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# Economics, Cash Profiling and Financial Balance – are we expecting too much for Defence in 2015?

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# Introduction

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- In CSR 2010 the Government announced an £81 billion reduction in public spending.
- In the Autumn Statement (Dec 2014) we are told that further cuts in expenditure are needed to reduce the deficit and provide a better balance in the budget.
- **Is this reasonable or is there no choice?**
- To understand the question it is necessary to start with a view of the national debt, its effect on the budget its likely impact on defence funding.

# Caveats

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- Due to its historical content, this presentation covers many generations and across many political domains. Any political bias is unintended.
- The financial figures shown are based on those provided in the Treasury's Autumn Statement. Forecasted costs may have changed between those published and the date of this presentation.

# History of UK National Debt

# UK National Debt

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- It is easy to say at the outset that during 2014/15 HM Treasury has forecasted:
  - Revenues of some £625 billion;
  - Expenditure of some £730 billion and;
  - A debt of some £1,500 billion.
- But what does this mean in terms of funds available for government departments?
- To provide some understanding to the question we will start by taking a look at the history of UK debt and put it into context.

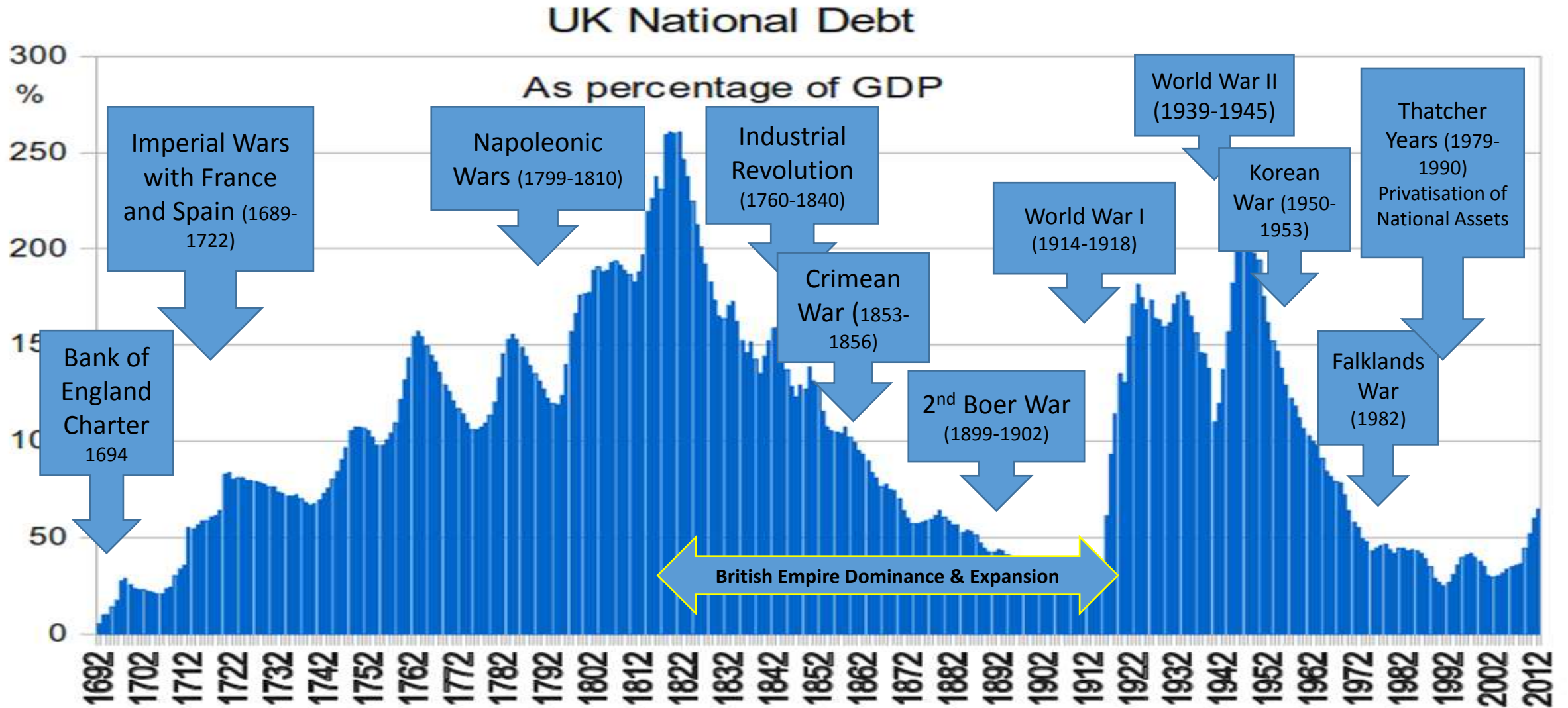
# Origins of UK National Debt

- The origins of UK debt can be found during the reign of William III (1650-1702). He engaged a syndicate of City traders and merchants to offer for sale an issue of government debt.
- This soon evolved into the Bank of England (founded in 1694) to act as the Government's banker and debt manager. It was privately owned until 1946 when it was nationalised.
- National debt increased dramatically during and after the Napoleonic Wars. Over the course of the 19<sup>th</sup> century the debt fell only to see increases again during the two World Wars.



*The sealing of the Bank of England Charter (1694)*

# UK National Debt – Notable Dates



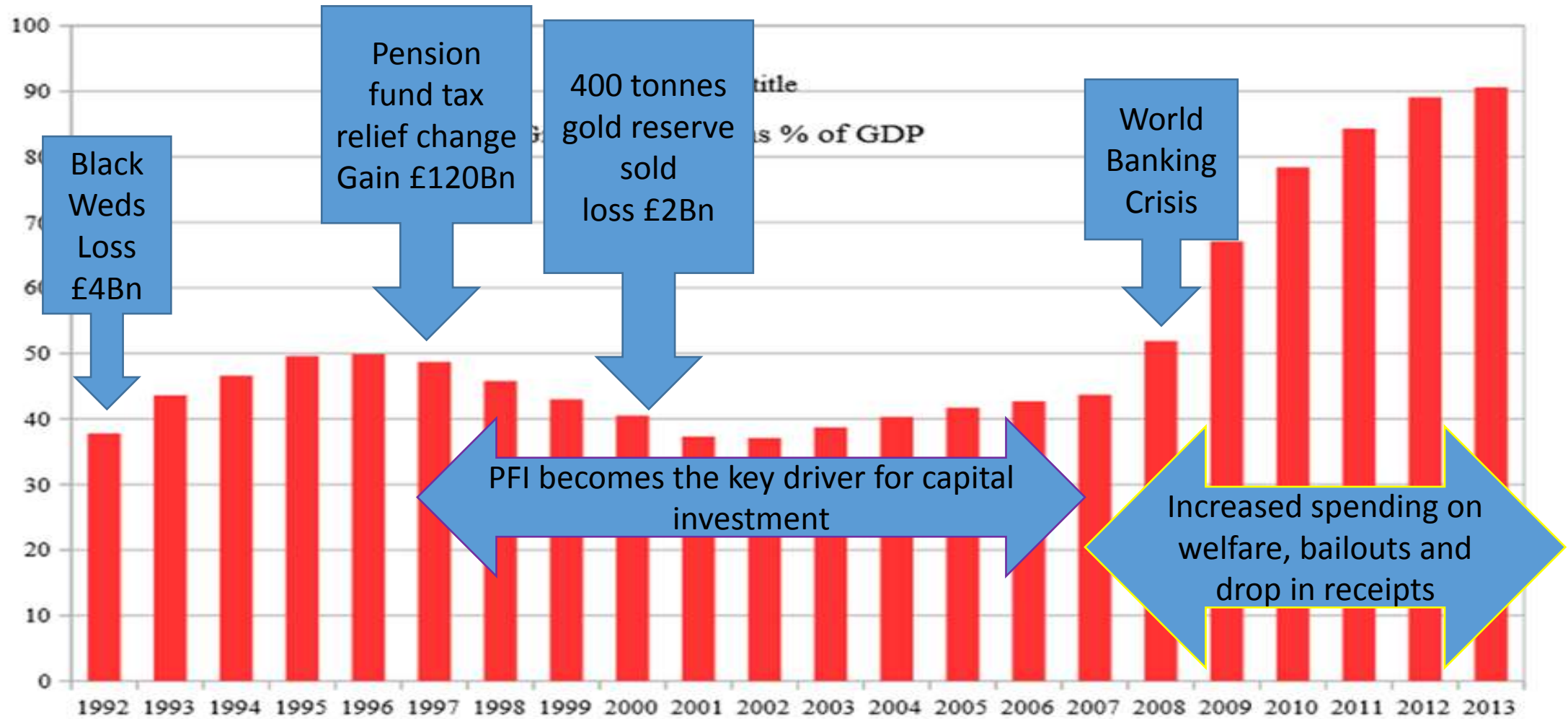


# Recent History

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- In 1976 the government faced a sterling crisis, pound tumbled, unable to raise funds, rescue package needed from the IMF who insisted on deep cuts in public expenditure (public humiliation).
- In 1992 the UK withdraws from the European Exchange Rate Mechanism (Black Wednesday).
- During the spending review of 2000 there was a looser fiscal policy and by 2002 annual borrowing had reached £20 billion.
- Over the years 1997-2008 PFI became the mantra for capital investment.
- In 2008 the financial banking crisis changed world economics.

# Notable Dates



# UK Debt Summary

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- Debt is not new – we have lived with it (at various levels) for over 300 years.
- As of Q3 2014 UK debt amounted to £1,449 billion (80% of GDP).
- Annual cost of servicing the debt is £53 billion (more than the annual defence budget).
- Debt is increasing by £107 billion/year (£2 billion /week).
- **The debt will continue to rise even if the deficit shrinks.**
- No light yet at the end of the tunnel.

# Balance of UK Revenue and Expenditure

# UK Revenues (2014/15)

Receipts	Amount
Income Tax	£167 billion
Value Added Tax	£111 billion
National Insurance	£110 billion
Excise Duty	£47 billion
Corporation Tax	£41 billion
Council Tax	£27 billion
Business Rates	£27 billion
Other	£118 billion
<b>Total Receipts</b>	<b>£648 billion</b>

The table shows the different sources of government revenue. Public sector current receipts during 2014-15 are expected to be around £648 billion.

Other receipts include capital taxes, stamp duties, vehicle excise licence and dividends.

*Source: HM Treasury Budget 2014-2015 estimates*

# UK Expenditure

Main Function	Amount
Social Protection	£222 billion
Health	£140 billion
Education	£98 billion
<b>Defence</b>	<b>£38 billion</b>
Public Order & Safety	£32 billion
Personal Social Services	£31 billion
Housing & Environment	£25 billion
Transport	£23 billion
Industry, Agriculture & Employment	£17 billion
Other	£53 billion
<b>Debt Interest</b>	<b>£53 billion</b>
<b>Total Expenditure</b>	<b>£732 billion</b>

The table presents public spending by main function. The Total Managed Expenditure is expected to be around £732 billion in 2014-15.

Allocations to Functions based on HM Treasury analysis.

*Source: HM Treasury Budget 2014-2015 estimates*

# 2014-15 Budget

Receipts	Amount
Income Tax	£167 billion
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# Budget Deficit

- HM Treasury stated in December that there had been a sharp fall in the amount of tax received. As a result, the budget deficit at the end of the year is expected to be £91.3 billion.

Source	Receipts	Expenditure	Balance
Budget (March 2014)	£648 billion	£732 billion	<b>-£84 billion</b>
Autumn Statement (December 2014)	£646 billion	£737 billion	<b>-£91 billion</b>
End of Year 2014/15	?	?	<b>~£80-£100 billion</b>



# Forecasting Budgets

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- Budgets are not based on ‘finger in the air’ assumptions but are derived from soundly based macro-economic modelling. These type of models are not confined to in-house developments and there are several examples that utilise and mirror HM Treasury’s approach.
- One such example of macro-economic modelling is provided by the Manchester Economic Forecasting Group and utilised for defence application by Decision Analysis Services.
- The model represents global economies as a system of systems and are used by the OBR, OECD, IMF, European Commission, US Fed as well as economics consulting houses.

# The Manchester Economic Model

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- The model is an example of a structural macro-economic model
  - It has explicit economic drivers/structure specified.
  - Contrasts to a pure time series.
  - Leverages current macro-economic modelling knowledge.
  - Does not assume economy is always 'on trend'.
  - Reflects the model/approach of the fair global model.
  - It has wide global coverage: G7, other OECD, BRIC+, Dynamic Asia and other trading zones.
- **These types of models are used by governments to forecast fiscal budgets and are also used by industry to support future investment strategies.**

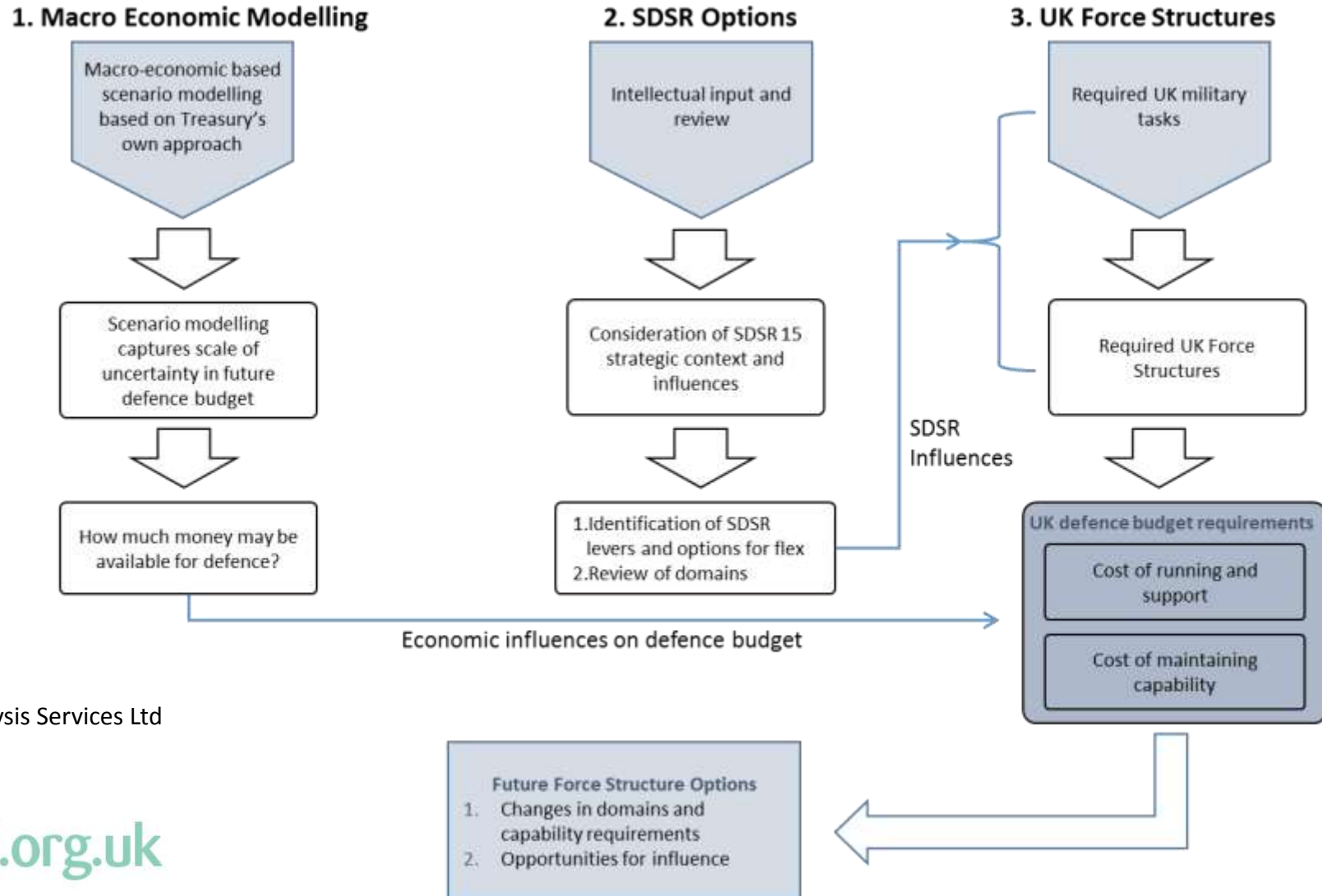
# Defining the Defence Budget Allocation

# Defining the Defence Budget Allocation

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- The previous slides discussed the macro-economic modelling and its influences. The next step in the process is to develop strategic options. This has a number of threads including:
  - Assessments on global strategic trends from the Development, Concepts and Doctrine Centre (DCDC) (MoD Think Tank). This group provides the intellectual bases that inform coherent decisions in defence policy, capability development and operations both now and in the future.
  - Review of the Military Tasks (in line with MoD's vision and priorities).
  - Review of the options available to undertake the Military Tasks.
  - The final component is to develop the Force Structure required.

# Top Level Assessment Process



Source: Decision Analysis Services Ltd

# Defence Funding Allocation for 2015/16

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- HM Treasury announced in the budget of 2014 that the defence budget for 2013/14 would be £34.8 billion and that the estimates for 2014/15 were £35.8 billion.
- They also stated that the defence budget for 2014/15 reflected a drawdown of funding from the special reserve.
- No such allocation has been made for 2015/16 (the funding remains in the special reserve).
- The plan for 2015/16 shows a budget of £32.9 billion (a reduction of some 4%)

# Spending Reviews

# CSR 2010

Department	% Reduction
Education	-3.4%
Health	+1.3%
Defence	-7.5%
Transport	-21.0%
Local Government	-27.0%
Housing	-51.0%
Law and Order	-23.0%
Scotland, Wales & NI	-7.0%
Overseas Aid	+37.0%
Climate Change	-18.0%
Culture & Sport	-24.0%
Welfare	-1.9%
Other Departments	-8.3%
Debt Interest	+35.0%

- CSR 2010 was described as the biggest cuts since World War II.
- The review proposed an £82 billion cut in public spending over the remaining four years of Parliament with average departmental cuts of 19%.
- The MoD faced expenditure cuts of around 8%.



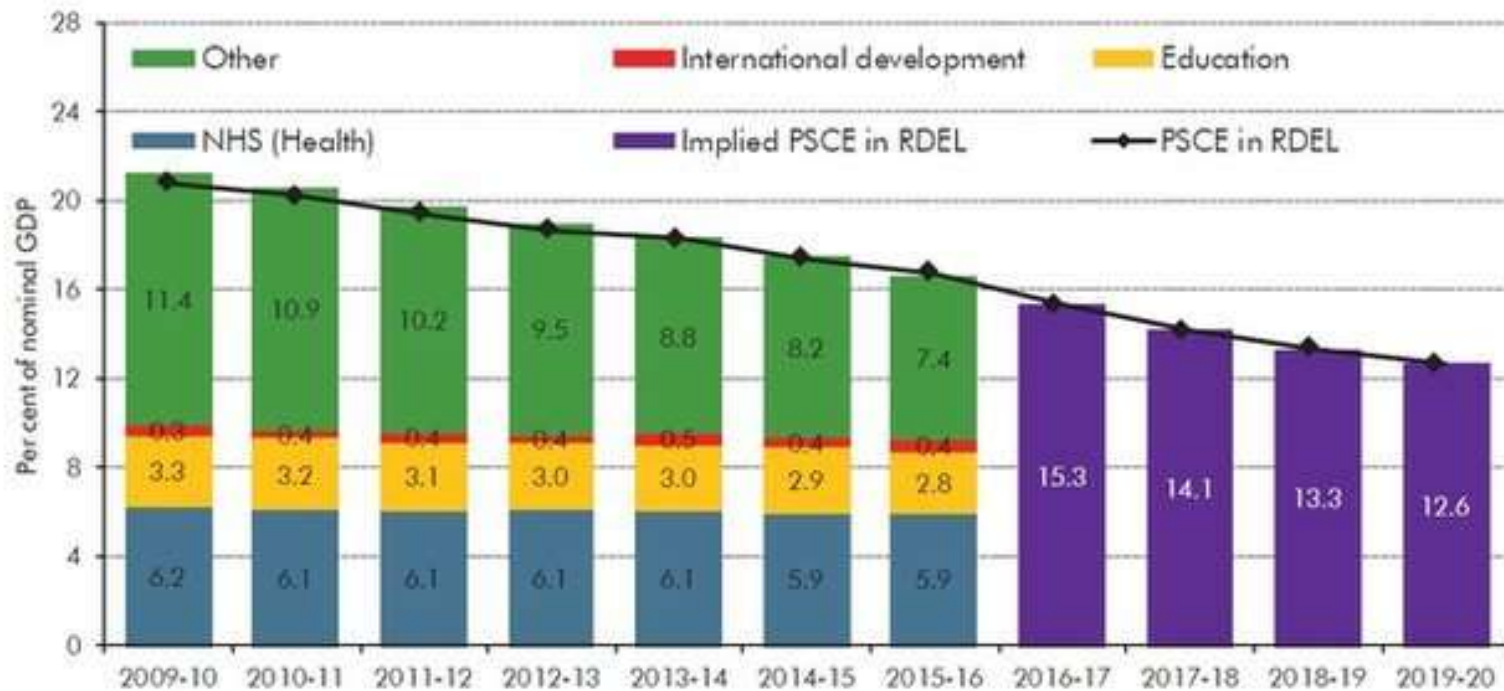
# HMT Autumn Statement

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- The Office for Budget Responsibility stated in its report that the Treasury plans for spending on public services were heading for an 80 year low.
- In its report accompanying the Autumn Statement it projected that spending by central government on public services was going to fall from 21.2% of GDP in 2009/10 to 12.6% in 2019/20.

# HM Treasury Plans to 2020

Chart 4.4: Resource DEL and implied resource DEL relative to GDP



Plans for RDEL excluding depreciation upto 2015-16. Beyond 2015-16 based on implied PSCE in RDEL calculated from the Government assumption for TME. Other includes unallocated amounts.

Source: HM Treasury Autumn Statement 2014, HM Treasury Public Expenditure Statistical Analyses, July 2014

OBR

- The chart shows that of the cuts made over that 10 year period (2010-2020), 40% would be during the current Parliament and the remaining 60% during the next Parliament.
- The OBR is questioning whether it is reasonable to accept that these level of cuts are possible.
- This sounds like a big job for whichever party ends up in government after the election.

# Challenges for the MoD

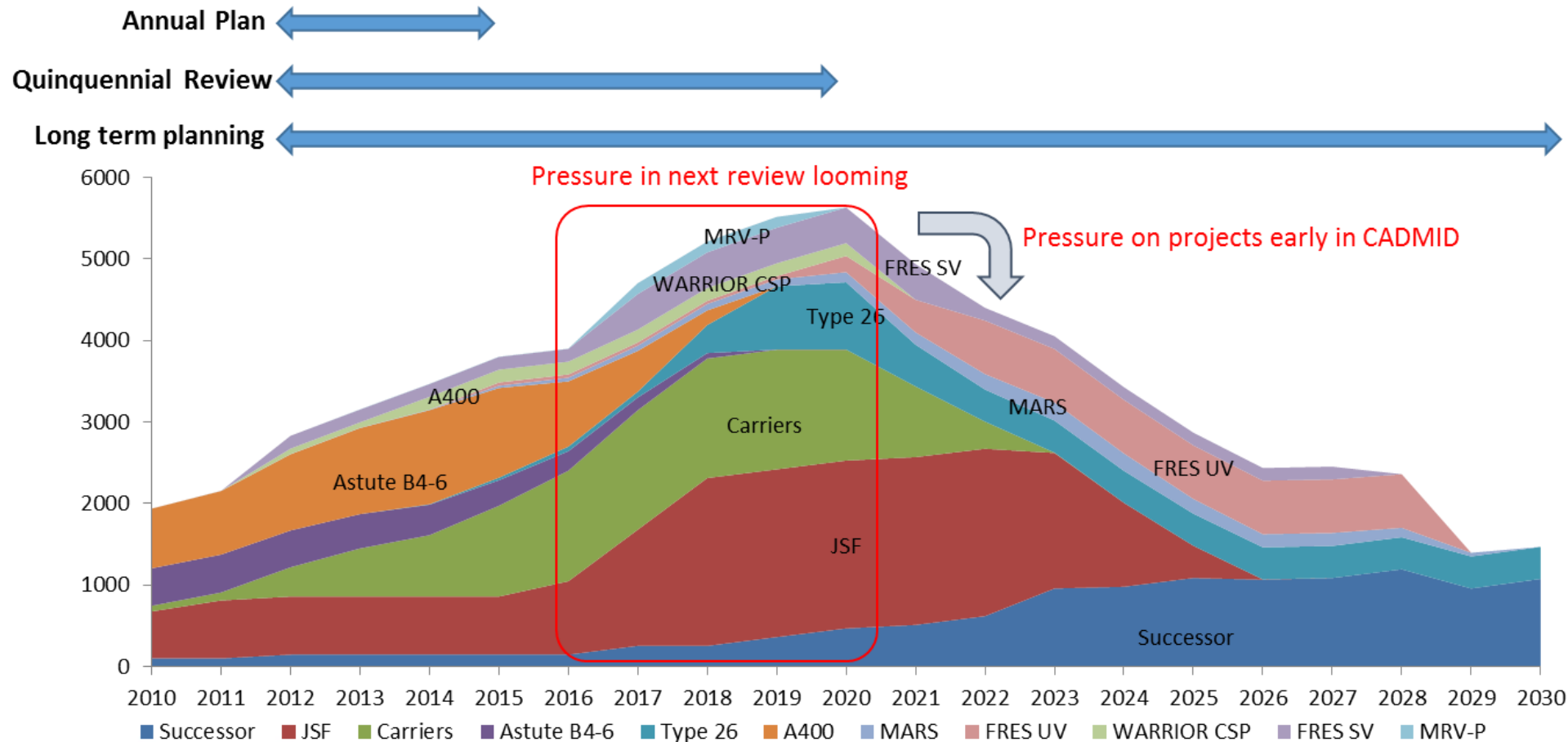
# Challenges for the MoD

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- In 2012 an independent review of the MoD's Equipment Programme was undertaken.
- The results showed the looming pressure on the budget from 2016 to 2020.
- This will add further pressure on funding available for the early phases of future programmes.
- There remains a danger of short term planning focus – fixes that fail with unintended consequences.
- There is a requirement for planning to look across multiple horizons continuously.
- **Is the MoD optimistic on a 10 year balanced budget ? (an illustration.....)**

# MoD Top 11 Programme Illustration

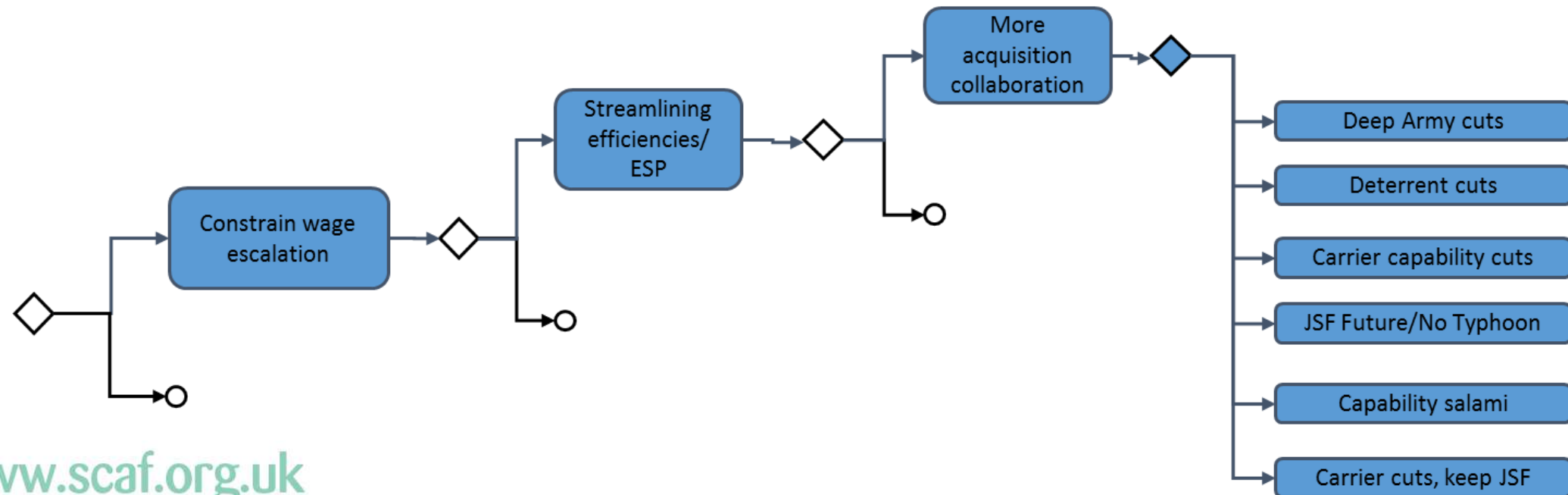
Estimated EPP budgets for selected major programmes (£Bn 2011 e.c.)



# Defence Analysis Review

- Although the SDSR may manage a 5 year window through delay, Force Structures assessments can be built on radical change.
- Budget over the longer period means capability must be lost.
- Key drivers will be efficiencies, collaborative acquisitions and capability cuts.

## Analysis framework



# In Conclusion

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What are your views now on the proposed further reductions in public spending in order to balance the budget?

- Are the plans to reduce public spending from 21.2% of GDP to 12.6% in 2019/20 reasonable?
- Is there no choice?
- Are there any alternatives?

**DISCUSS.....**

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# How do we balance the Budget ?

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# CSR 2015 ?

**What do you think  
will happen in 2015?**

Department	% Reduction
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Defence	-7.5%
Transport	-21.0%
Local Government	-27.0%
Housing	-51.0%
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# Write-offs reported in 2014

## Can we help to cut out failures?

IT Project	Loss
Surrey Police SIREN System	£15m
DSS Universal Credit	£180m
MoD Army Recruitment System	£70m
E-Borders System	£224m
Immigration Case Load System	£750m
BBC Digital Media Initiative	£100m
<b>TOTAL</b>	<b>£1,339m</b>

MoD Programme	Loss
SATCOM Services – unsuitable for UK use	£1.0m
Cancellation of software integration tool	£1.5m
Unnamed project – main contractor failure	£3.8m
Inventory liability – Sea King	£4.0m
Cancellation of level waste treatment plant	£19.3m
Unnamed project – main contractor failure	£42.8m
Termination of Project Hydra	£117.7m
<b>Total</b>	<b>£190.0m</b>
<b>Total Reported Value of Constructive Losses</b>	<b>£2,690m</b>

Source: MoD Annual Report 2013/14, Page 158