The Financial Context for the 2015 SDSR
The End of UK Exceptionalism?
Malcolm Chalmers

Executive Summary

At the Wales NATO summit – ongoing at the time of writing – the UK government has been a strong supporter of efforts to encourage all member states to meet the alliance’s target of spending at least 2 per cent of GDP on defence. On current spending plans and growth projections, however, UK defence spending is set to fall below the NATO 2 per cent target for the first time next financial year, to an estimated 1.88 per cent of GDP in 2015/16.

Existing Ministry of Defence (MoD) planning assumptions (for modest real-terms growth in its budget after 2015/16) would, in the context of projected GDP growth, see spending falling to around 1.7 per cent of GDP by 2020/21. Given wider government plans for spending cuts after 2015/16, however, this could prove over-optimistic. Further cuts in the 2015 Spending Review (of between 4 per cent and 10 per cent in real terms over five years) could see defence spending falling to between 1.5 per cent and 1.6 per cent of GDP in 2020/21.

Given the risk of further such cuts, the MoD’s interests would be best served by conducting the next SDSR in parallel with (rather than subsequent to) the 2015 Spending Review. This would help to ensure that government leaders (in both Nos. 10 and 11 Downing Street) are fully aware of the capability consequences of proposed spending cuts before they are finalised.

Because of the short time involved in such a schedule – perhaps only three months after the election before key capability choices need to be made – the MoD will need to complete much of the detailed work on the feasibility and cost-effectiveness of a range of possible policy options in advance of the May 2015 General Election. Without such work, ministers could find themselves – as in 2010 – being forced to make key decisions without adequate supporting data.
The End of UK Exceptionalism?

The Wales Summit has been used by the UK as a forum for urging other European states to raise their defence budgets to meet the NATO guideline, first established in 2006, that member states should spend at least 2 per cent of their GDP on defence. The UK has, until now, been in a good position to do so. It is one of only three European states – along with Estonia and Greece – that met the guideline in 2013.\(^1\) It also gets more capability for the money it spends compared to many of its allies, with a higher proportion being spent on equipment than in any other European NATO state apart from France.

But the UK will not be able to urge others to follow its own good example for much longer. Reductions in its core defence budget as a result of the 2010 Strategic Defence and Security Review (SDSR), together with cuts in Afghanistan-related operations spending (which NATO counts towards the 2 per cent target) mean that total UK defence spending is due to fall by 19 per cent in real terms between 2010/11 and 2015/16.\(^2\) And the country’s return to economic growth, together with the forthcoming upward revision of around 5 per cent to its estimated GDP to take account of new international national accounts standards, is raising the baseline for the NATO target calculation. As a result, UK defence spending is now due to fall to an estimated 2.07 per cent of GDP in 2014/15, on the cusp of falling below the 2 per cent NATO target. As a result of the further reductions announced in the 2013 Spending Review, along with officially projected increases in GDP, planned expenditure (on the NATO definition) will fall to only 1.88 per cent of GDP in 2015/16.

What happens next will depend on the outcome of the 2015 Spending Review, which is due to take place in late 2015 and which is likely to set defence budgets up to 2019/20, and possibly beyond. This briefing presents four possible scenarios: that the UK meets the 2 per cent target to 2020 and beyond; that there are modest real increases in the defence budget, in line with current planning assumptions; that defence suffers two more years of cuts; and that defence suffers five more years of cuts.

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**Graphs 1 and 2:** Projected UK Defence Spending in cash and GDP terms (fiscal years starting).

![Graphs showing projected UK defence spending in cash and GDP terms](image)

**Source:** See Tables 1 and 2 on page 8.

**Scenario 1: The UK meets NATO’s 2 per cent Target through to 2020**

The new government could decide to increase spending to meet the NATO 2 per cent target for the years through to 2020. Such a commitment would be welcomed by the US in particular, and would reinforce the UK’s position as NATO-Europe’s most capable military power. Because the UK will already have fallen below the 2 per cent mark in 2015/16, however, this would require the UK to increase defence spending more rapidly than the rate of GDP growth.

This does not appear to be politically plausible in current circumstances. Both the current Conservative–Liberal Democrat coalition government and the Labour opposition are committed to at least two more years of spending cuts after 2015/16, in order to eliminate the budget deficit created as a result of the 2008 financial crisis. As part of the resulting austerity programme, total government spending has already been cut from 47.0 per cent of GDP in 2009/10 to 43.8 per cent in 2013/14, and is due to fall to 41.6 per cent by 2015/16. But current government plans provide for a further reduction – to
just over 38 per cent of GDP – by 2018/19. Only after that year, if the economy recovers as planned, is it envisaged that there might be a resumption of real growth in total spending.

In the context of this unprecedented squeeze, no major government department will be able to receive a real increase in resources without others suffering even deeper cuts. An extension of the UK’s commitment to the 2 per cent target would therefore require that the MoD be given a budgetary priority that stood well above those given to the NHS, schools or other large departments of state. Over the next five years (2016/17 to 2020/21), it would require an additional £25 billion to be allocated to defence in addition to the level that the MoD is now assuming for planning purposes. If the 2 per cent commitment was further extended, through to 2025/26, it would cost an additional £74 billion compared to current MoD assumptions.

There has so far been little indication that any of the major political parties is willing to give defence a higher spending priority than education or schools. Perhaps the main circumstances in which this might begin to become plausible is if there were to be a wider mobilisation of European defence resources in response to a further worsening of the strategic situation on NATO’s frontier with Russia. If other major West European states – including France, Germany, Italy and the Netherlands – were to begin raising their own defence budgets substantially in real terms, this could put pressure on the UK to follow suit. So far, however, this has not occurred.

Scenario 2: Current MOD Plans for Modest Real Increases are Confirmed

A second scenario is that the government agrees to fund the defence budget through to 2020/21 on the basis of current MoD planning assumptions. These have allowed the MoD to plan its forward equipment budget on the basis of annual increases of 1 per cent in real terms through to 2022/23, and (in this scenario) this could be extended through to 2025/26. At the same time, the MoD is also assuming that other, non-equipment, spending will increase in line with inflation. Since the equipment budget accounts for just over 40 per cent of total defence spending, the combined effect of these two commitments is an overall real increase of around 0.4 per cent annually.

Such an increase, however, would be well below the expected rate of economic growth over this period, according to the latest projections from

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3. For this purpose, the Department for International Development – with a budget of £10 billion, equivalent to 26 per cent of that of the MoD – is not counted as a ‘major’ department.
the independent (but government-funded) Office of Budget Responsibility (OBR). These assumptions form the basis for wider government fiscal planning, and assume average annual GDP growth of more than 2 per cent per annum through the next decade. On these assumptions, continuation of existing MoD plans leads to defence spending falling to an estimated 1.71 per cent of GDP by 2020/21 and to 1.57 per cent by 2025/26.5

The MoD would do well to achieve such a settlement, which would still require the government to give it an exceptional priority compared to other departments. The 2015 Spending Review promises to be almost as austere as its predecessor review in 2010, with the Treasury already projecting that overall governmental departmental spending will fall by a further 8 per cent in real terms over the first two years of the Review.6 Even if these ambitions are moderated in practice, it is still hard at present to see the next UK government, whatever its political colour, being willing to exempt the MoD entirely from an overall package of austerity. Further deterioration in the international environment, however, might change the public and political mood over the next year. Certainly this scenario now appears more plausible than it did at the beginning of 2014, before the annexation of Crimea.

**Scenario 3: Defence Suffers Two More Years of Real-Terms Cuts**

Yet a more plausible scenario is still that the 2015 Spending Review will continue to reduce total government spending for at least two further years, and that the MoD will broadly maintain its current place in the pecking order for departmental spending, being cut more than health and schools, but less than most other government departments.

This scenario reflects a plausible path for the government budget as a whole. By 2017/18, it is assumed, the combination of further austerity and continuing economic growth will have allowed the government to meet its targets for deficit reduction. In subsequent years, as a result, government spending – including spending on defence – could return to modest rates of real growth, commensurate with wider increases in national prosperity.

On this scenario, the MoD budget would remain constant in cash terms through 2016/17 and 2017/18, equivalent to real-terms cuts of 2 per cent each year. In subsequent years, from 2018/19 onwards, defence receives enough additional cash to keep pace with general inflation. On this scenario, defence falls to 1.62 per cent of GDP by 2020/21 and to 1.46 per cent in 2025/26.

5. This assumes that annual GDP growth after 2018/19 is 2.2 per cent in real terms.
Scenario 4: Defence Suffers Five More Years of Real-Terms Cuts

Given the fragility of the UK’s recovery, now under further threat as a result of the economic fallout from the Ukraine crisis, a more pessimistic scenario is also possible. If UK economic growth fails to achieve current expectations, the UK may decide that it has no alternative but to extend its programme of cuts in departmental spending through to the end of the next Parliament.

In this scenario, which is at the pessimistic end of the range of plausible outcomes, the MoD would suffer a settlement in the 2015 Spending Review similar to that which it was given in 2010: flat cash for all five years through to 2020/21, with the promise of a return to stable real-terms budgets only in the first year of the 2020 Spending Review. Given the weight of inherited commitments and contracts, a reduction on this scale would be very difficult for the MoD to manage without suffering severe cuts to key capabilities and modernisation plans.

On this scenario, defence falls to 1.53 per cent of currently projected GDP by 2020/21 and to 1.38 per cent by 2025/26. It would be little comfort to the MoD if economic growth was more anaemic than currently planned, and therefore these proportions were somewhat higher.

The UK in Comparative Perspective

Even as UK defence spending seems likely to fall towards 1.5 per cent of GDP over the next decade, the defence budgets of other large West European states – including France, Germany, Italy and Spain – are on course to fall to around 1 per cent over the same period. Those members who are most exposed to Russian military pressure – Poland and the Baltic republics, perhaps also Norway – will probably resist this wider trend. In overall terms, however, the numerical strength of Europe’s armed forces – its personnel, aircraft, ships and formations – is likely to diminish substantially over the next decade.

Even on the worst case scenario outlined above (five more years of austerity), the UK could still maintain its position as the world’s fourth- or fifth-largest defence spender (much emphasised by the current government) for the rest of this decade. But its relative position in the global pecking order of defence budgets is likely to come under increasing challenge after 2020. According to a recent estimate, Saudi Arabia spent slightly more than the UK on defence for the first time in 2013.7 India’s defence budget is likely to exceed that of the UK within the next decade, and both Brazil and Japan might also do so. Russia – whose defence budget overtook that of the UK after 2010 – seems set to continue to improve the quality and effectiveness of its forces over

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7. IISS, The Military Balance 2014 (Abingdon: Routledge for IISS, February 2014). This does not imply that Saudi Arabia’s military capability is comparable to that of the UK.
the next decade. China, for its part, is likely to consolidate its position as the world’s second military power. In such a world, the UK’s ability to operate as a global military power would become increasingly constrained, and even more dependent than at present on close co-operation with the US.

**Implications for the Next SDSR**

In all but the most optimistic scenarios outlined above, the resources will not be available to make the 2015 SDSR a ‘steady-as-she-goes’ review. The deeper the cuts that are made in the defence budget, the more difficult it will be to maintain current plans for the shape of the armed forces a decade from now. Both the introduction of two new large aircraft carriers into service (in some form), and the commitment to build a successor generation of nuclear missile submarines, appear to be politically secure. The resultant economies in other areas of defence provision, however, could pose significant risks to the international credibility of the rest of the UK armed forces.

The risks from further cuts could be increased if, in line with Treasury projections for total government spending, the MoD is obliged to ‘front load’ economies in the first two years of the next Spending Review. If this were to occur, contractual obligations would limit the areas from which savings could be made, forcing the MoD to make cuts that could severely reduce operational readiness and undermine military morale.

In the approach to a general election, it is perhaps understandable that political leaders do not want to explicitly address the implications of their commitment to wider austerity for the defence budget. But even the possibility of such cuts, given the complex and interrelated nature of defence capabilities, means that serious technical study of options needs to take place well before the next SDSR formally starts in May 2015.

It has been argued that the next SDSR should be postponed until after the National Security Strategy – and, more importantly, the Spending Review – has been completed. Such a reordering, its proponents hope, would help the MoD to ensure that its defence priorities were more grounded in national strategic priorities, rather than a rushed response to Treasury demands for budgetary cuts.

While the motive for such a proposal is admirable, however, its implementation would result in a defence budget that was even more driven by cost reduction than would otherwise be the case. Opponents of defence spending would relish the possibility of being able to impose cuts in the MoD’s budget first, and then leave it to the MOD to work out how to make the requisite economies.
Given the risk of further cuts, therefore, the MoD’s interests would be best served by conducting the next SDSR in parallel with (rather than subsequent to) the 2015 Spending Review. This would help to ensure that government leaders (in both 10 and 11 Downing Street) are fully aware of the capability consequences of proposed spending cuts before they are finalised. Because of the short time involved in such a schedule – perhaps only three months after the election before key capability choices need to be made – the MoD will need to complete much of the detailed work on the feasibility and cost-effectiveness of a range of possible policy options in advance of the May 2015 general election. Without such work, ministers could find themselves – as in 2010 – being forced to make key decisions without adequate supporting data.

Annex

Table 1: Four Scenarios for UK Defence Spending (cash, NATO Definition), 2013/14–2025/26, £ billions

<table>
<thead>
<tr>
<th>Scenario</th>
<th>2013/14</th>
<th>2014/15</th>
<th>2015/16</th>
<th>2020/21</th>
<th>2025/26</th>
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<td>Further reductions (for five years)⁴</td>
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Table 2: Four Scenarios for UK Defence Spending as a Percentage of GDP, 2013/14–2025/26

<table>
<thead>
<tr>
<th>Scenario</th>
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<th>2015/16</th>
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<td>1.89</td>
<td>1.53</td>
<td>1.38</td>
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</tbody>
</table>

Notes

a. This assumes two more years of real reductions in departmental budgets, including defence, followed by maintenance of defence spending in real terms.

b. This assumes five more years of real reductions in departmental budgets, including defence, followed by maintenance of defence spending in real terms.
Sources and Assumptions

For Defence Spending, the NATO definition is used. Estimates are based on (a) current plans for Defence Departmental Expenditure Limits to 2015/16, as amended in the Autumn Statement 2013. See: ‘Public Expenditure Statistical Analyses 2014’, Table 1.10, July 2014, <https://www.gov.uk/government/statistics/public-expenditure-statistical-analyses-2014>; (b) projected net expenditure on Armed Forces Pension Scheme, taken from OBR, ‘Economic and Fiscal Outlook’, Table 2.19, 2014, up to 2018/19, and 3 per cent annual growth in cash terms in subsequent years.