved for what the authors have called 'inter-generational cost escalation', and the growth in cost estimates during project procurement was to be termed 'cost growth'. Strictly speaking, of course, the growth is in 'cost estimates', not 'costs', since the actual cost of a project is inherent in its design and only finally revealed when it is complete (i.e. its outturn cost). ■