BRIEFING PAPER
SDSR 2015: Hard Choices Ahead
Royal United Services Institute July 2015

Osborne's Summer Surprise for Defence

Guaranteed Real-Terms Spending Increases

Malcolm Chalmers

It was widely expected that the Ministry of Defence's (MoD) future budget would not be known until around November of this year, when the Spending Review is due to be completed. It was therefore a welcome surprise for the MoD when Chancellor George Osborne, in his Summer Budget on 8 July, announced that defence would receive annual real-terms increases in its budget of 0.5 per cent a year up to 2020/21, to around £38.9 billion that year.[1]

Given the Treasury's longstanding commitment to further cuts in overall departmental spending, this settlement is at the very upper end of previous expectations. For the first time since 2010, the MoD has become a 'protected' department, a privileged status (also enjoyed by health, schools and international development) that fixes its budget in advance of the Spending Review, leaving other 'unprotected' departments to fight it out for the resources that remain.[2]

The increased commitment to defence has been made possible by the Budget's relaxation of previous plans for cuts in total departmental spending, amounting to some £83.3 billion of additional resources over the

1. Author's estimates, based on the assumption that the 2015/16 baseline will be the 2013 Spending Review allocation of £32.592 billion, adjusted for the movement of war pensions (£820 million) and an additional element of Armed Forces Pension Scheme employers' contributions (£1 billion) from its Annually Managed Expenditure to its Departmental Expenditure Limit.
2. For discussion of what unprotected status might have meant for the MoD, see Malcolm Chalmers, 'Mind the Gap: The MoD's Emerging Budgetary Challenge', RUSI Briefing Paper, March 2015; Malcolm Chalmers, 'The Financial Context for the 2015 SDSR', RUSI Briefing Paper, September 2014.

current Parliament.[3] Even so, the Institute for Fiscal Studies still projects an average reduction in spending by unprotected departments (now excluding defence) of 12.6 per cent in real terms (or around £19 billion) between 2015/16 and 2019/20.[4]

While other departments continue to make their case to the Treasury, the Spending Review is now, for practical purposes, largely over for the MoD. Over the next three months, in its contribution to the Strategic Defence and Security Review (SDSR), the MoD will therefore be able to focus on how to spend a predetermined budget in the most effective manner possible. The service chiefs can now contribute to this process with some confidence that any savings that can be made in future programmes will be available to be reinvested elsewhere.

The Joint Security Fund

In addition to the guarantee of annual 0.5 per cent real growth, the Budget also announced that the MoD would be able to bid for further resources from a new 'Joint Security Fund', which will amount to 'up to an additional £1.5 billion a year' by the end of the Parliament.

Details of the Fund remain unclear, and are likely to be subject to negotiation as part of the Spending Review. The MoD and intelligence services look set to be the primary beneficiaries, but the BBC has suggested that the Foreign Office would also be eligible to bid for support for security-related activities.[5] The relationship with the existing Conflict, Stability and Security Fund (which allocates a budget of £1 billion annually to the MoD, Home Office, Department for International Development, Foreign Office and agencies) will have to be clarified, given the potential for duplication in mandate and administration.[6]

The Budget has estimated that this additional allocation will allow total spending on the military and intelligence agencies to increase by 1 per cent a year in real terms. It also protects overall counter-terrorism spending across government, which totals around £2 billion of expenditure by the agencies, police and other departments.

3. Office for Budget Responsibility, *Economic and Fiscal Outlook*, Cm 9088 (London: The Stationery Office, July 2015), p. 5.
4. Rowena Crawford, 'The Summer Budget: Taxes Up, Borrowing Up, Departmental Spending Up', presentation given at the Institute for Fiscal Studies, 9 July 2015.
5. Frank Gardner, 'Budget 2015: What is the New Joint Security Fund?', *BBC News*, 9 July 2015.
6. HM Treasury, *Spending Round 2013*, Cm 8639 (London: The Stationery Office, June 2013), p. 45.

Strategy and Politics

The improved protection now accorded to defence is partly a consequence of growing strategic risk. The worsening of relations with Russia, along with deepening concerns over terrorism and conflict in the Middle East, has increased the pressure for more defence resources across NATO. For the UK, growing concern over terrorist threats to its citizens (reinforced by the killings in Tunisia on 26 June) has played a key role.

The general-election result has also been important. The Conservative manifesto committed the party to increase the equipment budget by 1 per cent per annum in real terms, the assumption on which current plans are already based. It also added a further significant commitment: to maintain the number of regular trained personnel, and within this total also to maintain army regular numbers at 82,000. None of the other major parties gave similar commitments.

The subsequent July commitment to annual 0.5 per cent real increases should be enough to fund these manifesto commitments. After providing increased funds for the Equipment Plan, this growth will allow non-equipment spending to be (just) maintained at current levels in real terms through to 2020/21. There had previously been a concern that a level non-equipment budget would be insufficient to maintain personnel numbers, given anticipated growth in economy-wide earnings of 3.9 per cent over the four years to 2019/20.[7] But the government has now decided that scope remains for further reducing public-sector pay compared with that of the private sector. As a result, public-sector pay awards (both military and civilian) will be limited to 1 per cent per annum for the four years to 2019/20. Even though some more generous settlements are likely to be needed if the MoD is to retain specialist skills, continuing real-terms reductions in pay should allow the government to maintain military personnel numbers without increasing real personnel spending overall.

It now appears, therefore, that this year's SDSR will be able to avoid the severe capability reductions that were the main feature of its predecessor in 2010. It should also be able to set out provisional plans for the next decade (towards 'Future Force 2025') on the assumption of some further real-terms growth in the MoD budget beyond 2020.

The Magic of 2 Per Cent

Yet the most surprising defence-related element of the Summer Budget was the government's commitment to 'meet the properly measured

7. Office for Budget Responsibility, *Economic and Fiscal Outlook*, p. 82.

NATO pledge to spend 2% of national income on defence every year of this decade.'[8]

The government's previous refusal to commit to meeting the 2 per cent target after 2015/16 had been a focus of acrimonious discussion with US leaders and officials ever since the NATO summit in Wales in September 2014. Both in public statements and (even more bluntly) in private meetings, a succession of US leaders and senior officials had expressed their concern at the UK's willingness to contemplate reducing its defence budget below the NATO target level. Ministers sought valiantly to explain that the UK would remain NATO Europe's highest-spending member, that most other European Allies spend less than 1.5 per cent of their GDP on defence, and that the UK is one of the only member states to commit 20 per cent of its budget to new equipment (thereby meeting another of NATO's targets). US interlocutors responded by arguing that such comparisons were beside the point because they had always seen the UK as being in a special category of its own.

The first sign that the UK would continue to remain above the 2 per cent target came with NATO's publication of new defence spending data on 22 June.

These estimates showed that the UK spent 2.2 per cent of its GDP on defence in 2014 (equivalent to financial year 2014/15), and was projected to spend 2.1 per cent in 2015 (equivalent to financial year 2015/16) – comfortably meeting the NATO target for both years.[9]

This achievement was made possible by a number of significant changes in the UK's calculation of its defence budget for NATO reporting purposes. On the basis of the counting rules previously used for its NATO returns, the UK would have been on course to spend £36,820 million on defence in 2015/16, including £500 million on operations: equivalent to 1.97 per cent of GDP.[10] Applying the new counting rules, by contrast, the UK is projected to spend £39,019 million in 2015/16, equivalent to 2.08 per cent of GDP. In total, therefore, the UK has added around £2.2 billion to its NATO count.

8. HM Treasury, *Summer Budget 2015*, HC 264 (London: The Stationery Office, July 2015), p. 27.
9. NATO, 'Defence Expenditures Data for 2014 and Estimates for 2015', press release (2015) 093, 22 June 2015.
10. This does not account for the additional £500 million of in-year savings announced on 4 June 2015. See HM Treasury, 'Chancellor Announces £4.5 billion of Measures to Bring Down Debt', 4 June 2015, <https://www.gov.uk/government/news/chancellor-announces-4-billion-of-measures-to-bring-down-debt>, accessed 23 July 2015.

This has been achieved by the addition of several items in the NATO return for 2015 that have not previously been included by the UK: provision for war pensions (some £820 million); assessed contributions to UN peacekeeping missions (some £400 million); pensions for retired civilian MoD personnel (perhaps around £200 million); and a large part of the MoD's income (which totals around £1.4 billion).[11]

The defence secretary has confirmed that NATO has accepted these additions as legitimate inclusions. In some cases, notably in relation to MoD income, more information is needed before a proper independent assessment can be made of the legitimacy of inclusion. Such a detailed analysis, however, will not temper the relief that the UK and US governments now feel that, after the Budget decision, they can put this issue behind them.

Despite this, maintaining the 2 per cent commitment through to 2020 is likely to require further adjustments in the UK's counting methodology. While the MoD budget is set to grow by 0.5 per cent per annum over the next five years, national income (GDP) is projected to grow by an average of 2.4 per cent per annum over the same period.[12] If these assumptions are correct, UK NATO-countable spending would fall from 2.08 per cent of GDP in 2015/16 to 1.85 per cent of GDP in 2020/21, assuming the recently introduced counting methods are still used. A further £2.7 billion per annum would be needed in 2019/20, and a further £3.5 billion in 2020/21, in order to bring NATO-countable defence spending up to 2.00 per cent of GDP.

By indicating that 'the contribution made by the secret intelligence agencies' will be included in the future NATO count, the Budget statement has already pointed to how this gap would be closed. Total annual spending from the Single Intelligence Account (SIA) is set to total around £2,200 million by 2020/21 and will be sufficient to close the gap up to 2018/19.[13] The further allocation of up to £1.5 billion to the Joint Security Fund by 2020/21 would be enough to close the gap through to the end of the Parliament, on the assumption that it would be fully NATO-countable.

11. Total MoD income for 2014/15 was £1,466 million, including £164 million from the sale of Defence Support Group to Babcock International in April 2015. Ministry of Defence, *Annual Report and Accounts 2014–2015*, HC 32 (London: The Stationery Office, July 2015), p. 143.
12. Office for Budget Responsibility, *Economic and Fiscal Outlook*, Table 4.1.
13. The 2013 Spending Review allocated a total of £2.0 billion to the three secret intelligence services in 2015/16. HM Treasury, *Spending Round 2013*, p. 54. If this allocation increases in line with inflation, it will amount to £2.2 billion by 2020/21. The allocation for 2015/16 has since been increased to £2,252 million, but it is not clear whether this will be used as the 2015 Spending Review baseline. HM Government, *Security and Intelligence Services Financial Statement 2014–15*, HC 19 (London: The Stationery Office, July 2015), p. 17.

It is not yet clear whether NATO officials have approved UK plans to include SIA spending in its future defence-spending reporting. But a large share of SIA activity is directly in support of military operations and capabilities. And the case for inclusion will also be greatly strengthened if, as appears to be the case, the US already includes substantial elements of its own secret-service activities funding in its NATO count. It has been estimated that more than 90 per cent of US National Intelligence Program spending – equivalent to $53 billion in 2013, and spread over seventeen organisations – is reported to Congress through the Department of Defense budget.[14] The US government has not explained in public how it calculates its own defence-spending return to NATO.

There is a risk that the UK's readiness to alter its counting rules – adding potentially around 14 per cent, or £5.7 billion, to the total amount eligible for counting as defence spending by the end of this Parliament – could undermine the credibility of NATO's 2 per cent spending target.

But it is just as likely to strengthen it. For the UK's ability to meet this target over the coming five years is not only a result of changing counting rules. It also reflects the fact that the government is now prepared to commit to a period of steady real-terms growth in the defence budget, giving it a degree of budgetary protection that it has not hitherto enjoyed. If, even after such an effort, the Alliance's leading European military spender had ended up being pilloried for having fallen just below the 2 per cent target, it would have dealt a serious blow to the credibility of Alliance burden-sharing commitments as a whole, with negative consequences for transatlantic relations.

The UK's reinterpretation of NATO's counting rules could perhaps provide some lessons for defence accountants in France, whose latest NATO-reported defence budget (for 2015) was 1.8 per cent of GDP. But few other NATO member states are anywhere close to meeting the 2 per cent target in 2015. Germany now spends only 1.2 per cent on defence, Italy 1.0 and Spain 0.9. Of twelve new member states from Central and Eastern Europe, ten spend less than 1.5 per cent of their GDP on defence in 2015, and only Poland and Estonia – spending 2.2 and 2.0 per cent respectively – meet the target. Even 'front-line' Latvia and Lithuania spend only 1.0 and 1.1 per cent, with Bulgaria and Romania only a little better at 1.2 and 1.4 per cent. The UK's renewed commitment to the 2 per cent target should enhance its own reputation within NATO and with the US. But it may not persuade many other Europeans to rapidly match its commitment.

14. Marshall C Erwin and Amy Belasco, 'Intelligence Spending and Appropriations: Issues for Congress', Congressional Research Service, September 2013, p. iii.

Now Deliver

Now that the MoD budget has been protected, there is likely to be sustained political pressure for it to deliver. The prime minister's comments on defence spending on 14 July – arguing for more resources for reconnaissance aircraft, special forces and drones – mark the next stage in the intense bargaining over the outcome of the SDSR. The MoD will need to respond convincingly to such pressures, drive further efficiencies in its programmes, and ensure that the UK's defence capabilities remain relevant as new and unexpected security challenges emerge over the next five years.[15] Compared with the gloomy predictions of defence cuts which were prevalent only four months ago, however, this is a good set of problems to have.

Professor Malcolm Chalmers is Research Director and Director of UK Defence Policy at RUSI.

15. For further discussion of the strategic choices that the UK will face in the forthcoming SDSR, see Malcolm Chalmers, 'A Force for Order: Strategic Underpinnings of the Next NSS and SDSR', RUSI Briefing Paper, May 2015.

BRIEFING PAPER

Royal United Services Institute for Defence and Security Studies
Whitehall, London SW1A 2ET, UK

Tel: +44 (0) 20 7747 2600
Fax: +44 (0) 20 7321 0943

E-mail: publications@rusi.org
Web: www.rusi.org/