



A Collaborative Report—July 2001

Report Summary

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The Subsidy Trap

British Government Financial Support for Arms Exports and the Defence Industry

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The question of whether public support for the defence industry represents a proper use of public money is one that does deserve regular and closer examination... The position of the MoD, through the activities of DESO, in promoting the interests of UK defence manufacturers is an unusual one... The relationship between the defence industry and the MoD is inevitably open to suspicion – it is therefore all the more important to provide transparency and accountability in this relationship, and to be able to demonstrate that DESO provides an unquestionable benefit to the national interest. In an era of increasing internationalisation of the defence manufacturing industry, and of an increasing acceptance of the need for open markets and value for money in defence procurement, the precise costs and benefits of the MoD's relationship with defence manufacturers will be increasingly difficult to establish. For precisely this reason the MoD must be able to demonstrate the benefits of this relationship, particularly at a time of increased focus on the ethics of defence exports.

House of Commons Defence Select Committee, 2nd Report 1999,
extracts from paragraph 12.

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1 Introduction

There has been a long running debate between those who believe that arms exports are essential to a thriving British defence industry, and those who judge them a drain on the exchequer and the economy. Every significant government policy, if it is to present value for money, requires extensive analysis of its costs and benefits for society. An informed scrutiny of government subsidies for arms exports and the defence industry is long overdue. Because of the complexity of the economic relationships involved, debate has often in the past been informed more by expressions of faith than clear analysis of the facts. The purpose of this report is to review the economic, military and industrial rationale for government support for arms exports and the UK defence industry, and challenge the misuse of public resources. Saferworld and the Oxford Research Group publish this paper as a consultative document and will welcome information, analysis and responses from interested parties.

Consecutive governments have continued to argue that arms exports benefit the economy and support jobs, and that a successful home-grown defence industry is essential both for the security of Britain, and our standing in the world. The claim is also made that this industrial base ensures that we have ready and guaranteed access to the ever more sophisticated technology necessary to kit out our armed forces and the spare parts to keep it functioning and that we have the design teams, skilled labour, knowledge base and production lines to maintain a capability for the future. However, these arguments have not been backed up with clear economic evidence.

We calculate identifiable subsidies to UK arms exports to be around £420 million per annum. In addition, arms exports benefit from government military research and development (R&D), an additional subsidy of up to £570 million per annum. The cost of supporting both exports and the broader defence industrial base could amount to over £4 billion pounds per annum (this includes subsidies to arms exports and R&D), yet there is little evidence that the 1997-2001 Labour Government or previous Conservative governments ever undertook a comprehensive review of this support.

Summary of Subsidies	Subsidy	Subsidy per job
Arms exports	£420m	£4,600
Additional subsidy from R&D	£570m	
Total UK Defence Industrial Base (see page 7)	up to £4,250m	Up to £12,300

2 Direct government services and subsidies to exports

Direct government subsidies for arms exports involve several government departments. The report identifies four main categories of direct and measurable government subsidies:

- Export Credit Guarantees (£227 million)
- Marketing and other support through government agencies (£69 million)
- Tax breaks on bribes and other corrupt practices (£64 million)
- Distortion of MoD purchasing and other priorities (£60 million)

Export credit guarantees

The Export Credit Guarantee Department (ECGD), under the remit of the Secretary of State for Trade and Industry, has consistently featured in previous studies of export subsidy as the most significant element. ECGD's subsidy arises from its accepting the risk associated with exports. This is calculated by taking the risk premia that private lending organisations would add to their base non-risk interest rates on international sovereign loans to such countries and subtracting ECGD's premia charged to exporters (subsidy £227m).



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Marketing and other support through government agencies

The Defence Export Services Organisation (DESO), currently within the Ministry of Defence (MoD), plays a key sales promotion role in support of the UK defence industry (net subsidy £16m). Its influence extends beyond mere promotion of British industry abroad, since it also acts as an official 'buy British' lobby within the Ministry itself. In addition, the use of official personnel to promote British exports is common, and includes army units to demonstrate equipment, non-military embassy assistance to marketing, official ministerial visits and defence attachés advising on British equipment (subsidy £53 million).

Tax breaks on bribes and other corrupt practices

The third main category of subsidy involves tax breaks for bribes associated with the defence sector. According to a poll conducted by Gallup International, commissioned by Transparency International, the defence sector is particularly prone to bribery. Because the UK has not incorporated into statute the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, it is still legal for British nationals and companies to offer bribes, and still possible to claim tax exemption on corrupt payments within a company's tax return.

This was strongly criticised in April 2001 by the House of Commons International Development Select Committee which urged the Government to close this loophole immediately. We include the tax loss as an estimated subsidy (£64m) and echo the call to the Government to introduce legislation to end the practice altogether.

Distortion of MoD purchasing and other priorities

The strands connecting the Government to the UK defence industry are many and varied, and are a constant theme throughout this report. Government defence procurement decisions, particularly when they reach ministerial level, can be influenced by many things, not least the possibility of future exports. This political pressure to 'buy British' comes at a cost, be it in higher prices or reduced capability, or both. This distortion of procurement decisions represents the fourth direct subsidy (estimated subsidy £60m).

Summary table of calculable direct subsidies to arms exports

Organisation	Detail	Net subsidy in £m
ECGD	Cost of supporting military exports by accepting risk	227
MoD	DESO net operating cost	16
MoD	Use of MoD personnel to promote sales	10
FCO	Support by embassy staff and offices	7
MoD & FCO	Defence attachés	16
HMG	Official visits	20
Inland Revenue	Tax breaks on bribes and other corrupt practices	64
MoD	Direct distortion of procurement choices	60
HMG	TOTAL net subsidy for military exports	420

Wider costs and benefits of subsidies

In addition to the UK government's direct subsidies of arms exports, there are a number of wider costs and implications for the country arising from government intervention. In this context, it is important to examine:

- Fixed costs (such as R&D)
- Employment
- Offsets and balance of payments
- The cost of military intervention.

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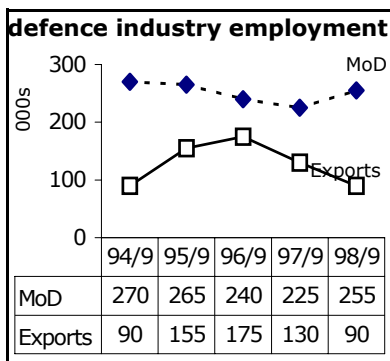
Fixed costs

A major point of contention in the subsidy debate concerns the position of fixed costs (those largely independent of output quantities), in particular expenditure on research and development (R&D). It is argued that as long as exports are sold at a price that is higher than marginal cost (the cost of the last unit of production) and so contribute to fixed costs of the weapon programme, there is potential to reduce costs to MoD. However, at present MoD itself pays for the bulk of R&D expenditure, and generally buys the first versions of equipment as they come off the production line, when the price is high and covers the set-up costs and there are few economies from learning or scale. By the time the manufacturer sells abroad they have already covered fixed costs and are reaping economies of scale and learning; they can charge a much lower price (at the implied expense of MoD). MoD itself recognises this and charges a levy on exports, but the amounts raised from this levy (around £50m annually) do not begin to match the level of benefit enjoyed by exporters.

The report outlines six additional reasons why it is reasonable to assume that government military R&D spending represents a net subsidy to exports. The subsidy represented could be anything up to the difference between exporters' share of government-funded development costs that go into producing the final weapon system and the levy raised—around £570m. Because this amount is so uncertain, we leave it out of our final calculation.

Employment

Another major cause for government support for arms exports rests on the belief that employment created by exports plays an important part in the British economy. MoD figures suggest that there was a drop of 45% in employment from defence exports in two years, from 165,000 in 1996/7 to 90,000 in 1998/9. This is largely due to the end of the



Al Yamamah contract and the collapse of the market in the Far East. But there have been no severe economic consequences in the UK, and many of those losing their jobs have found alternative employment. While 90,000 jobs is clearly significant, it amounts to just 0.3% of UK employment. Furthermore, due to the dynamics of the employment market, the figure amounts to the equivalent of less than 40% of the 230,000-250,000 people who leave the unemployment register each month. As a large proportion of defence jobs are in overheating local economies in the south east, where there is shortage of labour, the subsidies are misplaced if they are to protect employment. We estimate that there is an annual government subsidy specifically to arms exports of over £4,600 for every export-related job maintained.

Offsets and balance of payments

Any economic benefits arising from exports are significantly undermined by associated offset arrangements that involve the export of technology and jobs. While arms exports clearly contribute to the UK's balance of payments situation, this contribution amounts to only 1.84% of UK exports, or 1.18% of total credits from overseas. At this level, even substantial reductions in defence exports would only result in small fluctuations in the exchange rate. It is also said that defence exports act to facilitate civil exports, but there is little evidence for this, and indeed the effect could be the opposite.

Impact on international security

The UK's national security depends on stability at both regional and global level. There are a multiplicity of possible causes for the outbreak of war. However, the overcapacity in the international arms market, facilitated by government subsidies, drives the price of weapons down and increases volumes transferred. This can have a direct impact on the intensity of conflicts. Furthermore, UK forces increasingly find themselves engaged abroad in military intervention often within international operations. The need for military intervention can be traced, at least in part, to previous weapons supplies. These costs are significant but incalculable.



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Subsidies to the defence industrial base

Much of the success of the British defence industry comes from a long history of government support. There are three main reasons why successive UK governments have subsidised the UK defence industrial base:

- security of supply;
- technological excellence;
- employment.

Security of supply

At root, the justification for government support of the arms trade rests in the belief that an independent defence industrial base is linked inextricably with national security. As a result, around 85% of MoD's equipment spending goes to UK firms. Yet the world has changed a great deal since this assumption first took hold.

- We have a robust international market based on a number of multinational system suppliers dependent on a vast number of component manufacturers from all over the world. As companies merge and diversify, it makes little sense to talk of a British BAE Systems or a French Thales.
- Our armed forces have an increasing requirement for interoperability with allies as their activities centre on international operations rather than territorial defence.
- The market has significant overcapacity and heavy competition between subsidised suppliers for limited markets.

Technological excellence

There is a strong belief that Britain needs to maintain its technological excellence in research, development and engineering. There is no doubt that the defence industry employs a disproportionate amount of highly skilled labour, at the leading edge of development. However, employment within this industry represents an opportunity cost elsewhere, where there are significantly higher productivity rates. If many of the UK's greatest minds are employed on development in an industry with overcapacity, this is a waste of resources that urgently needs government attention.

Employment

According to the MoD there are 345,000 people employed in the defence industry (90,000 of whom are export dependent). Although this is a significant level of employment, it needs to be placed in the context of employment opportunities in the wider economy. First, as was the case for export related employment,

- there is a heavy downward trend in defence industrial employment that is likely to continue;
- the number of people who leave the employment register each month is 230,000 to 250,000.

The government subsidy to maintaining a British defence industry amounts to around £12,300 per job per annum.

Alternative Choices

In moving away from a protectionist and inefficient defence procurement policy, the MoD faces several choices:

- buying off-the-shelf;
- encouraging industry to collaborate with European or US competitors, or doing so itself (as it has with the Joint Strike Fighter); or
- taking this further and moving towards a joint European defence procurement arrangement.

Potential savings from these alternatives are impressive, arising from several advantages:

- open competition between companies within Europe or globally would lead to savings in price;

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- companies in the European or global market would be in a better position to exploit learning and scale economies;
- the government would be able to reduce its R&D spend to the small fraction of its existing level.

The savings from these alternative possibilities have been roughly costed, based upon data arising from previous work by Professor Keith Hartley of York University.

If the policy of protecting the UK defence industry were abandoned or weakened in favour of greater collaboration or truly competitive purchasing, not only would these savings be made but any subsidies to arms exports would be rendered unnecessary and many pressures to export reduced.

Potential savings to the MoD from a changed procurement strategy

Element of Saving	Competition within Europe	Competition in world markets	Single European procurement agency without collaborative projects	Single European procurement agency with collaborative projects
Competition price effects	400m	1,000m	1,300m	400m
Learning and scale economies	950m	950m	950m	1,200m
Reductions in R&D	2,000m	2,000m	2,000m	1,000m
TOTALS	3,350m	3,950m	4,250m	2,600m

5 Reviewing the subsidy trap

The underlying assumption that the Government should directly involve itself in promoting defence related exports and support a defence industrial base, in order to benefit the economy and support jobs, has not been backed by clear economic evidence. The UK's success in the international arms sector had been seen by many as a measure of the efficiency of the industry and its contribution to the UK economy. There is no doubt that defence exports are good for companies, maintain particular jobs, and help the balance of payments. But this is at an undetermined cost to the economy at large.

The challenge the Government faces is to demonstrate the economic advantage of continuing to subsidise military exports and the defence sector, with all the associated costs and benefits outlined in this report. This report recommends that the government undertake a full and open assessment of this policy, which should spark a much-needed public debate on this important issue.

Worldwide, government subsidies and offsets enable military and aerospace sectors to capture resources and create major production overcapacity, driving international trade and military technology proliferation. Such practices have been outlawed in civil sectors, as governments have perceived mutual advantage in free trade with minimal government intervention. Similarly, government intervention in the defence sector should be limited to addressing national and international security issues, through such tools as export licensing and arms control initiatives.

Recommendations

ORG and Saferworld recommend that:

General

- MoD publishes its forthcoming study into the cost of Government subsidies for the defence industry and arms exports;



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- the Public Accounts Committee undertakes a study into the full cost of the arms subsidy;
- a joint Select Committee investigation, made up of the five select committees principally concerned with this issue (Treasury, Defence, Foreign Affairs, International Development and Trade and Industry), be established to review the findings of the MoD study (and related studies such as this one) and to consider future policy options; and
- the Government initiate multilateral negotiations within OECD and WTO to regulate subsidies for defence industry and arms exports.

Export credit guarantees

- ECGD support for arms exports be abolished, or
 - the charges it levies for its services to reflect their full cost, including the cost of the notional capital necessary to provide for the credits.
 - the list of countries to which ECGD cover for military exports is banned be extended, notably to more than just the highly indebted poor countries, but also to other countries with development concerns. DFID draws up a list of countries that it views export licence applications for. These
 - countries are largely recipients of UK development assistance and countries where there is concern about the potential impact of military expenditure on development. This list is a useful starting point for drawing up a list of countries that should not receive ECGD cover for military exports.
 - the relevant Select Committees be able to examine proposals for export credits for arms exports. To facilitate such scrutiny, the 1991 Export Credit Guarantee and Investment Act should be amended to require prior notification of any proposed military credits to Parliament.
 - future ECGD Annual Reports provide clear, country-by-country statements on the level of annual export credits for military sales, and the levels of claims and recoveries related to credits for military sales.
 - the UK Government initiate multilateral negotiations (e.g. in the EU and OECD) to exclude defence and dual use equipment sales entirely from government export insurance guarantees.

Marketing and other support through government agencies

- public sector support for DESO be wound down and eventually ended over the lifetime of this Parliament;
- if such a bold decision is resisted, then DESO charge fees to exporters for all its services at a sufficient level to cover all running and marketing costs, services that are not profitable should be wound up, and consideration should be given to transferring DESO to the private sector;
- the Government ensure that the impact of DESO's marketing activities on MoD's procurement policy is minimised, in particular by putting greater distance between the two and moving DESO out of MoD.
- where the Government is inextricably involved in arms sales promotion (because other governments require government-to-government negotiations) it receive full compensation from the companies that benefit. The Government should ensure that the Exchequer receives full compensation for the use of armed forces and defence attachés to promote sales, and for the use of embassies and their staff. Where official visits involve defence sales promotion, a levy should be charged on exporters involved in the deals under consideration. These costs and receipts should be clearly set out in separate line items in government accounts;
- the extent to which the military assistance and training budgets are used to help forge links for the purposes of defence sales to be clearly set out in future defence budgets;
- the full role and cost of overseas visits, paid from public funds, that incorporate defence export promotion to be systematically reported to parliament.
- the role of defence attachés in British embassies to be reviewed with the aim of shifting the balance away from defence export promotion to monitoring the build-up of tension and military stockpiles, the end-use of British defence exports and defence diplomacy initiatives.

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Tax breaks on bribes and other corrupt practices

- the Government move swiftly to ensure full incorporation of the OECD Convention on bribery into statute, so that bribery of foreign officials is outlawed; and
- the Government encourage companies to set up their own codes of conduct and monitor the implementation of these codes regularly.

Distortion of MoD purchasing and other priorities

- the Government take steps to separate defence procurement from export promotion, in order to ensure that MoD procurement decisions are taken on the basis of defence needs and not industrial and employment considerations (see also recommendations for future of DESO above); and
- procedures be introduced to ensure that defence exports no longer influence decisions to enter into defence arrangements for any reasons other than British or international security.

Fixed costs

- the government consider leaving most military research and virtually all military development to the private sector, which can recoup such investments within the prices it charges;
- if MoD is to continue to have any clear involvement in R&D, its relationship with defence companies must be made more accountable to parliamentary and public scrutiny; and
- if military R&D is to continue to be associated with the public purse, all military R&D projects with a total value of more than £25 million require parliamentary approval prior to full-scale development and again prior to moving from development into production.

Employment

- the Defence Diversification Agency (DDA) be moved from MoD to the DTI, and the agency should be mandated to conduct a review of Britain's economic and industrial strategy to identify sectors where Government support should be most beneficial.
- the DDA develop an alternative research and capital investment agenda to shift industrial, scientific and technological resources away from military objectives and towards broader social and economic objectives;
- such a policy be driven by specific requirements or 'needs', like environmental restoration, renewable energy, public transport, housing and modernisation of infrastructure, which would be developed in a newly created Defence Diversification Council.

Offsets

- the Government work for an EU agreement to limit or ban offsets on any sales where only European manufacturers are competing for a sale, and at a minimum, ensure that details of offset packages are reported in Annual Reports required under the EU Code of Conduct on Arms Exports;
- all licensed production and co-production arrangements for defence equipment within an offset package themselves be licensed, with Government approval required before re-export of any finished product can take place. Controls should be agreed between governments and not companies. In short, the Government should take all possible steps to ensure that overseas producers do not export arms manufactured as part of an offset package to destinations to which the UK would not permit direct arms exports;
- the UK Government provides details of all offset packages regardless of value in its Annual Report and, where the offset involves defence technology transfer, explain why it is in the interest of the UK's national security to provide the recipient country with an independent arms production capability.

Broader Procurement

- the Government commission an independent study on future policy options for defence procurement and that such a study be published as a consultative document.