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Budget 2011 – Restraining Growth in Defence Spending?

A Policy Paper

By

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EXECUTIVE SUMMARY

DND's contribution to the government's deficit elimination goals will mean budget cuts of \$1.126 billion over the next three years.

The reduction of incremental funding for Canada's Afghanistan Mission will save \$3.608 billion over three years and achieve the necessary budget cuts without damaging the core finances of the Department.

INTRODUCTION

The Canada First Defence Strategy (CFDS) was tabled on June 19, 2008. Among its promises was “A Military with Stable, Predictable Funding,” which was to be delivered through a twenty year “new long term funding framework for the Defence Department,” which had not been the practice of previous White Papers and Policy Statements.

The framework included the promise of an increase in the annual inflation adjustment from 1.5% to 2%, plus a “Real Growth” adjustment of 0.6% annually for a total of 2.6%. The *CFDS* also forecast an increase in the total defence budget “from approximately \$18 billion in 2008-09, to over \$30 billion in 2027-28. In total, the Government planned to invest close to \$490 billion in defence over this period.” In addition, the Government committed to fund separately the incremental costs of any expeditionary deployments such as that in Afghanistan.

The *CFDS* also promised “A Military with the Right Equipment and Training.” The first new equipment tranche would include the already purchased four C-17 strategic airlifters, plus maritime helicopters, plus “17 new CH47F Chinook helicopters, three replenishment ships, 2,300 trucks, up to 100 Leopard 2 tanks and 6-8 Arctic/Offshore patrol ships.”

Further down the road the second tranche would add “15 ships to replace existing destroyers and frigates, 10 to 12 maritime patrol aircraft, 17 fixed wing search and rescue aircraft, 65 next generation fighter aircraft, and a fleet of land combat vehicles and systems.”

The *CFDS* also proposed to increase the Regular Force strength to 70,000 and the Reserves to 30,000.

The *CFDS* planned to allocate the total budget to the following categories:

| | |
|------------------|---------|
| Personnel – | 51%, |
| Equipment – | 12%, |
| Infrastructure – | 8%, and |
| Readiness – | 29%. |

Over the 20 year period personnel expenses would amount to \$250 billion; the first tranche of equipment purchases would account for \$15 billion of capital; the second tranche of major fleet acquisitions would account for \$20 billion; Infrastructure would account for \$40 billion and Readiness would account for \$140 billion.

PROOF OF THE PUDDING?

The Government followed up its challenging agenda by adding additional sums of money in the *Supplementary Estimates* of various years as well as making extensive use of a variety of sole-sourcing procedures in order to accelerate its equipment recapitalization projects.

These included the purchase of M-777 howitzers through the Foreign Military Sales Office of the United States government and the *Advanced Contract Award Notice (ACAN)*, which is a procedure in which the Government announces that it plans to award a contract to a supplier directly without a competitive bidding process, but allows any contractor who believes it has a competitive product to challenge the contract award and to seek a competitive bidding process.

Some contracts that involved “off the shelf” items, such as the C-17 heavy airlifters, went smoothly and quickly through the contracting process, whereas others, such as the CH-47 medium helicopters, which required some modifications to meet Canadian specific

requirements, took longer as the design modifications required the negotiation of more specific contracts.

A number of contracts were sole-sourced by means of an "Urgent Operational Requirement," particularly where the Canadian expeditionary force in Afghanistan was involved.

Competitive bidding, of course, is the normally expected acquisition model, but it sometimes doesn't work very well especially where items that are new and unique are involved, rather than "off the shelf," and price estimation is consequently difficult. The original Joint Support Ship project fell into this category and, while the process was a model of competitive bidding procedure, the result was a procurement failure as both bids were declared non-compliant.

Nonetheless, by the end of FY2010-11 the Defence budget had grown from the \$18 billion level cited in the *CFDS* to approximately \$21.8 billion, a figure substantially in excess of the approximately \$19.3 billion that a strict reading of the *CFDS* annual increases plan would have led people to expect.

It would seem then, that the Government met and exceeded its funding promises for the early years of the *CFDS* as well as the incremental funding needs of the expeditionary mission to Afghanistan which, by the end of the mission in 2011, had become a substantial addition to the core defence budget.

A CAVEAT: UNSPENT CAPITAL FUNDS

A problem with the Capital budget lay in the Department's inability to spend the money allocated to it for capital purposes within the FYs for which it had been allocated.

These unspent funds were substantial. In FY2009-10 the Government allocated a "Planned Spending" authority of \$4.971 billion to DND for capital purposes. However, by the end of the FY DND had been able to spend only \$3.343 billion, resulting in unspent funds of \$1.627 billion, or 32.7% of the capital budget. Indeed, in the five years from FY2005-FY2009 a grand total of \$2.930 billion of available capital funds remained unspent. Contract slippage seemed to be a major contributor to this spending shortfall, especially in the case of unique platforms, such as the maritime helicopters, or the revised JSS project.

While the figures for FY2010 will not be available until the publication of the Departmental Performance Report in Fall 2011, reliable sources have suggested that the pattern of unspent capital funds continued with a possible amount of unspent funds in excess of \$2 billion dollars.

THE FINANCIAL CRISIS OF 1978

As was the case with other governments, the Canadian government responded to the international financial crisis of 1978 by running a massive fiscal deficit initiative in order to stimulate the Canadian economy. By FY2011 the government concluded that no further stimulus was required and that the correct economic policy now called for a series of targeted spending cuts to eliminate the deficit and return the country to fiscal stability.

Simultaneously, 2011 was the year that the Canadian combat mission in Kandahar was scheduled to end and be replaced with a smaller and less expensive training mission.

The combination of the reduction of the mission and the intention of the government to reduce public sector spending left many in the defence community deeply worried about the future of the Defence Budget and the future of the *CFDS* itself

BUDGET MECHANICS

When we speak of *The Budget* we are really speaking of three separate documents. The first is the political document that is tabled in Parliament and is accompanied simultaneously, or shortly afterwards, by the *Main Estimates*. Taken together the two documents provide a one year forecast of the Government's spending plan.

The details of the business plans of individual departments comes later in the *Report on Plans and Priorities (RPP)*, which characteristically contains a four year planning horizon consisting of the FY that has just ended, the current FY that is just starting and the two future FYs that follow.

The Defence Budget 2011/12 *RPP* includes "Forecast" spending for FY 2010/11 and "Planned" spending for FYs 2011/12, 2012/13, and 2013/14.

DEFENCE BUDGET 2011/12

As had been feared, the Defence Department took a financial hit, reducing its budget by \$504 million from the \$21.803 billion of FY 2010 to the \$21.299.

This would be followed by budgets of \$21.689 billion in FY2012, down \$114 million, and of \$21.689 billion in FY2013, down \$508 million. The total reduction would be \$1.126 billion over the course of the three years.

THE DEVIL (ANGEL?) IN THE DETAILS

Closer analysis of the RPP, however, reveals a somewhat different outcome.

Table 1, at the end of this document, provides a breakout of total planned spending by Programme Activity and allows us to see what Activities are to bear the brunt of the lost \$1.126 billion.

For ease of analysis those Activities with significant cuts are highlighted in the table in red and those with significant increases are highlighted in green.

Five significant shifts stand out beginning in FY 2011/12. The first is a \$700 million reduction in spending on "International Peace, Stability and Security." This represents the reduction in the "incremental funding" of the Afghanistan Mission on the part of the government.

The next two are reductions of \$538 million for in Land Readiness and \$518 million for Aerospace Readiness budgets. These readiness cuts are presumably related to the drawdown of the Afghan mission as the requirement for new rotos to be trained for deployment to Afghanistan comes to an end.

The two remaining shifts are increases in the monies allocated for "Recruiting of Personnel and Initial Training" of \$763 million, and of \$807 million for "Equipment Acquisition and Disposal."

So, the \$504 million reduction in the Departmental bottom line has been "paid for" by the \$700 million reduction in Afghanistan incremental funding. Indeed, there seems to be effectively a real increase of \$200 million in the funds actually available to the Department!

Cynics might take the view that Budget 2011/12 is an intensely political document that permits the government to take the credit for apparently reducing the defence budget by \$504 million in the Budget year, while actually making significant increases in investment in

the “Future Force” by increasing funding for recruiting, basic training and equipment acquisition.

FUTURE YEARS PLANNED BUDGETS

A similar examination of the budgets for FY2012/13 and 2013/14 reveals a continuation of the reduction in the “incremental funding” for the Afghan mission, but a stabilization of the Recruiting and Basic Training, Land Readiness and Aerospace Readiness budgets.

The real winner though, is the Equipment Acquisition and Disposal Budget which reaches \$4,194 billion in FY2013/14, an increase of \$1.503 billion, or 56%, over that for FY2010.

In reality, the actual total for capital spending is considerably larger than that. Table 2 shows the Summary of Capital Spending by Program Activity and reminds us that each of the Program Activity areas is allocated a capital budget of its own for projects with a lower spending authority threshold than that of the main “Equipment Acquisition and Disposal” and “Infrastructure” Program Activities.

Adding in the capital spending authorities of the other Program Activities gives us a total capital budget of \$5.273 billion in FY2013/14 or 24.8% of the total defence budget.

THE CAVEATS

Two concerns remain: the promise of further growth in the defence budget that was made in the *CFDS* and the ability of the procurement system to deliver capital equipment in a timely manner.

The *CFDS* promised that the defence budget would grow “from approximately \$18 billion in 2008-09, to over \$30 billion in 2027-28.” Budgets 2010/12 show planned spending in the range of \$21.3 to \$21.7 billion – an essentially flat projection that reflects the “measures to constrain the growth in Defence spending.”

However, if we apply the promised 2.6% annual growth figure promised in the *CFDS*, compounded over the thirteen years between FY2013/14 and FY2027/8, we would still have a forecast figure of \$29.730 billion as opposed to the \$30 billion promised in the *CFDS* – close enough for government work.

Nonetheless, there remains the question as to whether the available monies over the next thirteen years will be enough to support the equipment acquisition programme that the *CFDS* envisaged.

Here the question is whether we can forecast the cost of future platforms accurately. We have already seen, in the case of the JSS project, one instance where we have not. And the series of wildly different cost estimates swirling around the F-35 JSF project doesn’t add to our confidence that we can do much better.

At the centre of our future costs estimate problem is the fact that defence equipment inflation rates are substantially greater than those of the larger economy and are driven especially by capabilities growth. Studies carried out by The RAND Corporation for the US Navy and Air Force have estimated the annual inflation growth for ships and aircraft run into the 7-12% range. Setting the RAND figures against the *CFDS* inflation estimate of 2% annually plus 0.6% growth leaves us with an uncomfortable feeling.

Closely related to the question of whether there will be enough money in the defence budget is whether the procurement system will move quickly enough to deliver the new equipment in a timely fashion.

Here the Canadian Association of Defence and Security Industries (CADSI) has argued for a single point of accountability for defence production and the defence industrial base within government, suggesting that it might be a separate agency attached to the Defence Department, as is the case with Defence Construction Ltd. Alternatively, it might take the form of a revived Department of Defence Production. Perhaps the appointment of Julian Fantino as Associate Minister of National Defence, with special responsibilities for procurement, represents an initial move in the direction of CADSI's eminently sensible recommendation.

SUMMATION

The Defence Department is expected to make a major contribution to the government's determination to eliminate the deficit by imposing cuts to government spending and has laid out a programme of reductions over the next three years. The current RPP shows cumulative cuts amounting to \$1.126 billion.

At the same time, however, the reduction of Canada's Mission in Afghanistan, and the reduced requirement for incremental funding to support it, provides the wherewithal to achieve the reductions listed in the *RPP* without damaging the core funding of the Department. Indeed, the relocation of funds within the Department allows a substantial increase in the Capital account.

**Table 1—RPP 2011/12—
Summary of Total Spending by Programme Activity Architecture**

| Programme Activity | Forecast 2010-11 | Planned 2011-12 | Planned 2012-13 | Planned 2013-14 |
|--|---------------------|--------------------|--------------------|--------------------|
| Resources are Acquired to meet Government Defence Expectations | | | | |
| Defence Science and Technology | 373,338 | 327,069 | 334,420 | 343,461 |
| Recruiting of Personnel and Initial Training | 653,758 | 1,416,719 | 1,390,338 | 1,377,324 |
| Equipment Acquisition and Disposal | 2,691,307 | 3,498,227 | 4,089,999 | 4,193,603 |
| Real Property and Informatics Infrastructure | 775,843 | 665,501 | 606,161 | 593,215 |
| Sub-Total | 4,494,246 | 5,907,516 | 6,420,918 | 6,507,603 |
| National Defence is Ready to meet Government Defence Expectations | | | | |
| Maritime Readiness | 2,001,206 | 2,188,533 | 2,260,119 | 2,183,647 |
| Land Readiness | 4,167,518 | 3,630,264 | 3,829,067 | 3,725,108 |
| Aerospace Readiness | 2,400,509 | 1,883,626 | 1,952,555 | 1,872,254 |
| Joint and Common Readiness | 2,325,417 | 2,237,251 | 2,340,639 | 2,273,152 |

| | | | | |
|--|-------------------|-------------------|-------------------|-------------------|
| Sub-Total | 10,894,650 | 9,939,674 | 10,382,380 | 10,054,161 |
| Defence Operations will Improve Peace, Stability and Security Wherever Deployed | | | | |
| Situational Awareness | 691,448 | 638,303 | 639,870 | 653,474 |
| Canadian Peace, Stability and Security | 394,647 | 282,628 | 287,759 | 296,368 |
| Continental Peace, Stability and Security | 197,835 | 197,907 | 204,418 | 212,045 |
| International Peace, Stability and Security | 2,732,893 | 2,027,838 | 1,404,882 | 1,159,337 |
| Sub-Total | 4,016,823 | 3,146,676 | 2,536,929 | 2,321,224 |
| Care and Support to the Canadian Forces and Contribution to Canadian Society | | | | |
| Defence Team Personnel Support | 671,649 | 762,395 | 785,094 | 811,715 |
| Canadian Identity | 346,767 | 354,351 | 352,020 | 358,985 |
| Environment Protection and Stewardship | 152,090 | 134,365 | 138,044 | 142,216 |
| Non-Security Support | 21,503 | 7,165 | 6,717 | 6,666 |
| Sub-Total | 1,192,009 | 1,258,276 | 1,281,875 | 1,319,582 |
| Internal Services | | | | |
| Internal Services | 1,205,426 | 1,046,937 | 1,066,558 | 1,092,815 |
| Sub-Total | 1,205,426 | 1,046,937 | 1,066,558 | 1,092,815 |
| Total | 21,803,154 | 21,299,079 | 21,688,660 | 21,295,385 |

**Table 2— RPP 2011/12—
Summary of Capital Spending by Program Activity**

| Programme Activity | Forecast 2010-11 | Planned 2011-12 | Planned 2012-13 | Planned 2013-14 |
|---|---------------------|--------------------|--------------------|--------------------|
| Resources are Acquired to meet Government Defence Expectations | | | | |
| Defence Science and Technology | 31,449 | 20,858 | 18,925 | 19,296 |
| Recruiting of Personnel and Initial Training | 9,338 | 2,610 | 2,367 | 2,414 |
| Equipment Acquisition and Disposal | 2,545,885 | 3,220,409 | 3,782,625 | 3,921,891 |
| Real Property and Informatics Infrastructure | 704,360 | 628,124 | 566,933 | 552,916 |
| Sub-Total | 3,291,032 | 3,872,001 | 4,370,850 | 4,496,517 |

| National Defence is Ready to meet Government Defence Expectations | | | | | |
|---|------------------|------------------|------------------|------------------|----------------|
| Maritime Readiness | 2,709 | 32,554 | 29,760 | 30,302 | |
| Land Readiness | 114,474 | 36,671 | 33,473 | 34,086 | |
| Aerospace Readiness | 88,047 | 33,062 | 30,292 | 30,826 | |
| Joint and Common Readiness | 197,953 | 176,309 | 198,477 | 205,895 | |
| Sub-Total | 403,183 | 278,596 | 292,002 | 301,109 | |
| Defence Operations will Improve Peace, Stability and Security Wherever Deployed | | | | | |
| Situational Awareness | 150,960 | 105,310 | 95,526 | 97,137 | |
| Canadian Peace, Stability and Security | 6,431 | 16,248 | 14,672 | 14,961 | |
| Continental Peace, Stability and Security | 5,352 | 3,180 | 2,909 | 2,961 | |
| International Peace, Stability and Security | 541,121 | 319,451 | 290,174 | 295,873 | |
| | Sub-Total | 703,864 | 444,189 | 403,281 | 410,932 |
| Care and Support to the Canadian Forces and Contribution to Canadian Society | | | | | |
| Defence Team Personnel Support | 15,580 | 21,254 | 19,313 | 19,684 | |
| Canadian Identity | 11,099 | 15,053 | 13,666 | 13,932 | |
| Environment Protection and Stewardship | 3,347 | 1,129 | 1,031 | 1,049 | |
| Non-Security Support | 78 | 105 | 95 | 97 | |
| Sub-Total | 30,104 | 37,541 | 34,105 | 34,762 | |
| Internal Services | | | | | |
| Internal Services | 63,865 | 32,248 | 29,350 | 29,928 | |
| Sub-Total | 63,865 | 32,248 | 29,350 | 29,928 | |
| Total | 4,492,051 | 4,664,573 | 5,129,587 | 5,273,247 | |

ABOUT THE AUTHOR

Brian MacDonald (Colonel, retired) is President of Strategic Insight Planning and Communications, and consults on international and domestic strategic and business security issues. A graduate of the Royal Military College of Canada and York University, he is a prominent media commentator on security and defence issues, counting over 1,200 television, radio, and speaking appearances. His international conference papers have included: Kings and Emmanuel Colleges of Cambridge University; the German Armed Forces University, Munich; the Beijing Institute for International Strategic Studies; the Shanghai Institute for International Studies; the International Society for the Systems Sciences in Atlanta; and the Atlantic Treaty Association in Budapest, Copenhagen, Edinburgh, Ottawa, Paris, Slovenia, and Washington. To date he has edited eighteen books and authored one, *Military Spending in Developing Countries: How Much Is Too Much?* (Carleton University Press, 1997).

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