CANADIAN GLOBAL AFFAIRS INSTITUTE
INSTITUT CANADIEN DES AFFAIRES MONDIALES

2017 Defence Budget Primer

by David Perry

March, 2017

POLICY UPDATE

2017 DEFENCE BUDGET PRIMER

by David Perry
CGAI Senior Analyst
March, 2017

Prepared for the Canadian Global Affairs Institute
1600, 530 – 8th Avenue S.W., Calgary, AB T2P 3S8
www.cgai.ca

ISBN: 978-1-988493-22-0

On March 22, the Government of Canada will publish the federal budget, the second for Prime Minister Justin Trudeau. Ahead of budget day, here are some things to watch for on the defence front.

SETTING THE STAGE FOR THE DEFENCE POLICY REVIEW

The 2017 federal budget is particularly significant for the Department of National Defence (DND), as it will establish the fiscal framework for the forthcoming results of the Defence Policy Review. While defence budgets inevitably change with government priorities and fiscal fortunes, matching policy ends with fiscal means is crucial at the outset of any new policy. An examination of the last four defence reviews, stretching back to 1987, demonstrates that the budget will tell us most of what we need to know about the fiscal aspects of the new defence policy. Having a policy misaligned to the funding from the beginning will result in an undermined policy almost as soon as it is launched.

The last two defence strategies, the 2008 Canada First Defence Strategy and the 2005 Defence Policy Statement, were expansionist; they were built on the premise of increasing defence budgets. Between 2005 and 2011, adjusting for inflation, defence spending increased by 35 per cent, allowing the Canadian Armed Forces to increase its ranks by several thousand soldiers and initiating a major recapitalization. The 2008 financial crisis, along with the former Harper government's deficit spending and subsequent move to eliminate the deficit, disrupted and ultimately curtailed the defence budget's growth after 2011. However, the 2005 and 2008 defence policies were given the budgetary resources needed in their first several years.[1]

In fact, in each case, DND actually received the related funding before the government even published a policy. The long-term budget increase, upon which the Canada First Defence Strategy was premised, was set into the fiscal framework in the February 2008 budget, months before the strategy itself was published in June of 2008. Similarly, in 2005, the massive budget increase needed to enact the Defence Policy Statement was announced in that February's budget, two months before the policy statement itself was published in April. The recent pattern here is clear; if the government is announcing a defence policy predicated on a growing defence budget, DND will get the money in the budget first, and then publish a policy outlining how it will be used.

The defence policy that preceded these two, the 1994 White Paper, had a different thrust, as it was contractionist; it was built on the premise of a greatly reduced defence budget. But while the budgetary thrust of the 1994 defence policy was completely different than the policies in 2005 and 2008, its sequencing with the federal budget was not. Major cuts to defence were announced in the February 1994 budget, which outlined significant reductions of funding, personnel, infrastructure and equipment. The white paper published that December reflected this loss of funds. A further major tranche of reductions was published only two months later in the February 1995 federal budget, which had been developed in concert with the 1994 White

[1] Whether this funding was adequate is a separate matter.

Paper, but these only accelerated the fiscal direction for defence outlined the year prior. The efforts outlined in the 1994 White Paper to find efficiencies, shrink the military and curtail spending all had to be amplified because of budget measures published after the white paper itself, but the general budgetary thrust for defence remained consistent with the last budget issued before the white paper.

The 1987 White Paper stands as an outlier from the other three that followed it, as it did not reflect the budgetary direction provided that year. The defence policy itself was very expansionist. It promised 15 years of budgetary growth at a rate of two per cent above inflation (at a time when inflation exceeded four per cent), with a commitment of additional money to fund a major acquisition spree, which included plans to buy a dozen nuclear submarines. The intent of this policy was to close the commit-capability gap between what Canadian defence policy had committed DND to do and the inadequate funding the Finance Department had actually provided.

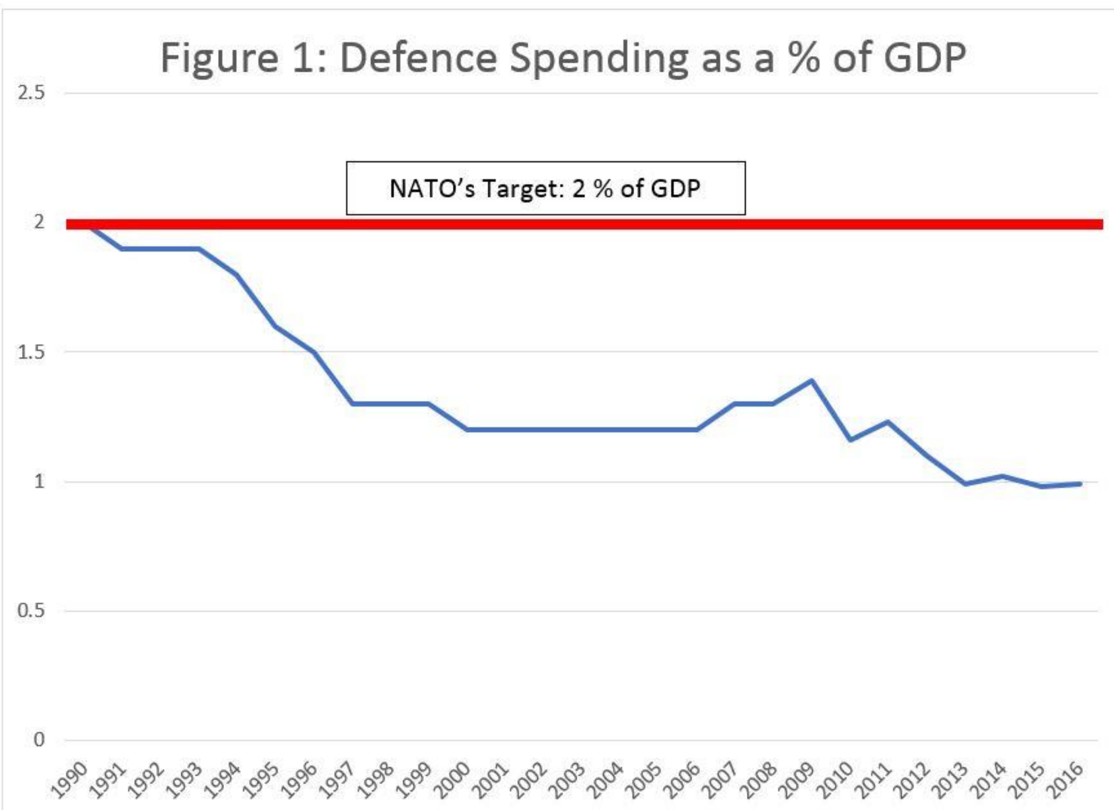
Unfortunately, the expansionist thrust of the 1987 White Paper, published in June, did not reflect the federal budget issued the previous February. While then-Finance minister Michael Wilson had increased the defence budget in the Mulroney government's first few years in office, he did not do so in 1987. In fact, in that year's budget speech, Wilson announced a significant deferral of defence funding into the future, and simply mentioned that a white paper would be forthcoming. This disconnect between the federal budget and defence policy in 1987 foreshadowed the white paper's exceptionally short shelf life. In less than two years the Mulroney government had gutted its defence spending plans and the submarine program was cancelled. Reflecting on the incredibly brief lifespan of the expansionist 1987 defence policy, political scientist Joel Sokolsky notes that then-minister of National Defence, Perrin Beatty, had "secured only tepid and conditional support from his cabinet colleagues, especially the Minister of Finance."

This short summary leaves two takeaways for the 2017 defence budget and defence policy review. First, the budget will likely provide a better indicator of the overall budgetary direction of the defence policy than the actual policy document itself. Second, if the outcome of the Defence Policy Review is an expansionist defence policy, and the minister of National Defence has indicated it will be, its short-term success depends upon getting the needed funding put into the fiscal framework in the 2017 budget. If the March 2017 budget offers no new funding for defence, but the Defence Policy Review is predicated on increased spending, this defence policy will likely go the way of the white paper published 30 years prior. If the minister of National Defence intends to close capability gaps, he needs to secure the funding first, not fight for it later.

CANADA'S NATO DEFENCE SPENDING TARGETS

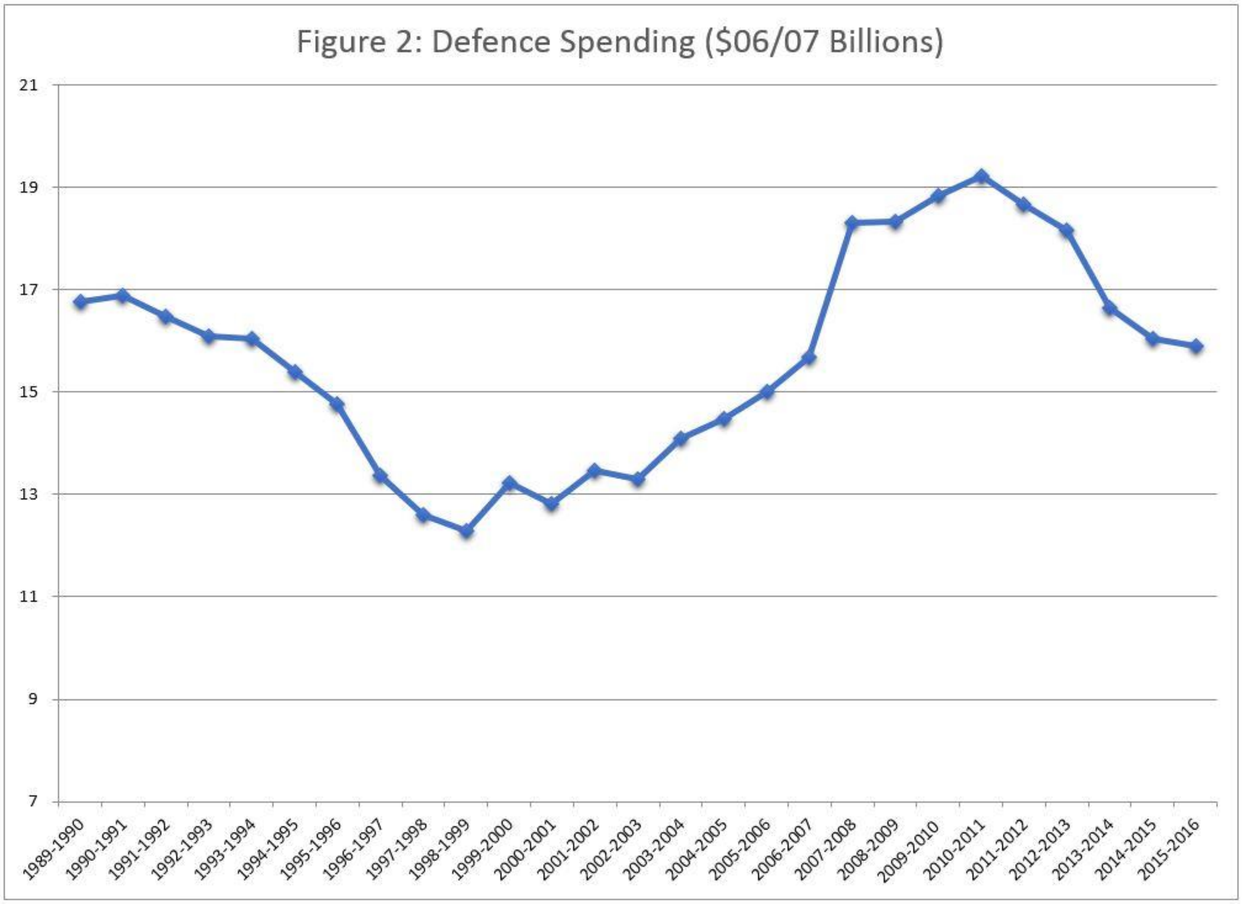
Ahead of the 2017 budget, there has been a surge in discussion about Canada's defence-spending commitment to NATO. The election of U.S. President Donald Trump has reinvigorated long-standing concerns about burden sharing within the NATO alliance, and especially allies' defence spending. Since 2006, NATO members agreed to spend two per cent of their GDP on defence, and spend 20 per cent of their overall defence expenditures on new equipment and related research and development. The alliance describes the two per cent target as an "indicator of a country's political will to contribute to the Alliance's common defence efforts." In a different vein, the alliance views the 20 per cent equipment-spending target as a "crucial indicator for the scale and pace of modernization." Furthermore, "Where expenditures fail to meet the 20 per cent guideline … there is an increasing risk of block obsolescence of equipment, growing capability and interoperability gaps among Allies." These targets were most recently reaffirmed at the 2014 Wales summit.

The value of these spending metrics as an indicator of Canada's support for the NATO alliance is debatable, and both prime ministers Stephen Harper and Trudeau have articulated a counter-argument publicly. Both argued that Canada's contributions to alliance operations, not the share of our GDP devoted to defence, is the basis upon which Canada's commitment to NATO should be judged. While that argument has merit, it would likely carry more weight if the share of our GDP devoted to defence were not in decline. As Figure 1 shows, as a share of GDP Canada's defence spending has been decreasing since 2009, and is now well below the level of spending reached during the 1990s' "decade of darkness." In longer-term perspective, aside from a brief increase between 2007 and 2011, the share of Canadian GDP spent on defence has been in decline for decades.



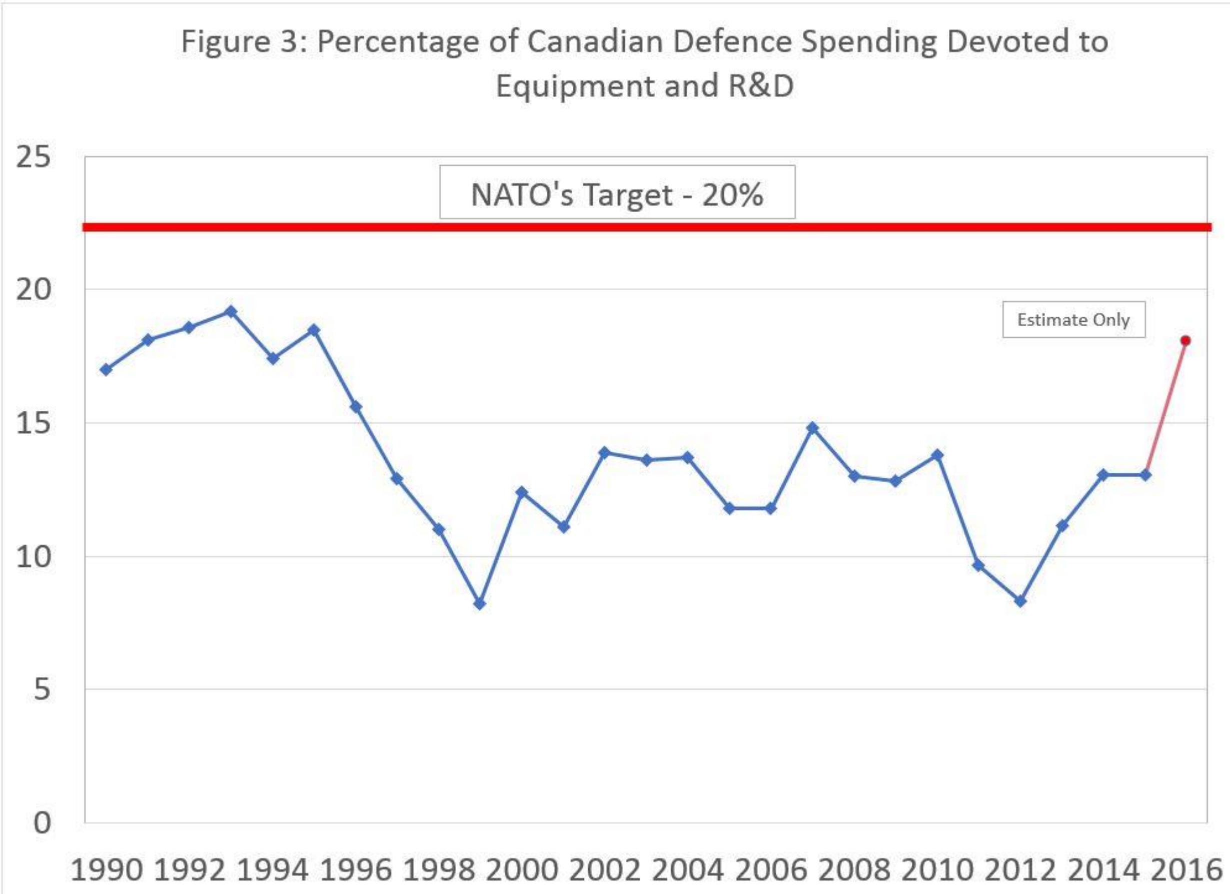
Source: NATO Defence Expenditures, various years.

While the share of GDP devoted to defence is a debatable metric for evaluating actual defence outputs, for Canada it happens to closely resemble the overall trend in actual defence spending. Adjusting for inflation, defence spending has been declining since 2011, and is now lower than it was in 2007, when the combined impacts of Harper's 2006 budget and Paul Martin's 2005 budget led to a sharp increase in defence funding.



Source: Public Accounts of Canada, Volume 2. Deflated using the Defence Economic Model.

Another qualifier to attach to the prime minister's arguments that Canada's defence contribution should be judged on actions and not spending, is that Canada's ability to act in the present is a function of spending in the past. Declining spending today will constrain Canada's ability to contribute to operations tomorrow. This is especially true of spending on new equipment, as it takes several years to translate expenditures on new kit into a useful military capability. This places an additional premium on Canada to spend adequately in this area, and as noted, NATO has set a target of spending 20 per cent of its budget on buying new equipment and related research and development. As Figure 3 shows, in this respect Canada has consistently fallen short of the 20 per cent spending-on-equipment target, as it has been able to devote only about 13 per cent of its budget to spending in this area in recent years. The most recent figures for 2016 — from the NATO Secretary General's Annual Report — show a significant increase in the share of the budget going towards equipment, to 18 per cent, but these are only estimates, not a reflection of actual spending.



Source: [NATO Defence Expenditures, various years.]

HINTS ABOUT SPENDING INCREASE

In the lead-up to the federal budget, there have been several hints that the Trudeau government might make additional investments in defence. When evaluating the information published in Budget 2017, it is important to consider that significant, additional future spending is already set aside in the fiscal framework for defence. DND is unique in the federal government in having a built-in automatic increase to its budget. Under the current arrangements, this additional funding, known as the defence escalator, gives DND several hundred million dollars of additional budget funding each year. Since 2008 and through the fiscal year ending March 31, 2017, DND has been receiving a compounding two per cent annual increase.

In the 2015 budget, the Harper government pledged to add another compounding one per cent to the escalator, increasing it to three per cent annually for a decade, starting on April 1, 2017. The Main Estimates for fiscal year 2017/2018 show that the Trudeau government has stuck to this plan, which is increasing DND's operating budget by $550 million for this fiscal year.

Any discussion about defence budget increases in the 2017 budget should be evaluated carefully to see whether they represent additional previously unplanned budget increases, or restatements of existing plans to increase defence funding which are already built into the fiscal framework.

CAPITAL EQUIPMENT FUNDING

One of the key areas to watch in Budget 2017 is the funding for defence capital purchases, which includes both equipment and infrastructure. DND continues to face two funding problems related to capital: i) in the short term, it is not able to spend the money it has, and ii) in the long term, it does not have enough money. In the short term, DND has not been able to spend money buying new equipment and infrastructure fast enough to use its accrual space, the room made available in the fiscal framework, to account for these purchases. As a result, last year's budget and two others before it have shifted these unused funds into the future — see Figure 4 for the cumulative impact of these shifts. The pattern to date has been that these shifts occur every two years, but it could happen again in Budget 2017.

Figure 4: Budgetary Reprofiling of DND Capital Funds ($B)

	11/12	12/13	13/14	14/15	15/16	16/17	17/18	18/19	19/20	20/21	Total
Budget 2012*	-0.40	-0.50	-1.300	-0.700	-0.300	-0.100					**-3.540**
Budget 2014**			-0.592	-0.575	-0.900	-1.075					**-3.142**
Budget 2016***					-0.205	-0.090	-1.319	-0.911	-0.684	-0.507	**-3.716**
Total	**-0.40**	**-0.50**	**-1.892**	**-1.275**	**-1.405**	**-1.265**	**-1.319**	**-0.911**	**-0.684**	**-0.507**	**-10.158**

*A total impact of $3.54 billion was announced in Budget 2012, Table 6.3, p. 236. The annual reductions depicted are those shown in Budget 2012, Table 6.3, p. 236, and do not sum to $3.54 billion

** Budget 2014 Table 4.1.1, p. 260.

***Budget 2016 Table 6.1, p. 204 and Information provided by Government of Canada Officials

In the long term (more than five years into the future), DND is facing a different problem of having insufficient budget room to purchase the equipment needed to deliver on current defence policy commitments. This funding shortage is in part the result of DND having two distinct sources of funds with which it can buy new equipment and build infrastructure. One is the accrual space in the fiscal framework, which operates using accounting rules that permit the annual budgetary impact of major purchases to be spread over their entire lifespan as a series of annual amortization charges. A $1 billion project with a 10-year lifespan using this source of funds, for example, would take up roughly $100 million a year in DND's accrual space. Consequently, the $1 billion purchase would consume $100 million a year of the defence budget for 10 years. National Defence also has a separate source of capital funds, in its A-Base budget, which gives it roughly $1.5 billion a year in Vote 5 capital funding. This source of funds uses modified cash-based accounting rules, however, which gives DND significantly less budgetary flexibility to buy very expensive items. Under modified cash accounting rules, the same $1 billion project with a 10-year lifespan would be charged in full to the defence budget in the year of the purchase. This means that the same $1 billion purchase with a 10-year lifespan would consume a full $1 billion, but only for a year.

Having these two sources of capital funding, or more specifically having an A-Base capital budget that uses modified cash account rules, reduces DND's ability to make major purchases because it does not allow for the budget impacts of big-ticket items to be spread over time. In the 2016 budget lock-up, government officials indicated that DND's budget model of having two sources of capital funds might be reviewed. Any change to these budget rules that would allow the cost of more major military purchases to be spread out over a number of years would provide a significant benefit to National Defence, as it would effectively allow DND to fund more capital projects than it can now.

About the Author

David Perry is the Senior Analyst and a Fellow with the Canadian Global Affairs Institute. He is the author of multiple publications related to defence budgeting, transformation and procurement. He received his PhD in political science from Carleton University, where his dissertation examined the link between defence budgeting and defence procurement. He was previously the Senior Security and Defence Analyst of the Conference of Defence Associations Institute and the Deputy Director of Dalhousie University's Centre for Foreign Policy Studies where he remains a Fellow. His research has been published in Defence Studies, Comparative Strategy, International Journal, and Journal of Military and Strategic Studies and he is a regular columnist for the Canadian Naval Review. He often provides comment for Canadian and international media on defence and security issues.

Canadian Global Affairs Institute

The Canadian Global Affairs Institute focuses on the entire range of Canada's international relations in all its forms including (in partnership with the University of Calgary's School of Public Policy), trade investment and international capacity building. Successor to the Canadian Defence and Foreign Affairs Institute (CDFAI, which was established in 2001), the Institute works to inform Canadians about the importance of having a respected and influential voice in those parts of the globe where Canada has significant interests due to trade and investment, origins of Canada's population, geographic security (and especially security of North America in conjunction with the United States), social development, or the peace and freedom of allied nations. The Institute aims to demonstrate to Canadians the importance of comprehensive foreign, defence and trade policies which both express our values and represent our interests.

The Institute was created to bridge the gap between what Canadians need to know about Canadian international activities and what they do know. Historically Canadians have tended to look abroad out of a search for markets because Canada depends heavily on foreign trade. In the modern post-Cold War world, however, global security and stability have become the bedrocks of global commerce and the free movement of people, goods and ideas across international boundaries. Canada has striven to open the world since the 1930s and was a driving factor behind the adoption of the main structures which underpin globalization such as the International Monetary Fund, the World Bank, the World Trade Organization and emerging free trade networks connecting dozens of international economies. The Canadian Global Affairs Institute recognizes Canada's contribution to a globalized world and aims to inform Canadians about Canada's role in that process and the connection between globalization and security.

In all its activities the Institute is a charitable, non-partisan, non-advocacy organization that provides a platform for a variety of viewpoints. It is supported financially by the contributions of individuals, foundations, and corporations. Conclusions or opinions expressed in Institute publications and programs are those of the author(s) and do not necessarily reflect the views of Institute staff, fellows, directors, advisors or any individuals or organizations that provide financial support to the Institute.