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Mind the Gap

The MoD's Emerging Budgetary Challenge

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Executive Summary

The UK is now projected to spend 1.95 per cent of its GDP on defence in 2015/16 (£37.3 billion), excluding spending on operations – just short of the NATO 2 per cent target to which it agreed at the Wales summit.

On the current Ministry of Defence (MoD) planning assumption of modest real growth, and with the removal of £1.5 billion of one-off 2015/16 allocations, spending for 2016/17 is due to fall to £36 billion, equivalent to 1.85 per cent of GDP. In order to meet the 2 per cent commitment in 2016/17, therefore, the MoD would need an additional £3 billion. Further increases would be required in subsequent years to keep pace with GDP growth. By 2019/20, meeting the NATO target would require the MoD to be provided with an additional £5.9 billion in annual spending, compared with current assumptions.

In a context of wider austerity in public spending, such an increase is not plausible. Instead, this paper suggests two scenarios. In a pessimistic scenario, based on analysis of the spending plans of all three of the major political parties, the MoD would face a 10 per cent real-terms cut over the next four years. In its optimistic scenario, defence is given the same level of funding protection as health and schools, sending a powerful signal of increased priority for defence. The extra funds – around £4 billion per annum by 2019/20 compared with the pessimistic scenario – would probably have to be found from increased taxation and/or borrowing.

Since 2010, the bulk of real-terms cuts in spending has been felt in the personnel budget, with numbers of service and civilian personnel being cut by 17 per cent and 28 per cent, respectively. This will be harder to achieve in a further round of cuts. Planned increases in pension and National Insurance contributions, together with growing salary costs, will increase the pressure

on personnel numbers. Even on the optimistic scenario, numbers of service personnel could fall from 145,000 to 130,000 by the end of the decade. Under the pessimistic scenario, they could fall to 115,000.

Plans for equipment spending are also likely to be affected, especially on the pessimistic scenario. Planned spending on a successor submarine, designed to carry the Trident nuclear missile, is due to take the largest share of the forward procurement programme, and will be hard to change. If economies have to be made, air, maritime and land systems could all be vulnerable.

In either scenario, the result will be a remarkably sharp reduction in the footprint of defence in UK society over a decade. Even in the optimistic scenario, defence's share of GDP will have fallen by a third: from 2.6 per cent of GDP in 2010 to around 1.75 per cent by 2019; and the MoD workforce (service and civilian) will have fallen by around 30 per cent, from 265,740 to 184,000 by 2019.

The MoD's Emerging Budgetary Challenge

The timing of the start of the next Strategic Defence and Security Review (SDSR) has been known since 2010; and Ministry of Defence (MoD) officials and counterparts in other departments are now preparing the ground for the review to begin formally after the May election.

It remains to be seen whether the next government will be stable enough to take the necessary decisions as rapidly as in 2010. A Conservative government is likely to seek further substantial reductions in public spending. Even if it accords a relatively high priority to the MoD budget, the net result could still be, as in 2010, a significant real-terms cut. A Labour government may be likely to cut public spending less sharply, even if this means slower deficit reduction. Given the competing demands from other spending commitments, however, it may give defence a lower relative priority, potentially leading to a similar outcome for the defence budget. If there is a minority or coalition government, the situation could be further complicated.

While current ministers claim to have eliminated over-commitment from MoD budget plans, this relies on the assumption that the equipment budget will grow at 1 per cent above inflation every year, and that the rest of the budget is maintained at real 2015/16 levels.

This assumption appeared realistic in the 2010 Spending Review, which predicted that national deficit reduction would have been substantially completed by now.[1] If the December 2014 Autumn Statement is to be believed, however, the government is only half way through its programme of cuts in departmental spending, which it argues will now have to continue at least through to 2019/20. Neither of the two largest parties appears to be willing to exempt defence from wider austerity. None of the smaller political parties (with the possible exception of UKIP) favour more generous treatment for defence.

Yet this bleak fiscal outlook co-exists with capability commitments that, taken together, cannot be afforded without a sustained increase in real funding. The prime minister has made a strong commitment to maintaining the current number of regular army personnel and increasing reserve numbers.[2] While the 2010 SDSR announced that it would fund the operation of only

1. HM Treasury, *Spending Review 2010* (London: The Stationery Office, 2010), p. 16 predicted that public sector net borrowing would fall from 11.0% of GDP in 2009/10 (later revised to 10.2%) to only 1.1% of GDP in 2015/16. Now it is predicted that borrowing in 2015/16 will still total some 4.0% of GDP. See HM Treasury, *Autumn Statement 2014* (London: The Stationery Office, 2014), p. 7.
2. Steven Swinford and Ben Farmer, 'David Cameron Gives "Absolute Assurance" that Army Will Not be Cut to 60,000', *Daily Telegraph*, 21 January 2015.

one aircraft carrier, with the second held in extended readiness, the prime minister has announced that the UK will now operate two carriers, to ensure that 'we will always have one carrier available, 100% of the time'.[3] The MoD is also basing its internal plans for equipment procurement and support on the assumption that total equipment spending will grow by 1 per cent above inflation every year into the mid-2020s.[4]

The 2010 SDSR, together with the subsequent mini-review in 2011 (the 'Three Month Exercise'), had to make total savings of around £74 billion (over ten years) in order to balance the MoD's books.[5] The equivalent figure for the 2015 SDSR is not yet clear. Three key variables will determine its scale.

First, **the allocation that the MoD is given in the Spending Review**. This will be the product of two variables: the overall resources that the new government makes available for departmental spending, and the relative priority given to the MoD's 'core' budget for departmental spending (DEL) within this total. Separate allocations will be made for expenditure on operations and pensions.

Second, **the baseline from which any Spending Review reduction is calculated.** The MoD budget has benefited from a number of one-off provisions in its budget for 2015/16, which make it possible for the MoD to meet its commitment to spending 2 per cent of GDP on defence for one more year. The baseline on which any Spending Review decisions will be calculated will not include these one-off provisions.

Third, **trends in personnel and equipment costs**. Historically, the unit costs of defence inputs (both personnel and equipment) have risen more rapidly than general inflation in output prices, as is the case for the economy as a whole. This gap has been closed in recent years, largely as a result of exceptional pay restraint for military and civilian personnel. If trends in the unit costs of defence inputs rise faster than currently budgeted, however, this would exacerbate the MoD's financial challenges.

How Much Will the MoD's Budget be Cut?

Based on the coalition's Autumn Statement in December, the prospects for total departmental spending in the Spending Review – and even more so for 'unprotected' departments such as defence – are bleak. But analysis of

3. HM Government, Securing Britain in an Age of Uncertainty: The Strategic Defence and Security Review (SDSR), Cm 7948 (London: The Stationery Office, October 2010), p. 23; Peter Dominiczak, 'Britain Will Have a Second Aircraft Carrier', *Daily Telegraph*, 5 September 2014.
4. Ministry of Defence, 'The Defence Equipment Plan 2014', January 2015, p. 4.
5. Malcolm Chalmers, 'Looking into the Black Hole: Is the Defence Budget Crisis Really Over?', RUSI Briefing Paper, September 2011, p. 1.

recent commitments made by the political parties suggests a more nuanced picture, albeit one in which significant real cuts for defence remain likely.

The Autumn Statement

The spending plans outlined in December's Autumn Statement project a reduction of current spending on government services (resource DEL) over the next Spending Review period that is as rapid as it has been since 2010: from 21.4 per cent of GDP in 2009/10 to 17.4 per cent in 2014/15 and 12.6 per cent of GDP by 2019/20.[6] On these plans, the pace of spending cuts would accelerate, compared to the experience of the last four years. The independent Office for Budget Responsibility (OBR) has projected that this would require a further real-terms reduction of 16 per cent in total current spending between 2014/15 and 2019/20.[7]

The main political parties have made clear that not all departments will share similar levels of reduction. All three remain committed to protect the NHS from further real-terms cuts and to maintain the development assistance budget at 0.7 per cent of Gross National Income (GNI). The protection in real terms that the 2010 Spending Review provided for per-pupil school funding would end if the Conservatives return to power.[8] Given anticipated increases in pupil numbers, however, the total schools budget is likely to remain protected in real terms. If these three protections were to be maintained, the OBR estimates that current spending on 'unprotected' departments (RDEL) would have to fall by 42 per cent in real terms between 2014/15 and 2019/20.[9]

Table 1 shows the main elements of current departmental spending that remain 'unprotected'. Grants to the devolved administrations amount to some £49 billion in 2015/16, tied by the Barnett formula to equivalent levels of spending in England. Of the remaining amount currently spent with unprotected departments, about half is devoted to 'security' spending, broadly defined. As well as the MoD, the largest 'unprotected' department, this category includes the Home Office (including police and border forces), Department of Justice (including courts and prisons), the intelligence agencies and the non-ODA elements of the Foreign Office.

In practice, it is politically inconceivable to suggest that police, social care, prisons, border control, the Foreign Office, the intelligence services and

6. OBR, 'Economic and Fiscal Outlook', December 2014, p. 149. This excludes spending on transfer payments (welfare and pensions) and on capital investment.
7. Ibid., p. 148.
8. Helen Warrell, 'Tory Pledge to Maintain Schools Funding Amounts to Real-Terms Cut', *Financial Times*, 2 February 2015.
9. OBR, 'Economic and Fiscal Outlook', December 2014, p. 149.

university research spending could all be cut by 40 per cent in real terms over the next four years.

Table 1: The Unprotected Departments (2015/16 RDEL budget).

Item	£ millions
Protected budgets (health, schools and development)	172,261
Devolved authorities (Scotland, Wales and Northern Ireland)	49,161
Non-security, unprotected	43,237
Security related, unprotected	**47,115**
Defence (including special reserve)	26,916
Home Office	10,288
Justice	6,288
Cabinet Office	2,022
FCO	1,088
Law Officers Departments	513
Reserve (includes spending commitments not yet in budget)	2,400
Total resource DEL (excluding depreciation)	**314,200**

Political parties realise that cuts of this magnitude would inflict deep damage on key public services, including defence. A new government is therefore likely (depending on its composition) to reduce the extent of required departmental cuts by some combination of tax increases, postponed or diluted deficit-reduction targets and/or further cuts in working-age welfare benefits.

In its Green Budget the Institute for Fiscal Studies (IFS) provides illustrative scenarios for each of the main political parties for the budgets of unprotected departments. In the case of defence, it provides additional relief as a result of the relatively high proportion of its budget, 22 per cent in 2015/16, allocated to capital expenditure. Total departmental capital spending (CDEL) is due, under Autumn Statement plans, to increase by 7 per cent in real terms over the four years to 2019/20. If it is assumed that MoD capital spending shares in this increase, therefore, it dilutes the result of a reduction in RDEL and means that the MoD suffers a smaller overall reduction in its total budget, compared with most other unprotected departments.

Table 2: Real-Terms Changes in Departments' DEL, 2015/16–19/20, under Illustrative Scenarios for Each Party.

	Autumn Statement December 2014	**Conservative**	**Labour**	**Liberal Democrat**
Total DEL	-14.1%	-6.7%	-1.4%	-2.1%
Health	0.0%	+3.2%	+3.2%	+3.2%
Education	-9.0%	-17.6%	-6.7%	0.0%
Defence	**-36.2%**	**-13.8%**	**-4.6%**	**-10.2%**

Source: *'IFS Green Budget 2014', February 2015, p. 173.*

The results of the IFS's illustrative scenarios for defence are shown in Table 2. At the time of writing, only the Liberal Democrats have promised to protect education spending in real terms. This is the main reason why they are shown as making much deeper cuts in defence than Labour. Since the IFS publication, however, Labour has made clear that it would match the Conservative commitment to protect the schools budget in real terms, and provide similar protection to other elements of the education budget (pre-school and further education). Labour's projected cut in the defence budget (using the IFS methodology and assumptions) would therefore also be around 10 per cent in real terms.

A cut of around 10 per cent in real terms over four years would put the MoD once more behind the NHS, schools and international development in the pecking order of priorities, but ahead (at least under a Conservative-led government) of the police, prisons, social care, universities and local government services. If government predictions of revenues prove over-optimistic, it is possible that even deeper cuts might be made. In current circumstances, however, a 10 per cent real reduction is perhaps the most pessimistic, but still plausible, scenario.

Alternatively, a new government could be persuaded that, despite the wider need for austerity, this is not the time to further cut the nation's defences. In this optimistic scenario, current MoD planning assumptions – 1 per cent real annual growth in equipment spending, zero real growth for the rest – would be fully funded. For the first time since the early 1980s, defence would be given a spending priority comparable to that of health and education. By maintaining spending in real terms despite austerity, the government could make a strong case to its allies that the UK is determined to remain NATO's most capable European military power. It would still mean, however, that the UK would fall below the NATO target, with spending falling to around 1.8 per cent of GDP by 2019.

Box 1: The NATO Target

At the Wales NATO summit of September 2014, member states signed up to a statement that committed those who currently spend less than 2 per cent of their GDP on defence to 'halt any decline in defence expenditure', as well as 'aim to increase defence expenditure in real terms as GDP grows', and 'aim to move towards the 2% guideline within a decade with a view to meeting their NATO capability targets'. Those currently meeting the 2 per cent guideline, it was also agreed, 'will aim to continue to do so.' Only four states fell within the latter category in 2013, the latest year for which figures were available at the time of the summit: the US (4.4 per cent), the UK (2.4 per cent), Greece (2.3 per cent) and Estonia (2.0 per cent). Since the summit, UK ministers have made clear that the UK is committed to meet the target for 2015/16. They have not been prepared to commit to spending 2 per cent of GDP on defence beyond 2015/16.

A previous RUSI briefing estimated that UK defence spending in 2015/16 would be equivalent to only 1.88 per cent of GDP, short of the 2 per cent target. Since that estimate was made, the author has been informed that the MoD plans, for the first time, to include War Pensions (due to total £820 million in 2015/16) in NATO-declared defence spending. War Pensions are paid for disablement as a result of service prior to 2005, together with payment to war widow(er)s. Most of these payments relate to service in the Second World War. This is a legitimate item to include under NATO counting rules. It is unclear why this item has not been included in the past, but it may be because such payments are not related to the generation of current defence capability. As a result of this change in counting rules, the UK is now on course to spend 1.95 per cent of its GDP on defence in 2015/16, even if there is no net additional spending on military operations. If spending on operations totals £500 million (the amount provisionally earmarked for this purpose in the 2014 Autumn Statement), UK defence spending on NATO's definition would be equivalent to 1.98 per cent of GDP. Since NATO only reports national defence spending as a proportion of GDP to a single decimal point, it would therefore continue to show the UK as meeting the target.

NATO is not due to publish its initial estimates for UK defence spending in 2016/17 until early 2017. The UK is unlikely to meet the 2 per cent target in that year, at least without a large and expensive new military operation. In order to maintain core spending at 1.95 per cent of GDP in 2016/17, the MoD would have to replace £1.5 billion of one-off allocations for 2015/16 and, in addition, find a further £700 million to allow for projected real GDP growth. In total, this would be equivalent to a real increase in defence spending of around 7 per cent in the first year of the new Spending Review. This does not seem likely.

It remains possible that the new government could extend its commitment to the 2 per cent target, pledging to increase the defence budget every year by as much as necessary to keep pace with GDP growth. This could still be triggered by a further deterioration of NATO's relations with Russia.

A NATO-wide increase in defence budgets in these circumstances would also significantly increase the reputational damage to the UK if it were to cut its own budget below the NATO threshold. Absent such a wider NATO mobilisation, the most likely scenario is that the MoD will take a significant real-terms cut in its core budget.

The Baseline Budget

In addition to the overall percentage change in its budget, the MoD will have to pay close attention to the baseline used for calculating this change. As Table 3 shows, the MoD is planning on the basis of a 2015/16 budget allocation of £33,820 million. This 'Total DEL' includes all 'core' recurrent and capital spending, but not the net costs of pensions. Nor does it include the net additional costs of military operations, which are funded from the Special Reserve.

This allocation is unlikely to be the baseline for the Spending Review. As Table 3 shows, the 2015/16 budget includes £1 billion in transfers of underspends in previous financial years as a result of the Treasury's 'Budget Exchange' scheme.[10] The 2015/16 budget will also benefit from an allocation of £500 million from the Defence Recuperation Fund (DRF), which is the second and final instalment from a £1 billion fund agreed in 2011 to help the MoD cope with post-Afghanistan operational recuperation costs and to ensure taxpayer value for money on previous spending on such things as equipment Urgent Operational Requirements (UORs). It was never intended to be permanent, and is unlikely to be included in the baseline for the 2015 Spending Review.

The result is that the MoD would need an additional £1.5 billion annually from 2016/17, above the likely baseline, in order to retain the 2015/16 level of funding. If this additional funding is not provided, it will require a cut of around 5 per cent of the total budget, on top of whatever economies are imposed as a result of the Spending Review.

The baseline could be further reduced to take account of the £272 million reduction made in defence RDEL in the 2013 Autumn Statement (as part of a wider 1 per cent reduction in resource DEL across all government departments). For the purposes of the scenarios in this paper, however, it is assumed that this reduction will not be included in the Spending Review baseline.

10. HM Treasury, 'Consolidated Budget Guidance 2014 to 2015', July 2014. The Treasury appears to have allowed the MoD special latitude to go outside this guidance, both in the size and time period of the exchanges.

Table 3: Projected UK Defence Spending 2015/16.

	£ millions
Spending Review 2013 allocation[a]	32,592
Further reduction in Autumn Statement 2013[b]	-272
+ Defence Recuperation Fund	500
+ Budget exchange from 2012/13	(RDEL) 300
+ Budget exchange from 2013/14	(CDEL) 700
Total DEL Allocation	**33,820**
+ Armed Forces Pension Scheme (net cost)[c]	2,200
+ War Pensions[d]	820
+ Net additional costs of military operations[e]	500
Total planned spending, NATO definition, including NACMO[f]	**37,340**
Total spending as % GDP, NATO definition, including NACMO	1.978%
Total spending as % of GDP, NATO definition, excluding NACMO[g]	1.951%

Notes

a HM Treasury, *Spending Round 2013*, Cm 8639, June 2013, p. 43, Table 2.10.

b HM Treasury, *Autumn Statement 2013*, Cm 8747, December 2013, p 82, Table 2.4.

c Counted against Annually Managed Expenditure (AME).

d Currently counted against AME, but due to be transferred to DEL in 2015/16.

e In the Autumn Statement 2014, the Treasury set aside £1,000 million for the Special Reserve. £500 million of this will be used for the Defence Recuperation Fund, and it is assumed here that the remaining £500 million could all be available, and used, for operations spending.

f Net Additional Costs of Military Operations.

g This assumes that GDP for 2015/16 is £1,888 billion, as currently projected by the Office for Budget Responsibility. See *Autumn Statement 2014*, Table B.2.

Personnel Costs

Reductions in spending on defence personnel have made a disproportionate contribution to total savings in the defence budget in recent years. Between 2010/11 and 2014/15, inflation-adjusted spending on service and civilian personnel fell by 17 per cent and 26 per cent respectively.[11] This reduction has been made possible by similarly sharp reductions in numbers of service and civilian personnel, which fell by 17 per cent and 28 per cent respectively between April 2010 and October 2014.[12]

11. MoD, 'UK Defence Statistics 2012', February 2013, Table 1.3a; MoD, Annual Statistical Series 1 Finance Bulletin 1.03 Departmental Resources 2014 Edition, December 2014, Table 1.03.03; Written Evidence from the Ministry of Defence, Memorandum 1, 2014/15, House of Commons Defence Committee, *The Ministry of Defence Main Estimates 2014/15*, First Report 2014/15 (London: The Stationery Office, 2014).
12. MoD, '*UK Defence Statistics Compendium 2014*', 27 November 2014, p. 1. Data are for full-time trained service personnel and total civilian personnel (Level 0, full-time equivalent).

The deep reduction in personnel spending during this period was also made possible as a result of successive recent public-sector pay settlements below the rate of general inflation. Historically, average military earnings before the financial crisis had tended to rise at between 1.5 per cent and 2 per cent per annum in real terms, broadly reflecting trends in national average earnings. Similarly, public-sector pay restraint since 2010 has been made possible because of reduced average real earnings in the private sector.

With unemployment falling sharply, however, there are growing indications that average earnings will recover in the years ahead. The OBR estimates that real average earnings will grow by around 2 per cent annually from 2016/17 onwards.[13] If the MoD is to remain a competitive employer, it will be under pressure to broadly match this growth. If it fails to do so, it will find it hard to recruit and retain the skilled and experienced personnel on whom its operational effectiveness depends.

For the purposes of forward planning, as well as its continuing ability to attract and retain able and qualified personnel, planning for the 2015 Spending Review may therefore have to make allowance for a significant real increase in the average cost of MoD personnel.

Table 4: Personnel and Non-Personnel Spending 2010/11 to 2014/15 (2013/14 Prices, Excluding Operations).

	2010/11 £ millions	**2014/15 £ millions**	**Change in real terms**
Personnel	13,225	10,825	-18.0%
Non-Personnel	21,527	22,440	+4.0%
Total Spending	**34,752**	**33,264**	**-4.3%**

Notes: *MoD, 'UK Defence Statistics 2012', February 2013, Table 1.3a; MoD, 'Annual Statistical Series 1 Finance Bulletin 1.03 Departmental Resources 2014 Edition', December 2014, Table 1.03.03; Written Evidence from the Ministry of Defence, Memorandum 1b, 2014/15, House of Commons Defence Committee,* The Ministry of Defence Main Estimates 2014/15*, First Report 2014/15, Table 3.*

The non-salary costs of defence personnel are also due to increase over the next two years. First, the decision to end public-sector contracting out is due to increase employer National Insurance (NI) contributions from 2016/17 onwards, and the MoD is due to bear around £200 million of this from its annual personnel budget.[14]

Second, as a result of decisions announced in the 2014 Autumn Statement, the MoD will have to fund increased rates of employer's contributions to

13. *Autumn Statement*, December 2014, p. 98.
14. HM Treasury, *Budget 2013*, HC 1033 (London: The Stationery Office, 2013), Table 2.1, p. 64.

public-sector pension schemes. The MoD was due to spend £2.3 billion in 2015/16 on the net costs of the Armed Forces Pension Scheme, which is the amount spent on pensions for retired military personnel, less the allocation for MoD employer's contributions for existing personnel. As an interim measure, the Treasury has agreed that the MoD will find an additional £100 million from its 2015/16 budget. An additional £300 million per annum will have to be found from the MoD budget in subsequent years. Together with increased NI contributions, these extra on-costs are due to add around £500 million to MoD annual spending, equivalent to almost 5 per cent of the total MoD personnel budget.

Because of likely rises in both real wages and associated on-costs, therefore, the total personnel budget may have to increase by around 10 per cent in real terms over the next four years in order to maintain 2015/16 regular numbers. Increases in per-capita labour costs will make it harder for the personnel budget to take a disproportionate share of SDSR 2015 savings. Even on the 'plausible optimistic' scenario that the non-equipment budget is protected in real terms, and that personnel spending is also protected, a 10 per cent real increase in unit costs would require a commensurate cut in total personnel numbers: from around 145,000 service personnel and 60,000 MoD civilians in late 2015 to around 130,000 service personnel and 54,000 civilian personnel by late 2019.[15] In the pessimistic scenario of a 10 per cent budget cut, with personnel taking its share, a 10 per cent real-terms increase in unit labour costs would mean a reduction in personnel levels of around 21 per cent: to around 115,000 service personnel and 47,000 civilian personnel. Such a reduction would be similar in magnitude to 2010 SDSR personnel cuts. If that experience is a precedent, moreover, around two-thirds of this reduction (or 20,000) could fall on the army. If, in addition, Royal Navy numbers are protected as a result of the additional personnel demands of the new carrier, the army could find itself taking as much as 80 per cent of any required reduction.

Table 5: Service Personnel Scenarios with Real Growth in Unit Labour Costs.

	Regular Personnel Total
End-2015 level	145,000
Optimistic end-2019 (budget protection)	130,000
Pessimistic end-2019 (10% total cut, shared misery)	115,000
Pessimistic end 2019 (10% total cut, 1% equipment growth)	103,000

A steeper reduction could take place if additional tasks – and budgets – are contracted out to private providers and Reserves, as part of the

15. Estimates are for full-time trained service personnel and total civilian personnel (Level 0, full time equivalent).

implementation of the 'Whole Force Concept'. An increase in the proportion of experienced specialists within the defence labour force could have the same effect. On the other hand, to the extent that personnel reductions are disproportionately concentrated on higher ranks, the required reduction in numbers would be somewhat smaller.

Even the pessimistic scenario assumes that, in the event of a further 10 per cent real cut in the total budget, the personnel budget would only take a proportional share of the necessary economies. This seems the most likely outcome. Over the last five years, the personnel budget has been cut sharply in real terms, even as equipment spending has continued to grow. If full protection of 1 per cent growth in equipment spending were to continue under the pessimistic budget scenario, however, this could require a reduction in total regular personnel numbers to around 103,000 (see Table 5). This could, by way of illustration, leave the army with as few as 50,000 trained regulars, even as the other two services are asked to carry out a combined reduction in regular strength of around 15 per cent.

Equipment Costs

Planned MoD equipment spending for 2015/16 is £14.6 billion, of which £7.1 billion is on procurement and £7.5 billion is on support.[16] Total core spending on equipment may even have risen in real terms since 2010/11, despite the reduction in the overall budget. It is set to continue to rise as a result of the MoD's assumption that the equipment budget will grow by 1 per cent in real terms every year after 2015/16. By contrast, the MoD is assuming that non-equipment spending only keeps pace with general inflation.

In a more pessimistic scenario, in which the total defence budget is reduced in real terms, the government could still decide that the personnel budget should take the bulk of the savings. But increased real military salaries (for which there is no long-term budget provision) would make this significantly harder than it has been over the last five years. A policy that focused savings disproportionately on personnel would also have implications for the operational readiness of the equipment that the MoD was buying.

If there is a significant reduction in the total defence budget, therefore, the equipment budget is likely to have to share the pain. The MoD has recently been making a considerable effort to reduce the cost of the equipment support (ES) budget. In its 2014 Equipment Plan, the MoD removed £4.1 billion from its projected plan for ES spending in anticipation of future efficiency savings. However, the National Audit Office comments that 'the Department has chosen a higher risk approach to managing the affordability of the Equipment Plan by relying on future savings where a significant proportion has not yet

16. MoD, 'The Defence Equipment Plan 2014', p. 9.

been identified. This is in the context of potential continuing over-optimism in the project cost forecasts that make up the Plan.'[17]

In order to mitigate the risks involved in optimism bias, the equipment budget now includes a substantial contingency provision of £4.6 billion (over ten years) in order to provide some additional assurance against cost increases. In addition, the 2014 plan also included 'unallocated headroom' of £8 billion for new projects, together with a centrally held provision of £1.2 billion.[18] Even on current budgets, it is possible that some element of the 'headroom' budget may have to be reallocated to fund cost overruns on existing projects.

The MoD has reduced the extent to which its equipment budget is committed years in advance (see Table 6). As a result, the committed proportion of the budget declines sharply within four years. By the fourth year, likely to be the final year of the next Spending Review, only 31 per cent of projected spending is contractually committed. This should increase the MoD's ability to alter elements of the forward programme without financial penalty.

Table 6: Contractual Commitment at Close of Annual Equipment Budget Cycles.

	Percentage of budget committed	
	Equipment Plan 2013 (April 2013)	Equipment Plan 2014 (April 2014)
Year 1	71	69
Year 2	62	53
3	49	40
4	40	31
5	34	28
6	29	24
7	26	23
8	24	21
9	23	20
10	24	17
% of ten-year budget committed	**37%**	**32%**

The obstacles to cutting elements out of the forward programme are likely to be more serious. This is clearly the case for the programme to replace the current *Vanguard*-class submarines, which is set to be the single-largest procurement programme of the next decade. Spending on nuclear

17. National Audit Office, 'Major Projects Report 2014 and the Equipment Plan 2014 to 2024', HC 941-1, January 2015, p. 10.
18. MoD, 'The Equipment Plan 2014', pp. 7–8.

submarines and related deterrent capabilities is projected to need £40 billion from 2014/15 to 2023/24, equivalent to 25 per cent of the total equipment programme. By 2023/24, when production of the new submarines is due to be at peak rate, it is projected to amount to some 37 per cent of total projected procurement,[19] and is set to maintain this proportion through to the end of the 2020s.

The main production contracts for the new submarines are not due to be signed until mid-2016, after the Main Gate decision is approved by Parliament. In practice, the political momentum behind the programme is so strong that a further significant postponement does not appear likely.

The rest of the Royal Navy will also be a major beneficiary of the planned equipment budget. The Navy Command budget (which excludes successor spending) accounts for a further large part of the total ten-year budget, with spending on the planned Type-26 frigate due to increase once construction of the two *Queen Elizabeth*-class carriers is completed. Expenditure on the carrier-capable F-35B aircraft, together with related weapon systems, is also due to take a large share of Air Command's future budget.

Spending on procurement of land systems is also due to increase significantly during this period, with plans for the modernisation and replacement of older platforms coming to fruition after a long period in which UORs provided a major source of funding for new land equipment. In contrast, spending on procurement of Air Support is likely to decline as new strategic transport and refuelling aircraft come into service.

19. *Ibid*., pp. 9, 20.

Table 7: Equipment Programme by Sector, 2014/15–23/24.

Sector	Cost (£ billions)	% of total allocated
Submarines	40.0	25.5%
Ships	18.2	11.6%
Combat Air	17.9	11.4%
Information Systems and Services	16.9	10.8%
Land Equipment	15.4	9.8%
Air Support	13.8	8.8%
Weapons	12.6	8.0%
Helicopters	11.1	7.1%
ISTAR	4.9	3.1%
Naval Bases	3.1	2.0%
Joint Supply Chain and other	3.2	2.0%
Total allocated to sector	**157.1**	**100%**
Contingency	4.6	
Centrally held provision	1.2	
TOTAL	**162.9**	

Source: *MoD, Equipment Plan 2014.*

Note: *Sectoral allocations include £8 billion of 'unallocated headroom' which is notionally allocated to sector but 'will only be drawn down when programmes are at a sufficient level maturity.'*

In the optimistic scenario, current equipment plans should be broadly affordable. Further efforts will need to be made to increase the efficiency of both the equipment procurement and support programmes. The resources available for additional commitments – for example, for operating two carriers in parallel, or for an additional F-35B buy – will remain limited. At the same time, reductions in personnel levels as a result of the assumed real-terms freeze of the non-equipment budget may open up new opportunities for economies in infrastructure and support.

In the pessimistic scenario, it will be much harder to protect either the equipment or the personnel budget from significant real reductions. This will present ministers with a series of difficult decisions, with only a short period in which to make them.

The next briefing paper in this series will shed light on how the government could seek to ground this process in national strategic objectives. Some calls for a more 'strategic' approach are really only demands for new resources. In reality, however, it is precisely the severity of the resource constraints that could face the MoD this year that will make the exercise of a clear-headed strategic intellect vital to the management of defence.

Conclusion

So how do the scenarios in this paper compare with those that the MoD faced in the last SDSR in 2010? The answer depends most of all on the budget settlement that it secures in the Spending Review. But it also depends on the baseline used for calculating Spending Review allocations, as well as on trends in personnel costs. Table 8 below shows the potential funding gaps left by each of these factors.

Table 8: Calculating the Gap.

All in cash terms	2016/17 Cost (£ millions)	Ten-Year Cost (£ millions)
Total defence spending over next ten years – baseline	34,355	401,900
Plausible optimistic scenario		
Loss of 2015/16 one-off allocations	1,520	16,500
Growth in unit labour costs (salary, pensions and NI)	500	18,600
Total		35,100
% cut in programme		8.7%
Plausible pessimistic scenario		
10% real cut to 2019/20; then 1% real growth in equipment and 0% real in non-equipment thereafter		35,300
Total		70,400
% cut in programme		17.5%

This arithmetic, rough though it may be, suggests that the magnitude of the challenge facing the MoD in this SDSR – on the pessimistic scenario – could be comparable to that in the last SDSR, in which ten-year savings of around £74 billion were found. Even in the optimistic scenario (real growth annually until 2025/26), hard capability choices – amounting to a net saving of around £35 billion over ten years – might have to be made.

The final budgetary settlement will be one of the most strongly contested elements of this year's Spending Review. In contrast to the health, schools and international development budgets, none of the major parties has committed to protect the defence budget. Yet the MoD could face a substantial funding gap even on its own planning assumptions of 1 per cent real annual growth in equipment spending and the protection of non-equipment spending at baseline levels.

In either scenario, the result will be a remarkably sharp reduction in the footprint of defence in UK society over a decade. Even in the optimistic scenario, defence's share of GDP will have fallen by a third: from 2.6 per cent of GDP in 2010 to around 1.75 per cent by 2019; and the MoD workforce (service and civilian) will have fallen by around 30 per cent, from 265,740 to 184,000 by 2019.

While this trend has been accelerated by the ending of the Afghanistan commitment, its primary driver has been the sharp reduction in the share of national income spent on government services. Once the process of deficit reduction is completed, therefore, the MoD can reasonably hope that it will be able to share in the fruits of increasing public spending. Admittedly, this was also the expectation in 2010, when it had been anticipated that spending could rise again after 2015. In reality, the prospects for the defence budget remain closely tied to wider economic growth. The government is not yet convinced that strategic security risks are high enough to justify an exemption for defence from austerity.

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