

# What's Round Goes Around - Producing Turnover

## A Good Time to Invest in the UK Defence Industry

On 25th. February 2020, the Prime Minister, Boris Johnson, announced an integrated foreign, defence, security and international development policy review, that will cover Britain's place in the world, post her departure from the European Union (Brexit). It will collate the various requirements of several departments, so that a unified operational approach can be maintained across the whole of government. The government's claim is that this review will be far more comprehensive than those that have gone before and will result in Britain's defence forces being better structured to handle the perceived threats.

With a Prime Minister who has been quoted in the past as having said "there are no votes in defence" and with a very influential advisor who has been less than complimentary about the Ministry of Defence (MOD) and the defence industry in general, many defence observers and analysts have listened to the claims and are of the opinion that this review may become just another cost cutting exercise, which leaves the defence forces even more emaciated than they are at present. That may be the final result but there is justification for an in depth review of the MOD's procurement procedures and a positive outcome might be a ministry that is more dynamic and better suited to providing for the needs of the armed services. The Chilcot Report of 2016 stated that "The MOD is good at identifying lessons but less good at learning from them". Also, submissions to this review can claim with much justification that **there is case for more defence spending, not less**. An integrated review cannot be considered complete until it has fully considered the effect of investment in defence on the UK's industrial base and the resultant spin off into commercial activity. It should also take note, throughout the whole review that, **while our armed forces are the tip of the spear, our industrial base is the shaft that carries that tip to its target**.

The 2015 Security and Defence Review (SDR) required the MOD to include the promotion of prosperity as one of its objectives: "Seizing opportunities, harnessing innovation to strengthen our national security, and working with industry to ensure we have the capabilities and equipment that we need. **Our economic and national security go hand-in-hand**". Consequently, the Rt. Hon. Philip Dunne MP was asked, by the Secretary of State for Defence, to carry out a review of the contribution defence makes to the prosperity of the United Kingdom.

The Dunne Report was published in July 2018, eight months after the publication of the UK's Industrial Strategy in November 2017. That Industrial Strategy suggested a plan to bring together the different elements of the UK's industrial base, particularly in the high tech areas, in order to promote prosperity. Dunne reports that in 2015 no definition of prosperity was made but that by the time of his report the Treasury's Green Book, a set of procedures for judging the value of commercial contracts, had in fact produced one but not one that provided clarity across defence! The definition referred to social value and social welfare or well-being. For the purposes of his review therefore, Dunne took that to mean "the broad economic well-being of the United Kingdom and it's people". At the end of his report, Dunne listed 61 recommendations for the development of defence-industry interface, but of those he highlighted 6 as key. Those 6 key recommendations are taken as the subject headings below and will form the main discussion points of this article.

**1. MOD should take the opportunity provided by Brexit to look again at procurement process and culture, including discussion of approach to major procurements during the transition phase.**

Dunne suggests that, when looking at commercial contracts, the MOD may have been a little over zealous in its interpretation of the EU's competition rules. Article 346 of the Lisbon Treaty gives exemption from those rules for military equipment and thus the Type 31 frigate contract, for instance, did not have to go out for tender to foreign companies. The 3 proposed Fleet Support Ships (FSS) however are classed as merchant vessels, will be listed on the merchant ship register and will be crewed by merchant seamen. This classification gives those vessels certain operational advantages over warships but based upon a pure interpretation of EU competition rules they will not be exempted under article 346 and thus the contract for their build must go out for international tender.

With UK's exit from the European Union on 31st. December 2019 and her release from the bulk of that union's treaty obligations on 31st. December 2020, article 346 no longer needs to apply and the MOD should be free to ensure that those ships are built in Britain, to the benefit of the UK industrial base. The release from article 346 frees up procurement potential right across defence and this should be fully capitalised to support British industry.

Sir John Parker's review, published in November 2016, for the proposed ship building strategy, mentioned a lack of pace from the MOD, when pursuing commercial contracts and the delivery of equipment to the military. A review of procurement procedures, in the wake of Brexit, should be used to ensure that the inertia which often seems to be inherent in large government organisations and which may have become institutionalised in the MOD, is rooted out so that contracts do not get bogged down in process. That this has already started is apparent when considering the advancement of the Type 31 frigate contract, compared to that of the Type 26, but as will be seen from comment in the later points of this article, there is still some way to go.

## **2. Proposal for MOD to commission academic work on the UK tax take from Defence work.**

On 12th. May 2020, the House of Commons Defence Select Committee, held an on-line investigatory discussion, on the subject of "Defence Industrial Policy, Procurement and Prosperity". It was chaired by the Rt. Hon. Tobias Ellwood MP, chairman of the said committee, and had a panel to answer questions, made up of Professor Trevor Taylor of the Royal United Services Institute (RUSI), Francis Tusa, a defence analyst and editor of the monthly news letter Defence Analysis, and Lieutenant General (Rtd) Sir Mark Poffley. Later in the discussion, those three panellists were replaced by Philip Dunne himself. Facing them, to pose the questions, was an array of people with interest in the defence establishment.

Several items of interest came out of that discussion, which warrant further attention, and one of them was the tax take from defence work. Francis Tusa said that he had calculated the immediate tax return from the Queen Elizabeth (QE) carrier contract, which did not include secondary taxation from the likes of the corner shop etc., he then cut his findings in half and was left with a 20% return. Prof. Trevor Taylor of RUSI, later in the discussion, pointed out that their calculation showed a tax return of between 30% and 37%. Further to their statements, Andy Askham of Woodbank Marine, a Liverpool based marine technical and project management consultancy, has stated in an article published in this edition of the Pro Patria journal, that from commercial ship building projects, 35% of the costs are remitted in tax to HMRC. Thus it can be deduced from those three statements that one third of the up front costs of defence contracts, when they are pursued and carried out within the UK, are returned to the Treasury. This means, for instance, that the cost of £6 billion often apportioned to the QE carrier project was actually only £4 billion when the initial tax returns are taken into account and, had the government not procrastinated in their build, they would have been completed for the original estimate of about £3 billion. Each carrier would then have cost, after the

deduction of tax returns only £1 billion each, which compares favourably with that of a large and sophisticated cruise liner. Further to that, if we look at the proposed budget of £250 million for each of the Type 31 frigates, which many people claim is unrealistically low, with one third of the cost being returned to HMRC, up front cost can climb to £375 million and the project will still come in on budget.

Those returns do not include secondary taxation from, as Tusa mentions, the corner shop! VAT payments are due on most goods and services with the main levy being 20%. Presently much of that VAT is remitted to the EU, with the percentage being as high as 75% on some items. This is a direct tax on UK citizens when they buy goods or pay for services and is a drain on the economy. More than 50% of goods imported into the UK come from outside the European Union (EU) and they are subject to EU defined import tariffs. 80% of this import duty is remitted to Brussels as a part of the UK's contribution to the EU (20% is retained as an administrative cost for collection etc.) and this is another tax on the UK populace, which again is taken out of the system. Post 31st December 2020, any import tariff on goods and possibly services, from both outside and inside the EU, can be tailored exclusively and specifically to UK requirements, and will remain in the British economy to help produce turnover and prosperity.

Primary and secondary tax returns to the Treasury are not the end of the benefits gained from investing in defence. The defence industry is generally hi tech. The skills which that industry requires and develops in the working population doesn't all stay in defence. People move on and take those skills with them. One could consider this a form of vocational adult education which benefits everybody. They migrate to other industries and help to develop them, which again produces a tax return for the treasury. Many of the companies that accept defence contracts also work in the civilian sector and that defence work helps them to sustain the skills base which they then use to attract commercial work; again, a tax return. Further to that there are the export deals that those companies will attract, for both defence and pure civilian contracts, which will produce another tax return, as well as an injection of foreign currency into the UK economy; but more of that in section 3 below. With all of these people working, they are not being supported by the welfare budget, resulting in less need of treasury support for that government department.

The message of returns to HMRC from expenditure within the UK is of course recognised by the treasury and in fact, their Green Book states that when considering the approval of government contracts, **the net value (or cost) must be taken into account**. To this end I have been advised that the major defence contractors provide an estimate of tax returns as part of their submissions for government contracts. This information can inform fairly accurately on the returns from Primary taxation (after all, those firms deduct much of the tax from the work force under PAYE), and the VAT collected from their dealings with suppliers etc., but it can only be a rough assessment of what comes from secondary taxation and other benefits to society as a whole. The information is sent to Defence Equipment & Support (DE&S) at Bristol (a department of the MOD), who then send it on to HMRC. However, I understand DE&S are grossly under resourced and at times lack the dynamism required to keep up with commercial requirements. Also, the general feeling of the panel answering questions at the Defence Committee discussion in May was that, when considering the funding of defence contracts, not enough emphasis was being placed upon tax returns to the treasury and the benefit to UK society as a whole.

That our continental neighbours have appreciated these benefits and act to fully incorporate them into their defence procurement strategy, was highlighted by Francis Tusa. He stated that it is not difficult to calculate the returns and benefits that accrue from defence spending and that the French, Italians and Germans give it considerable weighting when deciding upon defence expenditure. He said that the difference between them and us is that "they do it", while we only talk about it. To emphasise this point, President Macron of France is quoted as telling President Trump of the USA,

that France would increase her defence spending in line with the NATO 2% minimum but that he (President Trump) should not think that they (the French) were going to spend that money supporting the American armaments industry. Therein lays the rub, if you buy your military equipment from abroad, none of the above mentioned benefits feed back into UK Plc. The money has to be spent in this country, supporting our industry!

It can be seen from the fore-going that the proposal for the MOD to commission an academic study on the tax take from defence work is extremely valid and that it is actually long overdue. This should be recognised by the present review and become one of their prime recommendations.

### **3. Need to seek greater co-ordination across MOD's relationship with industry.**

While interviewing Guy Platten, the CEO of the UK Chamber of Shipping, defence writer Mark Lane realised that, "Naval procurement doesn't happen, and the Royal Navy doesn't exist, in a vacuum; but they both have impacts beyond the military sphere".

In the article that Mark Lane wrote following that interview, he points out that, "In 2008, a newly revived Cammell Laird on Merseyside won a Ministry of Defence contract to overhaul the Royal Fleet Auxiliary ship RFA Fort Rosalie and two years later it received a contract for the flight decks of the new aircraft carrier HMS Queen Elizabeth. Two years after that complete ship building returned to the yard with two car ferries". He quotes Platten thus "five years ago we weren't building any commercial ships in the UK and now we are; in my opinion, part of that is due to things like the carrier program, sustaining that background of skills. Programmes like that help to keep that skills base going and allow for some expansion. What they are doing at Cammell Laird and what they are doing elsewhere are examples of where we haven't quite lost those core skills. What we need is a sustainable, over all maritime offering; which, to me, does also include an element of shipbuilding".

Lane also quotes from the Engineering Employers Federation (now Make UK) guide to the Successor submarine programme, "The companies that form part of the Successor programme supply chain, both large and small, will also be able to capitalise on the advanced technologies, skills and capabilities they develop as part of the programmes as they seek to grow their businesses across a range of industry sectors".

The above mentioned article highlights just one aspect of the skills base that military contracts help to sustain and which spill over into the commercial sector. Without such contracts skills fade and eventually disappear, making further military procurement extremely expensive. As an example consider the Astute submarine programme at Barrow. BAe had not built a submarine there for 10 years, the skill base had withered and expensive assistance had to be brought in to keep the programme on track. Also do not forget that the MOD recently paid £635 million for 5 Batch 2 Offshore Patrol Vessels, that the navy did not really need, at a cost 3 times that of what it should have been, just to keep that skill base alive on the Clyde, so that later they could build the Type 26 frigates!

In the defence Select Committee discussion on 12th. May, the effect of Sir John Parker's report for the ship building strategy was mentioned. Lt. Gen. Poffley commented that we didn't have a ship building strategy, we had a "warship building strategy" and that the contract for the Type 31 frigates was an attempt to follow that strategy and adopt Sir John's recommendations. When asked if the MOD actually had a strategy for interfacing with industry, he said not unless there was one sculling around in a cupboard somewhere, that he was unaware of; and this from a man who was the Commander of Force Development and Capability in 2014-2015, Deputy Chief of the General Staff

in 2015, and Deputy Chief of Staff (Military Capability) 2016-2018. So we can assume that he knows what he is talking about!

An over-riding requirement of military procurement, is that, regardless of from where equipment is purchased, it must be fit for purpose and provide our front line forces with the kit to do the job. However, once that requirement has been met, it is important to ensure that, as far as possible, our home industrial base is supported and nurtured. I draw your attention back to the tip and shaft analogy, in the last line of this article's 2nd paragraph. Without industrial back-up our armed forces will be much reduced in capability, our foreign policy options will at times be hampered and, without that sovereign capability, government room for manoeuvre in the international theatre will be reduced. As an example of what that can mean, consider the recent situation, where the German government, because they disagreed with the way Saudi Arabia was pursuing the war in Yemen, stopped the UK from selling Euro fighter Typhoons to that country. They were able to do this because Typhoon is not a totally UK sovereign product.

Another example of how a hollowed out industrial base can adversely effect military operations was relayed to me a number of years ago. I was told that when the UK embarked upon the 2003 Iraq war, the MOD placed an order for 50 Raptor aerial reconnaissance pods, which were to be carried by the RAF's Tornado GR4 aircraft. The company receiving the order realised that they could not comply with the very tight time frame but accepted the contract anyway. Eventually a reduced number of Raptors did make it into service in time to be used during that war. This resulted from a policy of 'Just in Time Delivery', where a company is expected to retain a capability but not produce, at least not in any great volume, until the call comes through from the MOD, who will want the goods 'Yesterday!' Maintaining that industrial capability, without production and the resulting revenue flow is very expensive, it is corrosive on a company's skills base, and in the commercial world it is a nonsense.

That a proper strategy is needed to fully interface the military with industry is realised by just about everybody involved. You only have to look at the outcomes of the 2015 SDR, the Chilcot report, the government industrial strategy, Sir John Parker's report, the Dunne report and the various findings of the select defence committee, to realise that. Additionally, there has been much comment over the years of a mismatch between the requirements of various elements within the defence establishment and indeed in the interface of government departments that influence and impinge upon that establishment. That moves are in place to correct some of these weaknesses is apparent, but that afore mentioned inertia of large organisations is still in play, and the moves appear to be a drift rather than a drive!

If this review results in the bringing together of those different requirements and gets the interested parties working cohesively, even if it requires the metaphoric banging together of a few heads, it will have done this country a great service. The development of a proper working strategy between the military (MOD), industry and the other government departments that are either directly or indirectly involved, should be one of its main aims. If however, it really is a cost cutting exercise, then it will fail the nation and we will all be poorer and weaker for its passing.

#### **4. Incentivise MOD's high-profile training institutions to market their paid services more widely.**

The UK's armed forces are respected around the world. Not for their size, power and reach, which in many respects is now lacking, but for their professionalism. Two years ago, I was taken on a conducted tour of HMS Sultan, the Royal Navy's engineering training establishment at Gosport, Hampshire. What an excellent and impressive facility. Plenty of space, filled with first class

equipment, used by first class instructors, to train young people, many of whom become first class engineers and artificers. The only down side was that it was mostly empty of students! With the ever reducing size of our armed forces, facilities like HMS Sultan appear too large to be justified on cost grounds. With training establishments such as Sultan however, cost cannot be the only consideration for their existence. The military are basically a contingency service to protect us all and our way of life. They are the fire engine that we hope we will never need and hardly ever do, but we are loath to get rid of it, just in case. Sultan, and training establishments like it, may be under utilised at the moment, but when the call comes to again expand our military foot print, as I believe it eventually will, they will repay the investment in them, with dividend. Having to train and expand the armed forces in the face of a rapidly growing or, worst still, an immediate military threat is bad enough but if first you have to re-establish the training facilities and train the instructors, that task becomes so much more difficult and time consuming. Time that you might not have. Even with the reduced size of our armed forces it is imperative that the MOD's training establishments and their teaching staff are retained. It is they that will allow for a resurgence when that need arrives.

MOD establishments already train many over-seas military students. This brings in foreign revenue and helps to sustain those teaching venues. It also bonds alliances; a foreign policy benefit. Philip Dunne is correct in suggesting that the MOD should market their services more widely. This will help to keep them fully operational and able to react positively should the call come again to support a greater UK military force. There is potential however to market them within the UK and in civilian circles. The MOD already encourage and support STEM (Science, Technology, Engineering and Mathematics) courses through our colleges and universities. This support could be further expanded by encouraging some of those students, who may have no aspiration of following a military career, to undertake a short (or prolonged) training course at an MOD establishment. These young people would utilise otherwise unused capacity, see a different side of life, and would develop people as well as technical skills, that they might not otherwise acquire from purely civilian establishments. Those skills will accompany them in their future endeavours and generally benefit the country and industry as a whole.

In addition to those already embarked on an academic and technical training process, the military recruit young people who have no formal qualification and in fact some that are almost illiterate. Without support and direction, many of these would become the lost souls within our society, dependant upon social handouts. A training course in a military establishment could be the lifeline that these young people need. They need not have to follow the course with military service, although some might choose to do so, but the skills they gain, like those acquired by the more academically adept students mentioned above, will help them to develop into well rounded citizens, with something to offer industry and society in return for the investment in their further education. An investment that can be justified under the requirement for social value and social welfare or well-being, in the treasury's green book.

Occasionally a call is heard to re-establish some form of national service because it is thought that our young people would benefit from that. Many shy away from that suggestion however and the military themselves are wary of having their professional force watered down by a mass of people who have little interest in the service. For pure training purposes however, a requirement to undertake some form of instruction at a military establishment could be written into the conditions for receiving certain welfare payments. Above all, what military type training gives the student, which is often lacking from civilian establishments, is personal structure, self discipline and a certain amount of self esteem. That can only benefit the individual, the business they work in and may eventually run, and by default, the whole of industry and society in general.

## **5. Look again with Her Majesty's Treasury (HMT) and Her Majesty's Revenue & Customs (HMRC) at reducing the burden of VAT administration.**

VAT is not the only tax issue that needs looking at with HMT and HMRC. The tax return in its entirety needs to be researched and the amounts calculated should be at the forefront when assessing the cost of military procurement projects. Thus, in accordance with Net Value, laid out in the treasury's green book, the true cost of a programme is the one that should be used.

There are other issues between the three departments, MOD, HMT and HMRC, that also need to be looked at, because it is apparent that there is a mismatch in how they relate to each other, particularly between the MOD and the treasury. In fact, the review may find that many of the failings laid at the MOD's door can in fact be traced back to the treasury and their operating procedures.

A couple of years ago, someone who had previously been seconded from the army to work with the MOD on a procurement project, told me that he became frustrated, with what Dunne has described as a lack of pace. He further said that he was not alone in feeling that way as many military personnel, who like him had been tasked to work with that department, had felt similarly dissatisfied. When he asked why the department proceeded at such a slow pace and seemed exceedingly, even excessively, cautious in how they progressed with a project, he was told that experience had taught them that it was the best way to proceed. I suspect that a large part of that caution and the afore mentioned inertia, stems from the way the treasury has, for its own accounting purposes, at times withheld funds when they are needed to persecute a certain financial requirement in a large commercial contract.

In his report for the ship building strategy, Sir John Parker suggested that when a large building contract was signed, the money for that project should be ring fenced, so that it is immediately available when require. Many of those contracts (possibly all of them), require a percentage of the final sum to be handed over when certain waypoints in the build program are reached. If that money is not available, the project will stall, slow down and may even stop until the cash is handed over, and the costs will increase as the time frame is stretched out. Dunne has said that "landing and spend within end of financial year can lead to inefficient use of resources. Some flexibility over year-end processes for large individual capital procurements might reap efficiencies". Build projects do not follow the financial year and artificial accounting restrictions, just to keep the books straight, when they halt the flow of money, will invariably induce cost and time over runs, for which the MOD will get the blame, but the reality is that it is the treasury's fault.

If this review really is integrated, in that it looks across departments, then it should analyse in depth, the interface between the MOD and the treasury.

## **6. MOD to continue public information on its regional economic impact.**

Within our society there are many detractors of defence. They vary from the pure pacifist element to those who think that money spent on arms is money lost and that it should be spent elsewhere. There seems to be a common perception that the defence budget is huge. Whenever the cost of a particular project is made public, the cries always go out, "how many schools, hospitals, doctors, nurses, policemen etc. could we purchase with that wasted money"? In fact the defence budget is only one quarter of the welfare budget, one third of the NHS budget and it is only two thirds the size of the education budget. The people in those other services however, especially the two largest, are never slow to shout about how short of cash they are and the media are very quick to pick up their call. By comparison the financial plight of the armed services is very muted and is

usually put down to inefficiencies within the MOD; often without justification. As previously mentioned the defence industry tends to be hi tech. It is an innovator, a technological power house within our industrial base and as such an initiator of further industrial and business activity, that produces turn over beyond the initial outlay from the treasury.

Dunne is right in saying that the MOD should publicise information on the regional impact of its activities. How it directly employs 100,000 people in this country, with the spin off supporting many more. The people working on the submarines at Barrow, the ship yard workers on the Clyde and at Rosyth, those within British Aerospace and many other companies directly involved in the production of military equipment know it, but the companies that supply the toilet paper in the toilets of those establishments? They are all in the defence industry supply chain and they should be made aware of it. It is time for the MOD to start blowing its own trumpet and informing the public of the facts. When the facts are widely known, then there may be some votes in defence!

### **Conclusion:**

An integrated review, one that crosses all government departments, merges their different requirements and gets them working as one team, is long over due. In the past, defence reviews have appeared to be narrow in that they have concentrated primarily on defence procurement, manpower and the tasks the military might be called upon to undertake. How the MOD have related to industry in general and the restrictions the treasury put upon the working relationship between the two, seems to have only lightly been touched upon. This review covering the Foreign Office and International development, as well as Defence and Security, is set to run parallel to the spending review and to conclude at about the same time. Let us hope that it is able to dig deeply into issues mentioned above and come out with a set of rulings that enable the MOD to develop a proper working relationship with the UK defence industry; A Strategy.

This strategy, which must have the treasury as one of its main supporters, should ensure that where ever possible, military equipment is sourced from within the UK, using the UK supply chain and employing British workers. Evidence of the returns to the UK exchequer, from such a strategy, are clear to those who wish to look. The spill over to commercial activity can be seen as considerable and the social benefits huge. When all of this is taken together it will be seen that the net cost of such a process can be no more expensive and in many cases (probably most) less so, than purchasing equivalent equipment from abroad; from which there is no, or very little return to the treasury.

It can also be seen from the foregoing that, defence projects are not as expensive as the up front costs suggest and further to that, the money pumped into the UK defence industry is a great producer of turn over, which stimulates further growth, prosperity and well-being. As the UK economy recovers from Covid-19, it will act as a metaphoric dynamo that get the lights glowing again.

There is one final point and word of caution; we do not have a crystal ball. Don't try to define too tightly where the threats lie because we won't know them in their entirety. Operational flexibility is a potent weapon in its own right but ensuring that we have that will carry a cost, which we must pay. It has been said many times that the next fight will always be the one we don't expect. So remember, when that fight comes, the votes for defence will be the only ones that matter!

Jock McCody  
A member of DefenceUK.