

Escaping the Subsidy Trap

Why arms exports are bad for Britain

Paul Ingram and Roy Isbister

British American Security Information Council

Saferworld

Oxford Research Group

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This report, published by three leading UK security policy think-tanks, explodes the myth that arms exports are of particular value to the British economy and therefore deserving of unique support from government. It concludes that UK Government subsidies to arms exporters, worth at least £453m and possibly up to £936m a year, are based upon false economics. Far from providing jobs, UK Government support for arms exports divert investment away from more effective job-creating economic activity. It is highly unlikely that arms exports either significantly offset domestic procurement costs or make a positive contribution to Britain's overall economic well-being. At a time when public spending is under pressure the onus is on the Government to withdraw the subsidies and encourage similar withdrawals in other countries.

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Executive Summary

There are few if any economic or employment benefits from the considerable government support to arms exports. This report, published by three leading UK security policy think tanks, explodes the myth that arms exports are of particular value to the British economy and therefore deserving of unique support from government. It concludes that government subsidies to arms exporters, worth at least £453m and possibly up to £936m a year, are based upon false economics. Far from providing jobs, government support for arms exports diverts investment away from more effective job-creating economic activity. The only significant impact from reducing these exports would be felt by a handful of highly-dependent local economies that would need short-term, targeted government assistance to cope with the transition to civil production. On the other hand, excessive government spending on defence research and development (R&D) attracts too many skilled workers away from the civil sector, thereby exacerbating a shortage in the non-military economy and harming prospects for long-term economic growth.

Exports are not an automatic 'good': unless they achieve an adequate rate of return they are in fact a drain on the economy. Given the level of subsidy involved and the relatively low profit margins achieved in a competitive global market it is highly unlikely that arms exports either significantly offset domestic procurement costs or make a positive contribution to Britain's overall economic well-being. In any case, arms exports make up only 1.5 percent of the UK's overall exports, and any reduction in sales is likely to be partially offset by higher civil exports.

It has been highlighted by recent experience that the desire to promote exports can also have a deleterious influence upon domestic procurement decisions, thereby weakening value for money and potentially impairing the operational effectiveness of the UK's armed forces.

The recent export of BAE *Hawk* trainer jets to India and the related decision by the Defence Secretary, Geoff Hoon, to buy *Hawk* in the face of reported opposition from his own Permanent Secretary and other government departments, clearly demonstrates the erroneous assumptions driving current policy. Internal government estimates reported in the press indicate that export and employment considerations actually added, rather than saved, £1bn to the price tag for the *Hawk* procurement over the lifetime of the project.

UK Government support for defence exports is made up of direct subsidies, export credits, distortion of Ministry of Defence (MoD) procurement and a proportion of government spend on development costs. Explicit financial (and political) support of £31m per year is provided through such organisations as the Defence Export Services Organisation (DESO) within MoD. Export credits are provided as insurance to exporters and purchasers of UK equipment at premium rates well below the market rate, an annual subsidy that amounts to £222m. The cost of the distortion of MoD procurement to accommodate export promotion is more difficult to estimate, but if the experience of the *Hawk* deal is in any way indicative, our estimate of £200m is extremely conservative.

In addition, the report seeks to identify the extent of subsidy to arms exports that accrues through government contributions to defence R&D. The government spends £1.5bn on R&D of weapon systems each year. Approximately 40 percent of defence equipment produced in the UK is exported. Yet last year MoD succeeded in clawing back only £12m of these contributions from the exporting companies. This represents a form of subsidy, though there is major disagreement as to how this should be calculated, as R&D costs may be partially offset by exports and - some commentators argue - this money would be spent regardless of export sales or prospects. If, however, one does assume that 40 percent of R&D spending relates directly to exports (the same percentage of total UK defence production that is exported), this would give an upper estimate of the R&D subsidy of £483 million.

We estimate that the subsidies provided to UK companies involved in defence exports are therefore worth at least £453m and possibly up to £936m; in other words, between £7,000 and £14,400 for each job supported by exports. At a time when public spending is under pressure the onus is on the Government to withdraw the subsidies and encourage similar withdrawals in other countries.

1. Introduction

Tony Blair's Government has a foreign policy that involves the tightening of controls on arms exports, yet at the same time it promotes UK arms exports around the world, extolling the economic benefits they bring to the UK. These benefits purportedly include: retention of skilled employment; enhanced balance of trade and other spin-offs to the wider British economy; and reduced costs for domestic defence procurement (as follow-on exports result in lower average unit costs of production). Successive governments have deployed these arguments about perceived economic benefits when justifying their export promotion. Some of these exports might otherwise have been refused for their potentially negative impact on human rights, peace and stability and sustainable development - as set out in the Government's export criteria and its stated international commitments.¹ This economic justification is further influenced by 'constituency politics' and the fear that job losses in the defence sector are likely to have negative electoral consequences.

Successive UK governments, therefore, have provided financial and political support for arms exports. In July 2001 the Oxford Research Group and Saferworld published a report entitled *The Subsidy Trap*,² which estimated annual government subsidies to arms exports of at least £420m, or £4,600 for every job involved. A report published later in the same year by independent academics and MoD's own senior economists entitled *Economic costs and benefits of UK defence exports* (the 'York Report'), concluded that as the economic benefits are at best insignificant, the "balance of argument about defence exports should depend mainly on non-economic considerations".³ Furthermore, as the recent decision to purchase the domestically-produced *Hawk* trainer aircraft for the RAF demonstrates, far from equipping UK forces with the best equipment at the

lowest cost, this policy can lead to poor procurement decisions and higher costs to the taxpayer. The report also concluded that five years after a 50 percent reduction in UK arms exports "overall national income would be substantially the same as it would otherwise have been without the loss of defence exports,"⁴ and that "the economic cost of reducing defence exports are relatively small and largely one off".⁵ Yet, UK Government ministers have wildly misinterpreted the York Report's findings, claiming erroneously that it concluded, "defence exports represented a significant net benefit to the UK economy".⁶

It should be noted that the Government does provide non-economic justifications for supporting arms exports. For example, there is the argument that a strong indigenous defence industrial base (which, so the argument goes, requires a strong export performance if it is to be sustained over time) is necessary to safeguard the UK's security of supply of defence equipment. However, in a written parliamentary answer in June 2004, Defence Minister Lord Bach appeared to restrict the application of this argument to "a very small number of capabilities which for national security reasons we place a high priority on retaining within the United Kingdom industrial base". The examples Lord Bach gave were "in the fields of nuclear technology, defence against biological, chemical and radiological warfare, and some counter-terrorist capabilities".⁷ Nevertheless, time and again when justifying the merits of arms exports, ministers continue to frame the debate in terms of economic benefits.

This report re-examines the economic arguments for the Government's support for arms exports, and calculates what that level of support is

¹ The Consolidated EU and National Arms Export Licensing Criteria (26 October 2000—HCX 199-203W).

² Ingram P and Davis I, *The Subsidy Trap: British Government Financial Support for Arms Exports and the Defence Industry*, (2001, Oxford Research Group/Saferworld, Oxford).

³ Chalmers M, Davies N, Hartley K and Wilkinson C, *The Economic Costs and Benefits of UK Defence Exports*, (the York Report), York University Centre for Defence Studies, November 2001, para 86, p 33. This was later summarised in: Chalmers M, Davies N, Hartley K and Wilkinson C, 'The economic costs and benefits of UK defence exports', *Fiscal Studies*, September 2002, vol 23, no 3, pp 305-342.

⁴ *The Economic Costs and Benefits of UK Defence Exports*, op cit, Executive Summary, para 7d, p iv.

⁵ Ibid, para 86, p 33.

⁶ Lord Bach winding up the debate on the Export Control Bill, *Official Report*, House of Lords, 8 January 2002, col 515.

⁷ Lord Astor of Hever asked Her Majesty's Government: What technologies in the defence industry are considered to be critical to national security or imperative for defence capability. Lord Bach replied: The Government's defence industrial policy, published in October 2002, is aimed at enhancing the competitiveness and sustainability of the UK defence industry, while continuing to provide the Armed Forces with high quality equipment at best value for money. There are a very small number of capabilities which for national security reasons we place a high priority on retaining within the United Kingdom industrial base. Examples exist in the fields of nuclear technology, defence against biological, chemical and radiological warfare, and some counter-terrorist capabilities. Source: *Official Report*, House of Lords, 7 Jun 2004, Column WA9.

costing the taxpayer. In doing so, we are not calling for the defence industry to be closed down, an accusation that is frequently made whenever commentators question Government support for particular arms exports.⁸ Rather, the contention is that as there is no intrinsic economic benefit in exporting defence equipment, and as the current relationship between domestic and export markets can lead to poor procurement decision-making, taxpayers' money should not be used to provide a discount to foreign buyers of UK-sourced arms on the grounds that it protects particular jobs or benefits the economy in general.

Defence companies should be expected to operate on a level playing field with other exporting firms, pursuing export orders without support from government. If defence were not excluded from European Union (EU) and World Trade Organisation (WTO) regulations for reasons of national security, much of the current support and concurrent protectionism would be illegal. Therefore, justifications for the use of public funds to support arms exports should depend solely upon national security objectives, on the understanding that these are not used to trump human rights or regional stability concerns.

⁸ On 20 June 2002, the Prime Minister Tony Blair was asked: Why do you think you should be taken seriously when you call for a negotiated settlement in Kashmir, when within recent months your government has been authorising sales of rockets, bombs, missiles to both sides in the conflict? The Prime Ministers response was: "Because the idea that we should shut down our defence industry in those circumstances I find absolutely bizarre". (From Prime Minister's Press Conference, Downing Street, 20 June 2002, <http://www.number-10.gov.uk/output/Page2999.asp>.)

2: Myths behind UK Government support for arms exports

Successive government policy statements since 1997 (including the 1998 *Strategic Defence Review*, the 2002 *Defence Industrial Policy*, and most recently the 2003 *Defence White Paper*) have reiterated the government's intention to strongly support military exports. The UK Government pursues this assistance in a number of ways, including political and diplomatic aid, collaboration with defence companies through a number of fora (such as the Defence Export and Market Access Forum)⁹ and financial subsidies (the focus of this report). This section examines the main economic arguments that the UK Government uses to justify its support for arms exports in terms of the retention of skilled employment, the balance of trade and other benefits to the wider economy, and reduced costs for domestic defence procurement, and explains why the assumptions underpinning them are flawed.

The jobs myth

'The [UK defence] industry is a key part of our economy, contributing significantly to our balance of trade and employment'.¹⁰

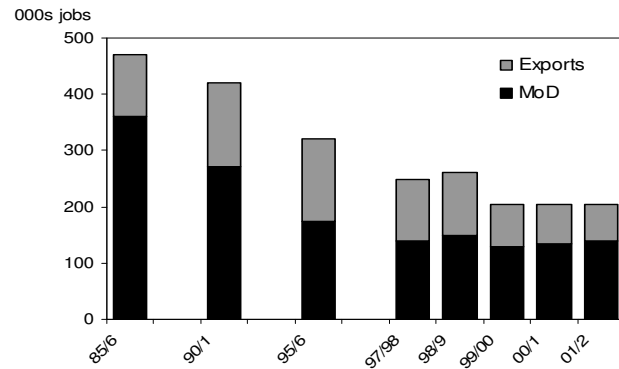
Protection of defence jobs is frequently the principal public rationale for granting questionable export licences and subsidising defence companies. However, in the context of the size of the UK economy and the flexibility of the labour market, it is far from clear that the Government should spend so much to save so few jobs. Of course, the loss of any particular jobs is significant to the people concerned, but if the concern is to maximise the number of high-quality jobs, defence export support is a highly inefficient choice.

⁹ Written Parliamentary Answer 'Defence Export and Market Access Forum' by Adam Ingram, MP, Minister of State, Ministry of Defence, to Michael Hancock, MP, *Official Report*, 30 June 2004, Col 350W.

¹⁰ Foreword by Lord Bach, Under Secretary of State, MoD, and Alan Johnson, MP, Minister of State, Department of Trade and Industry, to the *Defence Industrial Policy*, published at http://www.mod.uk/issues/industrial_policy.htm.

Defence Industry Employment Trends

Direct and indirect employment in the UK defence industry arising from MoD procurement and from exports, according to official statistics published by DASA.¹¹



Impacts on UK employment

According to official UK Defence Statistics, the total employment supported by Britain's defence equipment industry has reduced from 470,000 in 1985 to around 200,000 today.¹² This accounts for 0.7 percent of total UK employment, and less than six percent of those employed in manufacturing alone.¹³ Within the overall figure of 200,000 the Government estimates that those employed on arms exports account for 65,000 UK jobs,¹⁴ of which around half are generated directly, and half indirectly through the supply chain.¹⁵ Employment dependent on arms

¹¹ *UK Defence Statistics 2003*, op cit, table 1.13.

¹² *UK Defence Statistics 2003*, Defence Analytical Services Agency (DASA) (Civilian & Financial), table 1.9. Note that we use MoD equipment expenditure to identify the defence industry, to separate this from other employment arising from MoD spend outside of the defence industry.

¹³ See July 2003 edition of *Labour Market Trends*, Table A1, at: http://www.statistics.gov.uk/downloads/theme_labour/LMT_July03.pdf. Manufacturing employment is at: Table B.12.

¹⁴ *UK Defence Statistics 2003*, op cit, DASA (Procurement), Table 1.9. It is difficult to come to an accurate figure for the total number of jobs dependent upon arms exports because some equipment can have both military and civilian purposes ie the equipment is dual-use.

¹⁵ Here we use official terminology, which contrasts with economic terms (usually used to distinguish employment directly connected with the industry with that created by spending associated with the economic wealth generated). 'Direct employment' refers to employment

exports therefore constitutes 0.25 percent of the national labour force, and less than two percent of that in manufacturing.

The debate over government intervention in supporting employment in particular sectors has evolved considerably since the 1970s. The prevailing view held by the vast majority of economists and by recent governments is that intervention in the labour market should be minimised, thereby enabling a more flexible labour market to respond to changes in supply and demand. According to the Treasury, "flexibility in labour... is critical to ensuring that firms and individuals can adapt... and thrive in a globally competitive economy".¹⁶ More than a quarter of the workforce in the private sector now moves to a new job every year.¹⁷ Almost half a million people leave the unemployment register for a job each quarter.¹⁸

But the development of labour market policy appears to have passed the defence industry by. This is curious given the commitment of recent British governments to cut industrial subsidies and to concentrate scarce public resources where its impact is greatest. Both history and the relative figures strongly suggest that significant losses in defence jobs could easily be accommodated within the overall labour market, much as has happened in the last twenty years as a result of the contraction of the industry.

Indeed, the York Report concluded that a halving of exports would result in the loss of 49,000 jobs in the defence sector, but that this would be more than offset by the creation of 67,000 new jobs elsewhere in the economy. Although many of these replacement jobs were likely to be at a lower skill level, they would be helping to meet shortages currently within the civil economy. This conclusion is supported by a study on skills deficiency within England, from the Department for Education and Skills, which highlights the skills shortage in the craft-intensive construction and manufacturing industries, in particular.¹⁹

generated in those companies providing the product or service directly to the customer. 'Indirect employment' refers to employment in the supply chain sourced from a prime contract.

¹⁶ *Flexibility in the UK Economy*, HM Treasury, March 2004. Can be found at: http://www.hm-treasury.gov.uk/media/22EE0/flexibility_report_264.pdf#page=3.

¹⁷ See *Labour Market Trends*, November 2003, figure 9, p 549, available at: http://www.statistics.gov.uk/downloads/theme_labour/LMT_Nov03.pdf.

¹⁸ *Labour Force Survey 2003*, Office of National Statistics.

¹⁹ Terence Hogarth and Rob Wilson, *IER*, 'Skills Matter: a synthesis of research on the extent, causes and implications of skill deficiencies', Department for Education and Skills, Brief No: RBX 19-01, October 2001. Summary page 3, available at:

Since the years taken as baseline by the York Report, UK employment dependent upon defence exports has already almost halved. However, this has had a negligible impact on unemployment and the UK economy. The impact of the downturn in defence expenditure during the 1990s upon employment was of a greater order than any further possible reduction in arms exports, yet any significant impact was limited to a handful of local economies.

Regional and local impacts

It is not possible to determine the level of regional employment dependent on defence expenditure because official statistics are too unreliable,²⁰ but we do know that it remains concentrated in specific regions.²¹ The most recent comprehensive study of this issue, by Ian Goudie in 2002, demonstrated that only three regions: South East, South West and the North West would be likely to experience any immediate measurable rise in unemployment as a result of reduced arms exports and that, in any case, this would be small and short-lived.²²

Similarly, there are only a handful of local economies particularly dependent upon defence exports. Schemes provided by companies or government designed to mitigate the employment impact of defence cuts by helping people find new work, providing business start-up advice and early retirement packages and re-training schemes, can prove extremely effective.²³ Such initiatives include the Defence Diversification Agency (DDA), the Partnership at Work Fund, and the Rapid Response Service. Regional Development Agencies are also mandated to advise on strategies of support for those leaving declining industries.

<http://www.dfes.gov.uk/research/data/uploadfiles/ACF1874.doc>. A shortage of skilled labour for the defence industry reflects a general shortage of key skills in the economy as a whole. See 2003 *Defence White Paper*, Supporting essay 7, 'Making Defence Industrial Policy Work for the Armed Forces and UK Industry', para 7.7.

²⁰ See Turner, Chalmers and Hartley, 'Defence Statistics Bulletin No. 5', Defence Analytic Services Agency, March 2003, p v.

²¹ See Morgan B, *Defence Employment: 1996-97*, House of Commons Library, March 1999.

²² Goudie I, *The Employment Consequences of a Ban on Arms Exports*, Campaign Against the Arms Trade, September 2002, p 16.

²³ *Ibid*, p19. Following the closure of Vicker's Challenge II tank factory in Leeds in 1998, 80 percent of the workers achieved a 'positive outcome' within the twelve-month multi-agency redeployment programme.

In 1997 the Government established the Prestwick Taskforce to "assist in the economic development of Prestwick in the light of recent job losses" (650, to be precise).²⁴ The taskforce operated until December 1998, by which time the Government announced that 90 percent of the people laid off by British Aerospace had secured alternative employment locally, and 600 additional jobs in the area had been created.²⁵

Employment in innovation

*'The UK's innovative science base supports the defence industry's high levels of technology development, and this brings benefits to other industry sectors through the application of military technology to civil products...'*²⁶

As part of its longstanding policy of supporting the British defence industrial base, the UK Government spends £2,057m on military research and development (R&D), which equates to 32 percent of its military procurement spend within the UK.²⁷ Traditionally, it has been argued that defence R&D spending produces significant beneficial spin-offs to the civil sector, and, therefore, that the military is one of the most cost-effective recipients of public R&D funding. However, while technology development in the defence sector does still have occasional application elsewhere, this argument has now largely been reversed. For at least the last two decades, the civil sector has been the driving force in terms of technological advances, for example, in communications technology. Civil

²⁴ <http://www.publications.parliament.uk/pa/ld199798/ldhansrd/vo980212/text/80212w03.htm>

²⁵ <http://observer.guardian.co.uk/business/story/0,6903,564445,00.html>. In 1999 Sandra Osborne, MP for Ayrshire, stated in Parliament: "The task force set itself eight targets. They have all been fully achieved or are well on the way to being achieved and have been picked up by other bodies. Alternative employment has been found for the majority of Jetstream workers affected by the closure, and all 270 aerostructure jobs at British Aerospace, which were at risk, have now been secured. In addition, more than 600 jobs have been created or are planned for the Prestwick area." *Official Report*, House of Commons, 21 January 1999, col 1099. Can be found at: <http://www.parliament.the-stationery-office.co.uk/pa/cm199899/cmhansrd/vo990121/debtext/90121-26.htm>

²⁶ *The UK Defence Industrial Policy 2002*, Foreward, authored by Lord Bach, Minister of State for Defence Procurement & Alan Johnson, Minister of State for Employment Relations, Industry & the Regions. Available at http://www.mod.uk/issues/industrial_policy.htm

²⁷ *Defence Statistics 2003*, op cit, R&D budget, Table 1.7. Procurement budget extracted from Table 1.8 amounts to £6.4m (separated from services, fuel, administration and other equipment running costs).

technology development is more rapid and responsive to market pressures. With long lead-times and the often-consequent use of redundant technologies, along with a greater emphasis upon reliability, the defence sector has become a great deal less relevant to innovation.

Government support for innovation should target growth sectors, such as renewable energy and biotechnology.²⁸ Support for defence R&D pulls away highly-skilled personnel from more productive sectors, limiting the contribution towards economic growth.

The balance of trade myth

The Government has also sought to justify support for arms exports on the grounds that they are significant for the wider economy, in terms both of their scale and their contribution to the balance of payments and national income. In 2002, the gross UK arms exports revenue of £4,120m amounted to only 1.5 percent of total UK exports.²⁹

This gross figure may overestimate the benefit to the national balance of payments, given that a high percentage of the components incorporated within exported systems originated as imports (a percentage that has increased significantly in recent years with the globalisation of the industry's suppliers). Despite the unusual level of government support received by defence exporters, their share of total UK exports has consistently reduced.

The Government's assertion that the export of arms is automatically good for the economy is also open to question. The mercantilist pursuit of exports as an end in themselves has long been discredited. As the respected financial journalist, Sir Samuel Brittan, has observed: "Export drives really amount to the diversion of public resources towards special interest groups under the guise of patriotic slogans."³⁰ Exports are a drain

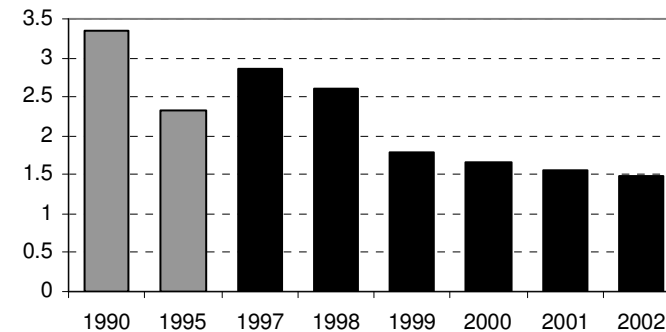
²⁸ The latest Congressional Research Report appears to suggest that a long-term decline in global transfers of weapons continues. See analysis on BASIC's website: <http://www.basicint.org/WT/wtindex.htm>.

²⁹ See *Defence Statistics 2003*, op cit, table 1.13. These figures are based upon Society of British Aerospace Companies and could be on the high side.

³⁰ Samuel Brittan, 'Weapons Exports: The bogus moral dilemma', *World Economics*, vol 4, no 2, April-June 2003.

on the economy unless the exporter receives an adequate rate of return; a highly debateable proposition in the defence sector, which is a buyers' market and when so many subsidies are involved. Yet Government thinking on this matter appears to be rooted firmly in the past, assuming that if arms exports contract, then the inputs that would have gone into that production will simply be lost to the economy.

Defence Exports as a Percentage of Overall UK Exports³¹



This type of approach would also appear to be behind a recent report commissioned by BAE Systems, which referred to the contribution the company made in terms of numbers of people employed, the amount of private investment, the total level of exports, the corporation and income tax contributions to the Exchequer and the level of R&D spent. However, this failed to take into account the net costs and benefits if that capital were deployed elsewhere.³²

In a modern mixed economy, as one industry contracts the capital

³¹ Ibid, and *National Statistics*, Balance of payments - Trade in services 1955 – 2003 and Trade in goods 1955 – 2003 (constant prices), can be found at National Statistics website: <http://www.statistics.gov.uk/CCI/nscl.asp?ID=5819>.

³² *The Economic Contribution of BAE Systems to the UK and Implications for Defence Procurement Strategy*, (Oxford Economic Forecasting, January 2004). This report lists the contributions of BAE to the UK economy. There is no dispute that the jobs created by defence equipment purchases are highly capital intensive, so that productivity per employee and R&D spend are likely to be impressive on the surface. However, without any indication of alternative applications for the investment and skilled labour tied up in BAE Systems, there is no way of putting the figures in any context sufficient to give an indication of the benefits of BAE operations within the UK.

released is re-deployed elsewhere in the economy, while long-term imbalances in the UK current account are addressed automatically by changes in the exchange rate. As a consequence, the long-term impact on the economy overall of a drop in defence exports would be negligible. The York Report estimated that were exports to fall by 50 percent, “at the end of the five year period, overall national income would be substantially the same as it would otherwise have been without the loss of defence exports”.³³ Adair Turner, former Director General of the CBI, is similarly unimpressed by the difference arms exports make to the economy, calculating that if they were to fall by 35 to 40 percent, this would have the effect of merely stalling GDP growth for six weeks.³⁴

The cheaper defence procurement myth

*A thriving, innovative and competitive defence industry is essential for the defence of the UK. It is the primary source of world-class equipment for our Armed Forces... the Government's new defence industrial policy [is] aimed at enhancing the competitiveness and sustainability of the UK defence industry, while continuing to provide high quality equipment at best value for money.*³⁵

The Government sometimes defends its support for arms exports on the basis that foreign sales drive down unit costs of production and MoD's equipment bill. This 'economies of scale' assumption appears to be based in part on the premise that domestic sales will precede exports and that all customers will be satisfied with the same finished product. The reality is frequently more complicated, both in terms of the timing of sales and the specifications of the different buyers. In addition, there are a number of other reasons to question the extent of any cost savings.

- As the world market in arms is so competitive, exports are frequently sold near the marginal cost of production, with suppliers competing against each other after their fixed costs are covered

³³ *The Economic Costs and Benefits of UK Defence Exports*, op cit, Executive Summary, para 7d, p iv.

³⁴ Adair Turner, *Just Capital: The Liberal Economy*, (London, Pan Books, 2001), p 362.

³⁵ *The UK Defence Industrial Policy 2002*, Foreward, authored by Lord Bach, Minister of State for Defence Procurement & Alan Johnson, Minister of State for Employment Relations, Industry & the Regions. Available at http://www.mod.uk/issues/industrial_policy.htm.

by protected domestic defence markets.

- Defence exports are highly unpredictable in advance of investment in, and development of, the system, and tend to lengthen the life of production lines rather than the scale (so that some economies are lost).
- Many 'fixed costs' are not fixed, and actually vary with the scale of production. This makes sense in managerial terms in that the scale determines the revenue (or expected revenue), which in turn determines the level of investment in so-called fixed costs.
- MoD procurement rules inadvertently allow some level of cross-subsidy for marketing, servicing and risk abroad (in that costs are shared as a proportion of production even when the costs of selling abroad are greater).

Systems developed for domestic use are frequently inappropriate for world markets, and require significant re-design and re-tooling (thus losing some of the scale benefits). Furthermore, the knowledge that different buyers have different requirements can skew R&D and even UK procurement itself. Occasionally, the pressure to sell overseas and the greater competition in export markets can result in the export 'tail' waving the procurement 'dog', with the designs of systems for domestic use being geared more towards export needs, or domestic orders being placed on the grounds that they will help secure exports. This, of course, is exactly the opposite intention of providing subsidies. It is graphically illustrated by the recent case involving the purchase of the *Hawk* trainer aircraft for the Royal Air Force (RAF). MoD may have paid £1bn too much, and possibly purchased the wrong aircraft in order to secure a sale of similar aircraft to India (discussed further in section 2). In this case, any benefit possibly acquired from reduced MoD overheads is offset more than several times over by the costs of the distorted decision designed to boost export prospects.

If the argument that export sales lower the costs of domestic procurement comes under question, then so too does the notion that this is a rational basis for subsidising arms exports. When one takes into account the impact that the drive to export can have on the quality or relevance of MoD purchases and on the overall cost to the taxpayer, it would seem that such a policy can be positively harmful, in both economic and operational terms.

Some commentators justify support for subsidies for strategic-industrial

reasons, to avoid over-dependence upon a single monopoly supplier (in the United States).³⁶ While a policy of buying 'off the shelf' may present superior value for money, better equipment for the armed forces, and a higher level of inter-operability with allies, some believe it may expose future UK defence acquisition to the whims of foreign manufacturers.

Two factors weaken this argument. First, it is no longer meaningful to talk of a British defence industry *per se*, as ownership and production facilities do not now respect national boundaries, and those companies that are located in Britain source many of their components from abroad. Second, responsible for almost 50 percent of global defence spending, well over half of global military equipment spending, and an even greater proportion of military R&D, the US is *the* determining market for successful defence companies. Companies without clear access to the US market are frozen out of any realistic competition in all but a handful of the most specialised military technologies. An alternative approach could be to turn to Europe for economies of scale. However, this would involve significant collaboration costs.

In light of the requirements outlined in the *Defence White Paper* in December 2003, which are presently under review, the alternatives need further consideration and debate. MoD's stated policy of balancing value for money with ensuring future diversity of supply is sensible, but does not justify support for British companies specifically.

³⁶ There is also a fear that over-dependence would have implications for security of supply in times of crisis, or for being dependent upon sources that could be cut off for political or proliferation reasons.

3: Case study: Hawks to India... A £1bn subsidy?

Introduction

In September 2003 BAE Systems secured a contract worth £1bn with the Indian MoD to sell 66 *Hawk* jets - 24 of which are to be delivered to India fully complete while the remaining 42 will be built under licence by Hindustan Aeronautics Limited in India.³⁷ Despite stiff competition from Czech-US (jointly), Italian and Russian rivals, the contract was awarded to BAE Systems - eight years after the initial tenders were issued.

However, this deal was flawed on many grounds. The UK Government's political and financial support for the deal undermined its own criteria on arms exports and cost the taxpayer dearly both in terms of the cost of promoting the deal and the estimated £1bn subsidy cost of procuring *Hawk* aircraft for the UK military, which was linked to the India deal.

Government support for the deal

From the outset, the UK Government actively supported the BAE tender. Lobbying was undertaken in a series of visits by the Defence Secretary, Foreign Secretary, Deputy Prime Minister and most notably in reciprocal visits involving the Prime Minister himself. According to press reports, when Tony Blair met the Indian Prime Minister, Atal Bihari Vajpayee in October 2002 at the height of the Kashmir crisis, he lobbied strongly on behalf of BAE's *Hawks*.³⁸

The Quadripartite Committee³⁹ of the UK House of Commons later expressed concern that such lobbying could have a prejudicial outcome on any licensing application for the sale of the *Hawks*. It recommended that

³⁷ David Gow, '5,000 jobs safe as India buys Hawks', *The Guardian*, 26 July 2004.

³⁸ Richard Norton-Taylor and Ewen MacAskill, '£1bn arms push to India', *The Guardian*, 19 July 2004.

³⁹ The QSC comprises the Defence, Foreign Affairs, International Development and Trade & Industry select committees. Its role is to scrutinise the British Government's arms export licensing regime.

“before any minister becomes personally involved in promoting the sale of defence equipment abroad, the Government should consider the proposed export in question against the consolidated criteria with as much care as it would an export licence application”.⁴⁰

Ministers claimed that the deal did not contravene criterion 4 (regional peace, security and stability) of the consolidated criteria, as the *Hawk* is a trainer aircraft.⁴¹ This conveniently overlooks the fact that *Hawks* can be refitted as fast ground-attack aircraft, as the Indonesians are reported to have done during their repression of the East Timorese.⁴² The *Hawks* are also ideal for Kashmir’s mountainous terrain because of their size, speed and manoeuvrability. Furthermore, as the *Hawks* are likely to be used to train pilots to fly aircraft capable of carrying a nuclear payload (such as, for example, India’s UK-supplied Jaguars), their export would appear to be inconsistent with the UK’s counter-proliferation goals in South Asia.

The case highlights the inherent conflict of interest that exists as a result of the dual role of the Government as a regulator of arms exports and promoter of UK exports. If Ministers have already lobbied hard on behalf of the sale, they are hardly likely to refuse an export licence.

Distorted acquisition

In the face of criticism of its support for the *Hawk* deal, the UK Government returned to the stock defence of British governments over the years: it argued that the deal was economically beneficial to the UK. A spokesperson for the Prime Minister said, ‘we make no apology for supporting a legitimate defence industry’.⁴³

⁴⁰ *Strategic Export Controls Annual Report for 2001, Licensing Policy and Parliamentary Scrutiny*, Second Joint Report of the Quadripartite Committee, House of Commons, HC474, 20 May 2003.

⁴¹ The criterion states: ‘The Government will not use an export licence if there is a clear risk that the intended recipient would use the proposed export aggressively against another country or to assert by force a territorial claim’. Annex F: The Consolidated EU and National Arms Export Licensing Criteria, *United Kingdom Strategic Export Controls Annual Report 2003*, pp491-494.

⁴² Ryan Dilley, ‘The ‘trainer’ jet the UK loves to Hawk’, *BBC News*, 8 September 2004.

⁴³ Jean Eaglesham and Edward Luce, ‘Anger as Blair uses Kashmir talks to sell Hawk jets’, *The Financial Times*, 22 October 2002, p 6.

The UK Government demonstrated its support for the aircraft when it decided to buy the *Hawk* for the RAF. In July 2003 it signed an £800m deal with BAE Systems for the purchase of 20 *Hawk* trainers and the option on a further 24 for the RAF. The fact that this would help secure the BAE tender in India appears to have been a strong motivating factor in that decision, as it provided evidence to the Indian Government of the British Government’s faith in the aircraft and that it had a long-term future.

This contract between BAE Systems and UK MoD for the *Hawk* is said to be worth £3.5bn over 25 years.⁴⁴ On signing this agreement the Defence Secretary Geoff Hoon said:

Hawk 128 is an excellent aircraft. It is the right choice for training the pilots of our future advanced fighter jets and the right decision for our defence industrial capability. This is excellent news for BAE Systems, its employees at the Brough factory on Humberside, where Hawk 128 will be designed and built, and for the several hundred people involved in the UK supply chain for the aircraft.

In a letter to his own Permanent Secretary justifying his decision he stated:

*An order for a new advanced variant of the successful Hawk aircraft would support our high technology aeronautical capability, including skilled jobs and assist future exports of Hawk variants.*⁴⁵

Despite the Defence Secretary’s assertions of the benefit to jobs, the economy and domestic procurement, the £3.5bn deal was reported to have faced severe criticism from within the Treasury and MoD. First, as the deal was not opened to tender, it was impossible to negotiate a better deal with BAE or another supplier. Second, the *Hawk* is an aircraft built using 30-year-old technology and according to an internal UK MoD assessment would be unable to ‘maintain its present tasks beyond 2006’.⁴⁶ Alternative aircraft were not only cheaper, but also in some respects more technologically advanced.⁴⁷ For example, the Italian *Aermacchi 346* is

⁴⁴ ‘Hawk 128 the right choice for new jet trainer – Geoff Hoon’, *MoD, Defence Procurement Agency*, 9 July 2004.

⁴⁵ David Hencke, ‘MoD chief refused to sign £800m Hawk order’, *The Guardian*, 5 July 2004.

⁴⁶ Clayton Hirst, ‘MoD’s £6bn sweetener for BAE’, *The Independent*, 20 July 2004.

⁴⁷ These included the *L-159B* a Czech-American jet made by Aero Vodochy, the Italian produced *Aermacchi 346* and the Russian built *MiG-AT*. The *MiG-AT* was at least \$5m

cheaper *and* technologically superior to the *Hawk*, in that it possesses ‘fly-by-wire’ computerised technology, a desirable feature for pilots training to fly the *Eurofighter* and *Joint Strike Fighter*.

According to press reports in July 2003, the purchase of the *Hawk* aircraft is likely to cost MoD at least £1bn more for trainer aircraft over the lifetime of the deal than would have been the case if it had bought the *Aermacchi 346*.⁴⁸ This at the time when, according to recent press reports, MoD “is so short of cash that it is axing investment in playground equipment for the children of service personnel [and] scrapping orders for power showers in barracks”.⁴⁹ The jobs of 2,200 employees at the BAE plant at Brough in East Yorkshire are said to have been directly secured by the deal, although the total number of jobs at stake is likely to be in the region of 4,000 to 5,000.⁵⁰ The overspend of £1bn, therefore, works out at a subsidy of £200,000 to £250,000 per job. Indeed, Sir Kevin Tebbit, Permanent Secretary at MoD (the department’s most senior civil servant), refused to sign off the deal because of value for money concerns. Such a decision is rare, and is only taken when a Permanent Secretary is convinced that a ministerial decision may infringe upon the ‘propriety’ or the ‘economy, efficiency and effectiveness’ of the department in which they work.⁵¹ Geoff Hoon was forced to overrule his Permanent Secretary - a decision that has since been referred to the National Audit Office (NAO) and the Commons Public Accounts Committee.⁵²

Evaluating the precise extra cost and the impact on performance caused by MoD’s favouring one supplier over another in such a large and technically challenging procurement is inevitably difficult. However, given the reported concerns of the Treasury and the unusual actions of the Permanent Secretary, irrespective of the exact cost, it is clear that the Government is willing to provide multi-million pound subsidies in order to secure jobs and exports in the face of evidence that such a decision may be deeply flawed.

cheaper per jet than the *Hawk*.

⁴⁸ Mary Fagan, ‘How the Hawk fought off an Italian predator’, *Daily Telegraph*, 19 July 2004.

⁴⁹ David Hencke and Richard Norton-Taylor, ‘Service families suffer as arms bills soar’, *The Guardian*, 6 September 2004.

⁵⁰ David Gow, ‘5,000 jobs safe as India buys Hawks’, *The Guardian*, 26 July 2004

⁵¹ David Hencke, ‘MoD chief refused to sign £800m Hawk order’, *The Guardian*, 5 July 2004.

⁵² *Ibid.*

4: The Subsidies

We have identified three broad categories under which we have allocated the types of financial support the UK Government provides for military exports:

- Direct assistance to defence manufacturers in exporting abroad;
- Export credits;
- MoD’s procurement policy.

In addition, we have allocated a proportion of the funds provided by the Government in support of military R&D as comprising a subsidy for exports. This figure has been treated separately as there is considerable disagreement among experts as to whether this subsidy can be applied to defence exports *per se*. On the one hand, exports do take a proportion of the government military R&D spend; but on the other hand, revenue from exports may cover some of the R&D costs, thus reducing the price to MoD of their own procurement, and it is sometimes argued that these funds would in any event be made available for military R&D, regardless of export orders.

One of the biggest challenges in calculating the support for arms exports is separating it from spending on other military and broader foreign policy activities (as stated at the outset). For example, military assistance and training provided to other countries can be motivated by strengthening military capability of allies, security sector reform, strengthening strategic and diplomatic ties, or simply encouraging the sale of British equipment. More often than not it is a complex combination of these objectives. We attempt here to focus exclusively on government support explicitly for export promotion.

Wherever possible, we have used information in the public domain. However, inevitably there are areas where we have been forced to form a reasonable estimate of support based on incomplete data.

We calculate that total subsidies to arms exports are at least £453m, and possibly up to £936m, broken down as follows:

Summary table of UK arms export subsidies

	£million
DESO	14
Defence attaches	6
Use of armed forces for promotion	6
DAF	5
Direct assistance	31
Export credits	222
MoD procurement distortion	200
Total	453
Support for development of systems	up to 483
Grand total	up to 936

Direct assistance: £31m subsidy

Defence Export Services Organisation (DESO): £14m

*As a central unit in the UK Ministry of Defence, our mission is to maximise legitimate UK defence exports in coordination with Industry.*⁵³

DESO was established by the Labour Government in 1966 in response to a sharp decline in the UK's share of world aircraft markets, to "assist the defence industry in securing overseas orders".⁵⁴ It provides a range of services, including:

- bringing overseas customers and UK suppliers together;
- undertaking procurement as agents on behalf of overseas governments;
- assisting industry and foreign governments in acquiring UK export licenses;
- providing professional military support on doctrine,

⁵³ DESO's mission statement is on their website at: <http://www.deso.mod.uk/>

⁵⁴ <http://www.deso.mod.uk/origin.htm>

procurement and logistics;

- providing assistance on offset and financing schemes;
- organising military equipment demonstrations and training; &
- organising visits to the UK by senior government and military personnel from overseas.

The net operating budget for DESO for 2004-5 is £14.4m.⁵⁵ This includes income received for the sale of surplus MoD equipment, and a small amount as fees charged to exporters. The government has rejected calls for DESO to be privatised, believing its value stems from its integration with MoD. However, this creates a situation where the same department responsible for getting best procurement value-for-money and for assessing export licence applications, is also charged with assisting arms exports. On occasion this will provide for significant conflict of interest. DESO effectively operates as a defence industry lobby within the department.

Defence exporters derive additional benefit from the services offered by UK Trade and Investment (formerly British Trade International), which "bring[s] together the joint work of the FCO and DTI in support of British trade and overseas investment". This support is, however, provided across the board to UK exporters. By contrast, the assistance provided by DESO is uniquely available to the defence industry alone.

Defence Attachés: £6m

*Support of the Defence Export Sales [sic] Organisation (DESO) is one of the core functions of an attaché. However, the priority given in their job description varies according to the export prospects in the host country.*⁵⁶

A defence attaché's job description includes: the development of bilateral defence relationships; advice to the Ambassador or High Commissioner; representing the British military and working to MoD instructions; and supporting DESO in its efforts to promote military exports.

⁵⁵ Adam Ingram, MP, Minister of State, MoD, in response to Malcolm Bruce, MP, *Official Report*, House of Commons, 29 Jun 2004, col 176W.

⁵⁶ John Spellar, MP, Minister of State, MoD, in response to Austin Mitchell, MP, *Official Report*, House of Commons, 28 November 2000, PQ 642W.

The Defence Manufacturer's Association (DMA) states in its promotional materials:

*Overseas Defence Attachés – these are briefed regularly on the UK defence industry and they are invited to DMA events to help develop networking opportunities and contacts.*⁵⁷

According to MoD, defence attachés cost £28.7m in 2001-2,⁵⁸ with an additional cost for administrative, office and residential accommodation of £14m, making a total of £42.7m. An NAO Report in 1989 estimated that an average of 40 percent of defence attachés' time was spent directly or indirectly promoting defence exports.⁵⁹ However, a parliamentary answer from June 2004 states "defence attachés devote about ten percent of their time annually to supporting legitimate defence exports and defence procurement collaboration activities".⁶⁰ It is not clear from this answer whether it takes into account indirect promotion (as was explicitly stated in the earlier NAO Report). It would be surprising if the time spent by defence attachés on export promotion had indeed been cut to only a quarter of its original level in those 14 years, particularly as the market today is now more competitive. Thus, for the purposes of this subsidy calculation we use a conservative figure of 15 percent of total defence-attaché budgets allocated (ten percent direct, five percent indirect), which produces a figure of over £6m.

Use of the armed forces for promotion: £6m

The armed forces are called upon to support export promotion in a variety of ways, including by demonstrating equipment at arms fairs and exhibitions. 'Export Support Teams' were established in 1984 to demonstrate British land equipment at defence equipment exhibitions and shows, and to provide private demonstrations on-site to prospective buyers. The average net operating costs of these teams for the last two

⁵⁷ See, <http://www.contracts.mod.uk/dc/public/newsroom/vol1x13/DMAFeature070503.pdf>

⁵⁸ Adam Ingram, MP, Minister of State, MoD, in response to Lynne Jones, MP, *Official Report*, House of Commons, 2 July 2002, col 231W.

⁵⁹ National Audit Office (NAO), *Ministry of Defence: Support for Defence Exports*, HC 303 (London: HMSO, 10 April 1989).

⁶⁰ Adam Ingram, MP, Minister of State, MoD, in response to a parliamentary question by Malcolm Bruce, MP, *Official Report*, House of Commons, 30 June 2004, col 350W (emphasis added).

financial years has been £2m.⁶¹ In an answer to a parliamentary question regarding the estimated cost to the UK Government of the Defence Systems and Equipment International exhibition, held in London in 2003, the Defence Minister Adam Ingram replied that "the direct cost to the Ministry of Defence identified centrally is estimated at some £400,000", and that "[i]n addition, representatives of [the] Government may carry out activities associated with the exhibition, as part of their normal duties, which could be identified only at disproportionate cost".⁶² The Royal Navy (RN) and RAF also play a role in terms of demonstrations and marketing exercises. For example, 'Defence Industry Days' are frequently held on board RN ships as part of the Fleet visit programme.⁶³ However, the costs of these activities are not available. On the assumption that the use of the navy and air force for export promotion are likely to each comprise no less a cost than support for land systems (which would seem a conservative approach), we have a very conservative estimate of a total subsidy of £6m.

Defence Assistance Fund (DAF):⁶⁴ £5m

The Defence Assistance Fund (DAF) 'subsidises the cost of military assistance in support of Defence Diplomacy and Support to Wider British Interests... Defence Missions... and includes support to Britain's defence exports'.⁶⁵ According to Defence Minister Adam Ingram in response to a parliamentary question in June 2004, DAF expenditure in support of defence exports averaged £5m over the last three financial years.⁶⁶

⁶¹ Adam Ingram, MP, Minister of State, MoD, in response to a parliamentary question by Michael Hancock, MP, *Official Report*, House of Commons, 30 June 2004, col 350W. Previous years have been recorded in a different manner and cannot be compared.

⁶² Adam Ingram, MP, Minister of State, MoD, in response to a parliamentary question from Jeremy Corbyn, MP, *Official Report*, House of Commons, 20 May 2003, col 675W.

⁶³ See Dr. Lewis Moonie, MP, Parliamentary Under Secretary of State for Defence, in response to a question from Mark Todd, MP, *Official Report*, House of Commons, 16 November 2000, col 741W.

⁶⁴ Previously the 'Defence Military Assistance Fund'.

⁶⁵ Adam Ingram, MP, Minister of State, MoD, letter in response to a parliamentary question by Dr Vincent Cable, MP, 9 October 2002 (placed in the Library of the House of Commons).

⁶⁶ Adam Ingram, MP, Minister of State, MoD, in response to a parliamentary question by Michael Hancock, MP, *Official Report*, House of Commons, 14 June 2004, cols 637-8.

Export credits: £222m subsidy (see appendix)

Put simply, UK-based companies can buy insurance against non-payment by their foreign customers from the Export Credit Guarantees Department (ECGD) for less than if they were to buy this service on the open market. It is this discount that we use to estimate the subsidy to the exporting companies. In addition, ECGD offers Fixed Rate Export Finance (FREF) to exporters at a guaranteed fixed exchange rate. As with credit insurance, the financial markets offer equivalent instruments to hedge interest rate exposures.⁶⁷

ECGD has become a useful tool for governments to subsidise the exports of a relatively small number of well-connected companies; around a third to one half of ECGD support is devoted to military exports. While its mission statement mentions the wider UK economy,⁶⁸ it is clear from repeated communications with ECGD officials that it interprets its mission as simply to promote UK exports.

This approach runs counter to the general thinking behind current Government economic policy, which is based on the belief that the private sector is the best vehicle to finance many areas of the domestic public sector such as health, housing and transport (as represented by, for example, Private Finance Initiatives and Public-Private Partnerships).⁶⁹ There are several mechanisms that have been developed within international finance markets that companies can use to take up credit guarantees to cover their exports. Emerging-market bonds demonstrate the level of return the market demands when loaning to foreign governments. The difference between the rate offered by the market to UK Government bonds and those to emerging markets reflects the market

⁶⁷ In 2001 the estimated *daily* world turnover in exchange traded and 'Over the Counter' derivatives was over \$4 Trillion, and the notional amounts outstanding approximately \$100 Trillion. Bank for International Settlements (March 2002) "Triennial Central Bank Survey: Foreign Exchange and derivatives market activity in 2001", p.15 and 18.

⁶⁸ "To benefit the UK economy by helping exporters of UK goods and services win business and UK firms to invest overseas, by providing guarantees, insurance and reinsurance against loss, taking into account the Government's international policies", *ECGD Annual Report 2001-2*, p 4.

⁶⁹ It may or may not be accidental that the one common theme that the ECGD has with such schemes is that they enable the Government to receive monies now (whether capital sums or insurance premia) in return for a promise to return significant resources to the private sector at a later date.

estimation of the sovereign risk. The credit derivatives market is a direct alternative for exporters to offset the risk of export contracts. Where this facility exists, there is no compelling reason for the Government to continue to offer ECGD support.

Only a small proportion of ECGD guarantees by value support deals that the private financial markets are unwilling to cover because the risk is judged too high for a realistic premium. This does not in itself indicate a market failure, so much as a market where demand at the market price is close to zero. If there are political and social reasons for supporting the export of particular technologies it would be more transparent, accountable and efficient simply to provide a grant to such activities.

Under sustained pressure in this debate over subsidies, the Government has itself just acknowledged that ECGD provides a real subsidy, though their estimates of the level have yet to be finalised. A preliminary figure of £120m was announced in July 2004 in the Ministerial Statement supporting the establishment of the ECGD's Trading Fund.⁷⁰ But the Government has also announced that for the time being it intends to maintain premium rates at existing levels, ensuring the continuation of the subsidy.

Here we provide a simple estimate of the level of ECGD subsidy to military exports. Our subsidy calculation compares the premiums charged by ECGD with those in the financial markets. Claims that the Government is in a better position to offer cheaper rates are not credible; if it were true then it would be rational for it to generate a profit by undercutting the finance markets. Using a figure of 3.5 percent as an estimate of the average risk premium on military contracts covered by ECGD,⁷¹ and an additional one percent contract risk (based upon the physical export as opposed to the financing), we calculate that the risk premium on ECGD's military cover, amounting to over £5,000m, is £225m. From this we deduct

⁷⁰ Ministerial Statement, 30 June 2004: "The Government has charged ECGD to continue pricing to break-even, in line with international agreements on export credit, not to maximise profits. The Government estimates the economic cost of this commitment to be approximately £120 million per annum, and will be publishing budgeting arrangements for this in the 2004 Spending Review." Available on ECGD website: http://www.ecgd.gov.uk/news_home.htm?id=6213

⁷¹ This figure of 3.5 percent is of course notional. To obtain an accurate figure one would have to take the risk premium offered on the finance markets (through emerging market bonds or more directly through credit derivatives) on the particular sovereign risk accepted in the contract on the day. The overall subsidy would be the sum of all the risks entered into.

£38m in premium received, to reach a figure of £187m. To this we add £35m for FREF subsidies to reach a total figure of £222m for ECGD's support to military exports (see appendix for further details of these calculations).

Distortion of MoD procurement: £200m subsidy

This report has already highlighted the risk that pursuit of export contracts can lead to procurement decisions that provide the UK military with inappropriate equipment at excessive cost. Calculating the extent of this problem is difficult, as the procurement process is relatively opaque: ostensibly for commercial and national security reasons. Since the York Report was published (claiming that there are no known recent cases whereby a procurement decision has been influenced by export considerations), the *Defence Industrial Policy* of 2002 has stated that future export potential should play an explicit role in acquisition decisions, a point reiterated by ministers in evidence to the Defence Committee in May 2004.⁷² In addition, the publicity surrounding the recent *Hawk* deals has thrown some light on the sums that can be at stake. While this example may be unusual, it would appear to be indicative of the Government's approach, and is not the only case that has required a Ministerial Direction to over-rule the judgement of the Permanent Secretary over efficiency.⁷³

If the press reports are correct and MoD could have procured better aircraft at an overall cost of £1bn less than the *Hawks*,⁷⁴ and if the decision to purchase these aircraft for the RAF has indeed been determined by a

⁷² Lord Bach, Minister for Defence Procurement, in evidence to the House of Commons Defence Committee, 25 May 2004, published on 29 June 2004, HC 572-iv. Can be found at: <http://www.publications.parliament.uk/pa/cm200304/cmsselect/cmdfence/572/572we01.htm>

⁷³ Private communication with officials.

⁷⁴ Mary Fagan, 'How the Hawk fought off an Italian predator', *Daily Telegraph*, 19 July 2004, can be found at: <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2003/08/03/cchawk03.xml> 19; David Gow, '5,000 jobs safe as India buys Hawks', *The Guardian*, 26 July 2004, can be found at: <http://www.guardian.co.uk/print/0,3858,4746652-111087,00.html> 26 July 2004; Clayton Hirst, 'MoD's £6bn sweetener for BAE', *The Independent*, 20 July 2004, can be found at: <http://news.independent.co.uk/business/news/story.jsp?story=272761>; David Hencke, 'MoD chief refused to sign £800m Hawk order', *The Guardian*, 5 July 2004, can be found at: <http://www.guardian.co.uk/print/0,3858,4815689-110595,00.html>.

desire to keep the BAE Systems plant open and to secure the contract with the Indian Government, then the subsidy consequences are remarkable. The lifetime of the domestic project is 25 years, which generates an average £40m annual subsidy in MoD procurement distortion for these decisions alone.

The UK procurement and servicing of *Hawks* (£3.5bn over their lifetime) represents only 1.75 percent of total UK defence equipment procured from domestic sources,⁷⁵ and the sale of the *Hawks* to India is likely to make up around only two percent of all arms exports over the life of the project (at current levels). Therefore, given the relative insignificance of the *Hawk* deal in the context of total UK defence procurement and exports, and allowing for the fact that the sheer scale of distortion is unusual in this case, we consider a reasonable estimate that the overall annual implied subsidy arising from the distortion of procurement intended to promote exports would be £200m.

Development of new systems (R&D): up to £483m subsidy

There is considerable disagreement about whether it is legitimate to apportion some of the Government support for military R&D as a subsidy for arms exports. While some argue that R&D support would be forthcoming regardless of whether it might lead to foreign sales, others claim that if exports account for 40 percent of UK defence equipment production, then 40 percent of R&D spending should likewise be allocated to exports.

The Government is heavily and directly involved in military R&D, spending over £2bn a year, of which around £1.5bn is specifically for development.⁷⁶ Although the research enables MoD to maintain the expertise necessary to be an 'intelligent customer', much of the development is conducted in

⁷⁵ MoD spends roughly £8bn per annum on UK defence equipment, according to the latest figure in *Defence Statistics 2003*, table 1.8. We do not include fuel, clothes, administration and other costs not directly associated with equipment purchase and maintenance. Assuming an average annual cost of £8bn (at 2001 prices) over the 25 years, we have a total spend of £200bn.

⁷⁶ *UK Defence Statistics 2003*, op cit, table 1.7.

direct collaboration with businesses in order to develop weapons systems for the profit of those companies. The Government's contribution to military R&D is an indirect and inefficient mechanism to achieve a cheaper price for MoD.

MoD support for R&D comes in a number of guises, including Defence Technology Centres,⁷⁷ the Defence Diversification Agency,⁷⁸ the Defence Science and Technology Laboratory (DSTL, retained as an MoD agency) and QinetiQ.⁷⁹ Additional government support, not accounted for here but which is significant, comes through the Department of Trade and Industry's (DTI's) Technology Partnership in Avionics,⁸⁰ the Aeronautics Research Programme,⁸¹ Regional Selective Assistance under the Industrial Development Act,⁸² Research Councils and EU research programmes (such as the EU Framework Programme). There is also the R&D tax credit, which has been introduced this year and is designed to reward companies for their research spending and to give them incentives to increase their development spending.

⁷⁷ DTCs are collaborative arrangements between MoD, industry and academia, which focus on defence science and technology to "generate and enhance the technology vital to the delivery of future UK Defence capabilities." Each DTC will run for between 3-6 years and will be financed on a 50:50 basis by MoD and the participating commercial and academic organisations. MoD has committed up to £5m each year for each DTC.

⁷⁸ The DDA is intended to "promote cross-fertilisation of technology between the defence sector and industry."

⁷⁹ In 2001 the MoD's Defence Evaluation and Research Agency was split up into the Defence Science and Technology Laboratory (DSTL, retained as an MoD agency) and QinetiQ, which was prepared for privatisation the following year. DSTL research within MoD informs its evaluation capability on a range of specialist sensitive military technologies. QinetiQ provides research and evaluation into new military and civil technologies. In February 2003, the company was acquired by the Carlyle Group. But the MOD continues to hold significant economic interest with a stake of 62.5 percent of the business.

⁸⁰ DTI provides significant support to the aviation industry, a sector heavily subsidised by successive governments because they have perceived it to be a flagship manufacturing industry. It is unclear why a successful industry would need such heavy subsidies.

⁸¹ DTI provides research grants for work on aerospace, frequently with dual-use (civil and military) development applications. Along with MoD it supports the National Defence And Aerospace Systems Panel, a corporate lobbying organisation that seeks to ensure government support for further research into civil and military aerospace, as well as running a number (currently twelve) of Defence Aerospace and Research Partnerships, and producing the National Defence Industry Technology Strategy, which steers so much of MoD's R&D strategy.

⁸² The latest report on the Industrial Development Act can be found at http://www.dti.gov.uk/support/hc852_270803.pdf. In 2002/3 the RSA accounted for £294.6m of government support.

By its very nature it is difficult to determine who benefits most directly from R&D. In the civil commercial sector the price of a product generally reflects the investment (including R&D) required to develop, manufacture and market it. Prices in the military sector more strongly reflect a number of other factors including the subsidies and political support given to the industry, personal connections, lobbying and the like.

The Government recognises that its spending on R&D assists defence exports, and it does charge a 'Commercial Exploitation Levy' on these to claw back some of this support. However, the income from the levy has been reducing significantly, to the point where the amount collected now only reaches around £12.3m a year, a tiny 0.5 percent of the government's military R&D spend.⁸³

We can use a simple formula to estimate the top boundary of R&D subsidy for exports. Around 40 percent of the weapon systems constructed in the UK are exported.⁸⁴ If we were to assume that the government development spending is shared equally between exports and domestic procurement, 40 percent of the £1.5bn government spend on development is £600m. Subtracting the Exploitation Levy, we are left with £588m.

Export contribution to fixed costs

DESO estimates that the savings that accrue to the fixed costs of MoD procurement as a result of exports is some £300m.⁸⁵ If we strip from this figure the £40m included within it for sales of surplus equipment (already included in DESO's net budget) and the £50m included for the Commercial Exploitation Levy (the average level of income received in the 1990s), it reduces to £210m. We believe that this still fails to take into account the range of factors that were discussed in section 1 (pages 15-16), for example, the fact that exports are frequently sold near the marginal cost of production. We have, therefore, halved MoD's estimate of the contribution to overheads, to £105m. This reduces the top-level subsidy estimate from R&D to £483m.

⁸³ Figure based on the last three years, given in a parliamentary written answer by Adam Ingram, MP, Minister of State, MoD, *Official Report*, House of Commons, 10 Jun 2004, col 589W.

⁸⁴ *Defence Statistics 2003*, op cit. Exports amount to £4.1 bn. MoD spend on UK equipment purchases equals £6.4 bn (extracted from table 1.8).

⁸⁵ <http://www.deso.mod.uk/policy.htm>

Unquantifiable elements

The following two categories have not been possible to quantify. Their inclusion here highlights the fact that the value of the total annual subsidy to UK arms exports (above) should be regarded as conservative, and that the true figure is likely to be higher still.

Official staff visits

Whether directly or indirectly, cabinet ministers and royalty are frequently involved in large defence contracts when they visit abroad. For example, in 2002, according to information released to Parliament, "Foreign and Commonwealth Office Ministers carried out [arms sales] promotion activities in Chile, Czech Republic, India, Singapore, Slovakia and Tanzania".⁸⁶ The Foreign Secretary, Jack Straw, claims that, "it is an entirely legitimate part of British ministers' role overseas to support British industry, including British defence industries, and I am totally unapologetic about my very active support for all British industries, including the British defence industry".⁸⁷

Substantial numbers of support staff and advisers are usually involved in such visits, and their motivation and timing usually rests upon negotiations in progress on particular deals. While these visits represent a significant overall cost, in many cases it is very difficult to disaggregate the arms promotion component so as to calculate the specific arms promotion cost. In any case, the actual figure one may use to represent this pales into insignificance compared to the political, diplomatic and foreign policy costs and benefits of such visits.

⁸⁶ Rt Hon Jack Straw, MP, Secretary of State for Foreign and Commonwealth Affairs, in response to a written parliamentary question from Rt Hon Menzies Campbell, MP, (Liberal Democrat Spokesman on Foreign Affairs), *Official Report*, House of Commons, 15 May 2003, col 401W.

⁸⁷ Rt Hon Jack Straw, MP, Secretary of State for Foreign and Commonwealth Affairs, minutes of evidence to the Quadripartite Committee, 27 February 2003, appear in *Strategic Export Controls Annual Report for 2001, Licensing Policy and Parliamentary Scrutiny*, Second Joint Report of the Quadripartite Committee, op cit. Evidence can be found at: <http://www.parliament.the-stationery-office.co.uk/pa/cm200203/cmselect/cmdfence/474##022701.htm>. See also Jean Eaglesham and Edward Luce, 'Anger as Blair uses Kashmir talks to sell Hawk jets', *Financial Times*, 22 October 2002, p 6.

Embassy staff (not including defence attachés)

In countries that are significant purchasers of UK arms, or where a potential deal is in negotiation, other embassy staff will use their general relationships and political knowledge to help smooth the way for defence deals. Diplomatic staff in embassies in India, Saudi Arabia, Indonesia and South Africa have been involved in military negotiations. However, costing such involvement has proved impossible.

5. Conclusion and policy recommendations

Conclusion

Arms exports do not benefit the UK economy or jobs. Subsidies to arms exports distort the economy and divert resources, such as skilled labour and R&D investment, away from alternative economic activity. Although exports protect a relatively small number of particular jobs, there are at least as many lost elsewhere in the economy. The evidence suggests that only in a handful of local economies that are particularly dependent on defence contracts would there be a significant impact from reduced arms exports. Government intervention would be better targeted at ameliorating this local dependency rather than artificially prolonging it.

Defence exports today more frequently involve the transfer of technologies abroad and the production of equipment in the purchasing country itself – as is the case with the *Hawk* jet deal to India, which is another factor minimising any employment or economic gain from the transfer. The Government has recognised that the defence industry is now global in scope and that weapons platforms contain components sourced from around the world. Given this development, the Government should abandon the historical and costly commitment to procuring weapons systems from UK sources solely for the purpose of ensuring ‘security of supply’ in all but the half dozen sensitive technologies that it has already identified.

We estimate that the subsidies provided to UK companies involved in defence exports are worth at least £453m, and possibly up to £936m; in other words, between £7,000 and £14,400 for each job supported by exports. In actual fact, on the assumption that if subsidies were finished tomorrow there would still remain some defence exports from the UK, the cost for each job supported by the subsidies would be considerably more than this. At a time when public spending is under pressure the onus is on the Government to withdraw the subsidies and encourage other countries to do the same.

Policy recommendations

Marketing and Government Promotion

- 1 MoD should end public funding for the DESO and defence trade fairs.
- 2 MoD should end defence attachés’ involvement in arms export promotion and reduce the numbers of attachés accordingly.
- 3 Government Ministers should cease their involvement in military export promotion, and instead see their international diplomacy role as focused on conflict prevention and the promotion of international security.

ECGD

- 4 The Secretary of State for Trade and Industry and the Chancellor of the Exchequer should review the position of ECGD. ECGD exposures should be valued at their market values to facilitate the proper management of their risk portfolio.⁸⁸ Implicit subsidies should be either eliminated or at least recognised in the national accounts and justified in terms of their value for money against properly evaluated stated political and social objectives. They should then attempt to negotiate similar moves multilaterally within WTO and OECD for all other export credit agencies.

Domestic Procurement

- 5 MoD should reduce its spending on military R&D. Private companies should take greater responsibility for developing the products upon which their profits are based, and MoD procurement decisions should

⁸⁸ Whilst the inclusion of a cost of capital in the calculation of ECGD costs is to be welcomed, we do not consider it is likely to result in the elimination of subsidy, for reasons we explained in written evidence submitted by BASIC to the House of Commons Trade and Industry Select Committee, available on their website at: http://www.parliament.uk/parliamentary_committees/trade_and_industry.cfm. Oral evidence is on the Committee’s website <http://www.publications.parliament.uk/pa/cm200304/cmselect/cmtrdind/uc506-iii/uc50602.htm>.

focus *exclusively* on life-cycle efficiency in delivering operational objectives.

- 6 MoD should separate defence procurement from export decisions in order to ensure that procurement decisions are taken solely on the basis of defence needs and value for money.

Employment

- 7 Government ministers should end their reference to jobs when justifying their support for arms exports, and instead focus their industrial assistance on the handful of local economies that are dependent on defence contracts. Government intervention would be better targeted at ameliorating local economic dependencies rather than artificially prolonging them.

Appendix: Background to ECGD

Claims that the government is in a better position to offer cheaper premium rates than the markets are not credible; if it were true then it would be rational for the government to generate a profit by trading in international debt.⁸⁹ Neither is the Government able to operate efficiently in this market, because of the narrow base of the exposures that it holds.⁹⁰ Were the ECGD to mark its portfolio to the market value (as required by International Accounting Standards,⁹¹ and what we attempt in our subsidy calculation below) this would then offer ECGD the opportunity to manage their credit exposures in the same way they currently manage their FREF exposures.⁹²

We estimate from the ECGD annual report that approximately £5,000m of debts relating to military contracts are outstanding at any one time.⁹³ We further estimate that the sovereign governments who owe this money would, on average, pay 350 basis points (3.5 percent) over the UK government bond rate to borrow.⁹⁴ We add a further 100 basis points (one percent) as an estimate of the additional contract and legal risk relating to such contracts, as

⁸⁹ The NERA 2000 Report for ECGD (National Economic Research Associates, *The Economic Rationale for the Public Provision of Export Credit Insurance by ECGD*, 2000) cites on page 2 the major reasons for Government intervention as being risk bearing ability, privileged information and reputation. It is highly unlikely that the UK Government has a greater risk-bearing ability than the world financial markets, nor that it should choose to bear risks capable of being born by those markets and thereby lose the allocative efficiency advantages of competitive markets (NERA para 3.1.) And greater risk-bearing capacity would support all insurance being provided by the state. NERA recognise this logic in para 4.5.1. The subsequent conclusions of NERA that the lumpy long term nature of political risk explain the lack of a private sector market in political risk has not, with the emergence of the sovereign credit derivatives market, stood the test of time. It is equally unlikely that the UK Government has both access to and the ability to process privileged information on the repayment ability of foreign sovereigns, or that this ability would not be negated by political considerations in the decision to lend.

⁹⁰ See, for instance, the 1999 KPMG Report for ECGD, *Risk Management Review for HM Treasury and ECGD*, 1999, para 1.3.4, 1.3.12. and elsewhere.

⁹¹ See International Accounting Standard 39, or the American equivalent, Financial Accounting Standard 133.

⁹² By hedging some exposures using derivative products.

⁹³ The 2004 *ECGD Annual Report* shows that out of total support of £2,991m granted in 2003/4, 39 percent was defence-related. The total amount at risk at 31 March 2004 was £18,590m, of which £5,020m (27 percent), was defence-related.

⁹⁴ Emerging market risk premia are highly dependent on the appetite for risk in the market, and fluctuate considerably. However, given the long-term nature of ECGD business, and the profile of their portfolio, this estimate is probably too low.

compared to pure sovereign debt.⁹⁵ The annual value of the ECGD underwriting of these debts is therefore (3.5 percent + 1 percent) x £5bn = £225m. ECGD charges, on average, a premium of £38m for this business, so the net subsidy is £225m - £38m = £187m. To this we add £35m for FREF subsidies to reach a total figure of £222m for ECGD's support to military exports.⁹⁶

Our estimate is probably an underestimate of the true value of ECGD contracts to UK exporters. There is a significant delay between the date ECGD offers cover and the date the exporter confirms the contract. This represents a valuable option to the UK exporter, the value of which would need to be estimated on a case-by-case basis and which we have not been able to estimate.

The benefit from the subsidy is probably shared between the banks, the UK exporter and the overseas client. Corporate Finance Theory states that an organisation using cheap finance to fund a risky project will see an increase in its cost of capital. By analogy, the use of the Government balance sheet to support risk on the ECGD balance sheet will result in a small deterioration in the Government's capital market debt rating, and hence a small increase in its cost of borrowing.⁹⁷

⁹⁵ We have no information on which to base this estimate, other than the complexity of the products and deals supported.

⁹⁶ Prior to laying-off risk in the markets, the FREF subsidy was considerable. The 2003 NERA Report for ECGD, *Estimating the Economic Costs and Benefits of ECGD*, January 2003, p. vi, quote £300m in 1992 as the highest loss. The FREF scheme directly cost the UK taxpayer over £15bn (at 1999 prices) in its first 25 years. The cash loss appears in the ECGD accounts as the difference between income and expenditure on the FREF scheme. As the military and civil sectors are not disaggregated, for our purposes we estimate that the proportion attributable to military exports as being the same as that reported for ECGD business as a whole.

Figures in £,000	2001/2	2002/3	2003/4	3-year av
Total FREF subsidy	£141,212	£105,511	£21,597	£89,440
Percentage ECGD military	31	50	39	
Estimated military FREF	£43,776	£52,756	£8,423	£34,985
Source in Annual Report	2002/3 Note 10, p.92,	2003/4 Note 12, p.100,	2003/4 Note 12, p.100,	

⁹⁷ Measuring this effect is not directly feasible due to the small size of the ECGD portfolio as compared to total government borrowing. However, the principle of rationing borrowing capacity available to local authorities and other agencies is well established. Mechanisms to circumvent such rationing through derivative instruments were made *ultra vires* following the Hammersmith and Fulham debacle. Borrowing capacity allocated to ECGD is at the expense of borrowing capacity elsewhere in the state sector.

NERA and ECGD propose an alternative Value at Risk method for measuring the value of any subsidy. Given the use of the market to measure the subsidy for FREF, and the ready availability of an increasingly liquid credit derivatives market, and a very deep sovereign debt market, this is inconsistent and untenable.⁹⁸

⁹⁸ Much of the criticism of Value at Risk and the more reliable alternatives used here can be found in written evidence submitted by BASIC to the House of Commons Trade and Industry Select Committee, op cit. This contains extensive references to recent finance theory literature and market journals. Oral evidence is on the Committee's website <http://www.publications.parliament.uk/pa/cm200304/cmselect/cmtrdind/uc506-iii/uc50602.htm>