Budget and Management Program

ASPI
AUSTRALIAN STRATEGIC POLICY INSTITUTE

Sinews of War

The Defence Budget in 2003 and How We Got There

AN ASPI POLICY REPORT

Sinews of war—endless money
Cicero

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Roman coins. © AUSTRAL

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The Defence Budget in 2003 and How We Got There

AN ASPI POLICY REPORT

Prepared by
Dr Mark Thomson
Program Director
Budget and Management Program

'Nervos belli, pecuniam infinitam'
(Sinews of war—endless money)

Marcus Tullius Cicero, 1st century BC

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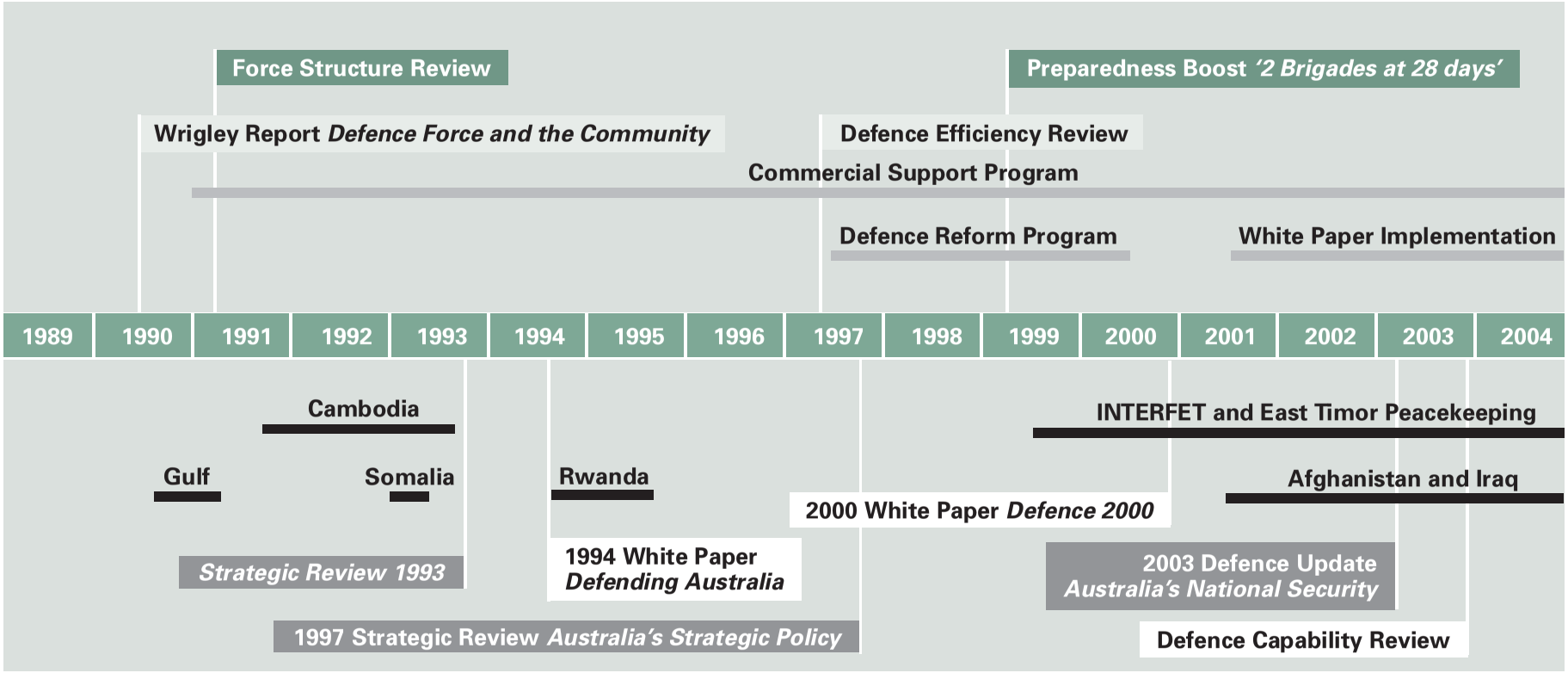
Defence Time Line



Note: All years are actual calender, not financial, years

Director's introduction

For two years now the Australian Strategic Policy Institute (ASPI) has produced an in-depth Defence budget brief titled *The Cost of Defence*. These publications are weighty tomes; the first edition came in at 145 pages and the second at 200 pages. They are also produced very rapidly with only a little over two weeks between budget night and launch day. Our motivation in producing so detailed an analysis so quickly is to support parliamentary scrutiny of the Defence budget the following week. Based on the experience of two years we think that *The Cost of Defence* has proven to be a useful, and to some extent influential, publication. But it remains a specialist document which is too long and detailed for most readers. That's where this report comes in.

This policy report aims to distil the key issues from the 2003 Defence budget in a way that is accessible to all. This is no easy task. Defence is one of the largest and most complex of enterprises in Australia, and its workings are shrouded by the limitations imposed by security, the inherent complexity of the issues, and a reluctance by officials to disclose information. It's worth making the effort to understand the issues involved because there are matters of public, and ultimately national, interest at stake.

In the coming financial year Defence will spend some $15.8 billion of taxpayers' money. The sheer scale of spending is more than sufficient to warrant close public attention. But the business of Defence is more important that just the dollars involved. The strategic challenges faced by Australia are as complex and serious as any time since Vietnam. Central to meeting these challenges is the effective use of the defence dollar. Indeed, while a clear and well-articulated defence policy is essential, it comes to naught without assurances that defence spending is aligned with that policy and achieves the goals sought. That's why we've produced this policy report.

This report builds on the previous two *Cost of Defence* budget briefs and we are therefore indebted twice over to the many contributors and others who helped make them possible. Our thanks go out to them all, and also to those who took the time to offer comments on draft versions of this report. In particular, Defence was kind enough to offer some valuable comments and clarifications. Of course, this does not in any way imply that Defence endorses this document or even supports its conclusions.

My thanks also to Dr Mark Thomson, who is the Director of ASPI's Budget and Management Program, and the author of this report.

Finally, the views expressed in the following pages are not to be taken as expressing the views of ASPI as an institution. Responsibility for any views lies with myself as Director and Dr Thomson.

Hugh White
Director

Defence Senate Estimates, November 2002. L to R: Defence Dept Secretary Mr Ric Smith, Defence Minister Senator Robert Hill and Chief of the Defence Force General Peter Cosgrove. AAP/Alan Porritt © 2002 AAP

Executive summary

This financial year over $15.8 billion will be spent in pursuit of what the budget papers describe as the 'defence of Australia and its interests'. This is an increase of $1.2 billion on the previous year, and includes additional funding for extra military personnel, an expanded Special Forces capability, increased security at Defence establishments and the cost of the ongoing Iraq deployment. But the largest initiative by far was a $1.1 billion boost to logistics over five years. This all adds up to a greater emphasis by the Government on an Australian Defence Force (ADF) that is ready and able to respond to the challenges of today. This is hardly surprising, given a strategic environment that sees a decision to deploy to Soloman Islands, and discussions on how to deal with North Korea, before the last troops are welcomed back from Iraq.

While spending is going up on the here and now, the opposite is occurring on investment to build the ADF of tomorrow. Only two budgets out from the 2000 White Paper the much lauded 10-year program of capital investment set out in the Government's Defence Capability Plan (DCP) looks decidedly shaky: $210 million worth of spending has been deferred over the last two years and another $642 million 'rescheduled' from the next four. Defence has also underspent the funds available for investment by around $200 million for two years in a row. Given the annual $4 billion size of the investment budget this is not (yet) a wholesale scaling back. However, if left unchecked, it could eventually mean a death by a thousand cuts for the Government's plans for the future ADF. Even now it means that some capability gaps will emerge as equipment planned for in the White Paper inevitably arrives late.

The reduction in planned capital investment does not reflect a reduced commitment to defence spending by the Government. In fact, all indications are that the money is available—if only Defence can provide an assurance that it will be spent. Unfortunately, the situation with the DCP is more serious than the issue of whether Defence can deliver it on

time. Escalating costs mean that we can't afford the capabilities sought with the funds set aside, and the changing strategic environment has sparked a debate on the force structure priorities that underpin it. Thus, as it stands, the DCP is undeliverable, unaffordable and uncertain. Accordingly, the Government has promised a review of the DCP due in October this year. This will be no mean feat.

If the issues with the DCP were not enough, Defence has had major problems with managing its budget over the last two budget years. The situation became chronic in 2001–02 when $777 million accumulated in the bank and administrative overheads grew to unsustainable levels while the Services went short of money for logistics. This reflects lax budget discipline and a failure to effectively allocate funds to priorities.

This year's budget shows encouraging signs that greater fiscal discipline is in place and that steps are being taken to improve financial management more broadly. But it will be some time before these initiatives take effect and, in any case, they may be something less than a complete solution.

…the DCP is undeliverable, unaffordable and uncertain.

There are three imperatives arising from this year's Defence budget:

Imperative 1: Deliver new capabilities on time

Over the last two years Defence has had a program in place to improve the delivery of major capital equipment projects. Yet in late 2002 the Government appointed an external 'Procurement Task Force' which, presumably, reflects dissatisfaction with the progress being made from within. The task force is scheduled to report later this year. The Government should move quickly to consider its recommendations.

Imperative 2: Continue to improve Defence management

Defence is working to improve its management information systems and budget processes. In doing so there are three things to be achieved as a priority:

- **Improve the understanding of the cost of capability.** Many of the problems faced today by Defence result from an incomplete understanding of the cost of acquiring and operating military capabilities. This impedes forward planning and justifiably undermines confidence in Defence's ability to manage its business.

- **Establish financial discipline then move to increase efficiency.** The current initiatives to reinstate tight fiscal control in Defence are appropriate. Once this is complete the next step should be to seek efficiencies in the same way as any private firm strives for increased productivity.
- **Enable and demand accountability.** Within Defence the responsibility for delivering military capability is all too often separate from the control of the resources needed to do so. Responsibility and control need to be aligned so that accountability for results can be firmly assigned.

Imperative 3: Sort out the DCP and the strategic policy that underpins it

The review of the DCP, or the Defence Capability Review as it has come to be known, needs to do far more than just juggle the current set of projects into a new package. To be credible the review must provide an achievable program of capital investment underpinned by a clear statement of our strategic and force structure priorities. This needs to be accompanied by a renewed funding commitment that covers the cost of both the current force and investment in the future force, and is based on credible (and hopefully enduring) cost estimates.

CHAPTER 1

Headlines and highlights

For the second year in a row the Treasurer began his budget speech this year with defence rather than the traditional focus on economic issues—even this year's tax cuts had to wait their turn. This is not surprising. National security has been, and remains, the key issue of the day. It's only been four years since Australia led the INTERFET deployment to East Timor, three years since the Defence White Paper, two years since the terrorist attacks on September 11, 2001, and less than one year since the Bali bombing. And as the Treasurer delivered his speech our forces were only just beginning to make their way back from Iraq—a conflict that saw the ADF going off to war without bipartisan agreement, thereby denting more than a quarter century of political consensus on defence policy.

As expected, and as has been the case for three years in a row, there was more money in the budget this year for Defence. Total Defence funding for 2003–04 will be $15.8 billion, which is an increase of $1.2 billion on 2002–03. This will continue to rise across the next four years with a budget of $17.1 billion planned for 2006–07. As a percentage of Gross Domestic Product (GDP) the 2003–04 Defence budget represents around 1.9%, although this will probably slowly decline over the next few years given the prediction of continuing strong GDP growth.

The five major budget measures announced this year were:

- $1.1 billion over five years for increased logistics funding. This funding will correct some of the long-standing shortages that have troubled Defence in the past, and to a lesser extent help meet preparedness requirements in the new strategic environment. This is in the vicinity of a 10% annual boost to logistics spending. It includes more money for F/A-18 fighter aircraft, C130-J Hercules transport aircraft, Collins class submarines and Army vehicles.

Freak storm hits Australian camp in the Middle East, 16 April 2003. © Defence Public Relations

- $645 million for the ADF's Iraq operations over three years. This is only an early estimate and a more refined figure is due later this year. It includes the estimated cost of the conflict phase of operations earlier this year, as well as the ongoing post conflict reconstruction phase.
- $157 million over three years to establish a Special Operations Command and to add more than 330 additional personnel. This includes an additional Company for the regular Commando Regiment that will make it easier for that unit to maintain its counter-terrorist Tactical Assault Group while deploying as a formed unit. The raising of a Special Operations Command elevates Special Forces to the same level in the ADF's command hierarchy as the current Land, Sea and Air commands.
- $103 million over three years to take advantage of favourable recruiting results in Army and Air Force. This will accelerate the build-up of the ADF towards the goal of around 54,000 personnel by the end of the decade by funding an average of 530 additional positions for each of the next three years. But Navy numbers remain a concern prompting an (internally funded) $10 million a year retention program for each of the next four years.
- $71 million over two years to continue enhanced security for Defence facilities and personnel around Australia. This comes on top of $41 million provided last year for this purpose.

These five measures account for this year's Defence budget headline, '$2.1 billion of new spending over five years'. Yet this is far from a complete picture. To begin with, another $348 million over five years was provided to maintain the buying power of the Defence budget against price and foreign exchange movements and to take account of

changed agency banking arrangements. On the other hand, buried in the fine print of the budget was a 'funding adjustment' that rescheduled (read delayed) $642 million of previously planned investment in new capabilities over four years. This year's reduction in funding to capital investment comes on top of $210 million rescheduled in the last two years, and the failure to spend similar amounts in each of the last two years.

To properly understand the impact of this delayed investment, and the budget more broadly, requires more than just reading the fine print (though that certainly helps). The budget process is incremental and each year only makes marginal adjustments to existing funding. This year's budget measures represent only around 3% of total funding for the period. The real question is what's going on with the other 97%.

Costs have been increasing across the board while planned investments have been slipping.

To answer this question requires an appreciation of how defence funding, and what the Government wants from Defence, have come to where they are today. This we examine in the next chapter, titled *The Defence budget in context*, beginning with an overview of defence funding stretching back 15 years. We make no apology for including this history lesson. Not only does the past have many lessons to teach us, but defence spending over the coming years owes much more to the cumulative impact of the many decisions made over the last 15 years than it does to the changes wrought by this year's budget.

Having set the scene, we then go on in that chapter to examine the developments since the last Defence White Paper in terms of the dual goals of funding the current force and investing in the future force. The result is sobering. Costs have been increasing across the board while planned investments have been slipping.

It is impossible to divorce defence funding from the question of how efficiently and effectively Defence spends the money it gets. So in the third chapter, *Turning the ship around*, we focus on Defence management. Increased defence funding is all very well, but unless the money is spent efficiently to deliver the results the Government wants, a change is needed. As we shall see, change has been occurring but the job is far from finished.

Finally in Chapter 4, *Three imperatives*, we set out the three challenges facing Defence budgeting in the immediate future. But we shan't spoil the ending by canvassing what we think needs to be done in this introduction. It's better for the imperatives to emerge from the analysis that follows.

For those readers not familiar with the way in which the Government funds and directs what it wants from Defence, we've included an annex, entitled *The business of Defence*, which outlines the budget framework as it applies to Defence, including a frank discussion of its strengths and weaknesses. To many people the notion of Defence being run as a business is an anathema, but that's precisely the rationale behind the Commonwealth budget framework. In any case, to properly understand how Defence spends the billions of dollars it gets, some familiarity with the framework is necessary—especially if you need to understand what's going to be delivered for the money.

CHAPTER 2

The Defence budget in context

Fifteen years in the making

At the end of the 1980s there were 69,000 uniformed Defence personnel and over 24,000 Defence civilians. The Government's expectations of Defence in the short term were modest to say the least. Prevailing wisdom held that it would take in excess of a decade for a credible threat to Australia to develop—and as a matter of policy that was all that really mattered. Bitter memories of the Vietnam War had long since removed any taste for forward defence. The most that could be expected of the ADF in the short term was to send contingents on peacekeeping missions (albeit sometimes involving sizeable deployments) or, if need be, to break a pilot's strike. Even the first Gulf War saw only a small and relatively low risk contribution from Australia.

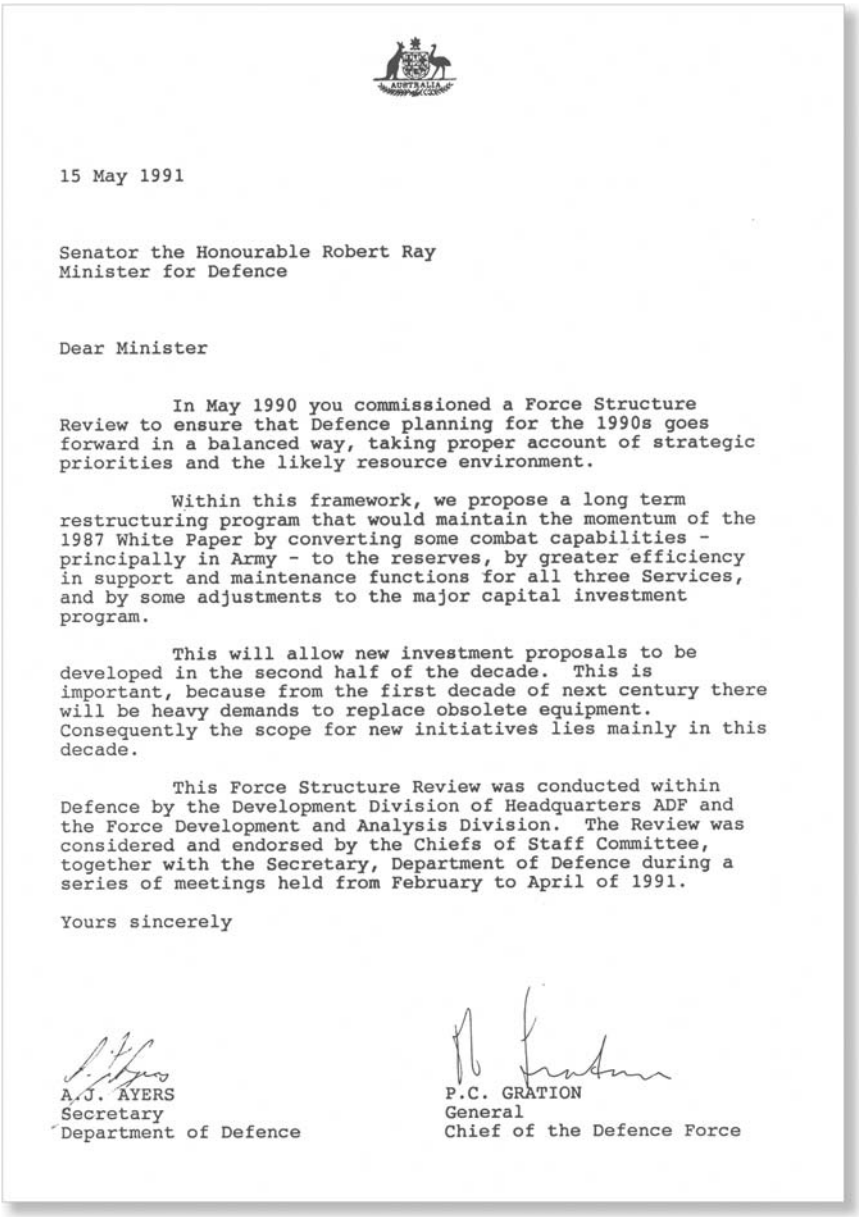
As it was, circumstances suited—and the Guam Doctrine encouraged—Australia's predisposition towards self-reliant defence. Yet while the immediate demands were limited, the longer-term expectations were great. The ability to defend the continent against an attack without relying on the combat forces of another nation demanded the maintenance of potent maritime capabilities suited to the control of the air and sea approaches to Australia. The fact that such capabilities might only be called upon a decade or more in the future was no consolation. Many existing capabilities were approaching obsolescence and would take at least that long to deliver. The F/A-18 Hornets were finally replacing the Mirage, but regional capabilities were growing in step with their economies. The strategic imperative was to modernise the force.

15 years of Defence policy guidance

The drive for efficiency

Faced with this situation the Government had three alternatives to fund the needed capital investment: increase the Defence budget, cut spending on the force-in-being, or demand greater efficiency from Defence. They chose a combination of the latter two. The plan was simple—keep defence funding largely constant in real dollar terms and make the ADF leaner and more efficient. The savings achieved would then be used to fund various capability initiatives including the funding of the new projects to modernise the ADF from the-mid 1990s onwards.

It began with the 1991 Force Structure Review, which saw 4,860 positions cut from the permanent ADF along with 1,390 civilians. Then followed the main part of the Commercial Support Program (from the 1990 Wrigley report), which saw the progressive contracting out of many non-core functions. By 1996 the size of the permanent ADF had dropped to around 57,000 personnel and the civilian workforce to 19,000. While substantial savings had been achieved on paper, the frustrating reality was that the amount of money going into new investment had not grown by nearly as much. Instead, rising per capita personnel and other operating costs had largely absorbed whatever savings were achieved. Figure 1 shows graphically how little the proportion of the defence dollar going to investment changed. It's important to note that some of the movement between personnel and other operating costs reflects accounting changes rather than cost pressures.



15 May 1991

Senator the Honourable Robert Ray
Minister for Defence

Dear Minister

In May 1990 you commissioned a Force Structure Review to ensure that Defence planning for the 1990s goes forward in a balanced way, taking proper account of strategic priorities and the likely resource environment.

Within this framework, we propose a long term restructuring program that would maintain the momentum of the 1987 White Paper by converting some combat capabilities - principally in Army - to the reserves, by greater efficiency in support and maintenance functions for all three Services, and by some adjustments to the major capital investment program.

This will allow new investment proposals to be developed in the second half of the decade. This is important, because from the first decade of next century there will be heavy demands to replace obsolete equipment. Consequently the scope for new initiatives lies mainly in this decade.

This Force Structure Review was conducted within Defence by the Development Division of Headquarters ADF and the Force Development and Analysis Division. The Review was considered and endorsed by the Chiefs of Staff Committee, together with the Secretary, Department of Defence during a series of meetings held from February to April of 1991.

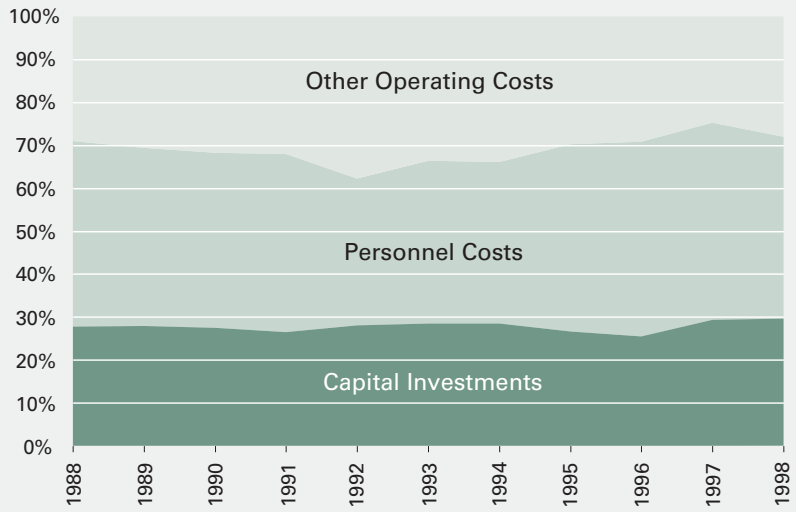
Yours sincerely

A.J. AYERS
Secretary
Department of Defence

P.C. GRATION
General
Chief of the Defence Force

With the new Government in 1996 came a renewed drive to make funds available for capital investment, again in the context of a constant budget. No time was wasted. Following an immediate redirection of $125 million of administrative spending, the Government initiated a wide-ranging review of Defence efficiency that led to the Defence Reform Program (DRP). The DRP aimed to deliver one-off savings of around $500 million and recurrent annual savings of as much as $1 billion—a good proportion of which was expected to go towards capital investment.

Figure 1: Defence spending by category, 1988–1998.



Source: 2001–02 Defence Budget Brief and various Defence annual reports.

Savings of this magnitude don't come easily. The projected DRP savings required a drastic reduction in the size of the permanent ADF down to 42,500. The catch-cry at the time was to build an ADF that was 'structured for war and adapted for peace'. Only those uniformed personnel who were absolutely necessary would be retained. This radical plan did not last long. Depending on how you view it, either saner heads prevailed or cold feet set in. In any case, acting on advice from the military the Government revised the goal up to 50,000.

The savings measures would still occur, but 90% of the recurrent savings would be used to 'buy back' 7,500 military positions. Some of these positions were used to boost the size of the combat force but many ended up being right back in the support areas they began in. Those positions maintained in non-combat support areas were justified in terms of the need for military skills in those areas, respite postings, and the need to 'shadow post' personnel pending surges in operational tempo. Whatever the reasons, the result was that personnel spending won out over long-term equipment modernisation. At the same time it meant that the early DRP savings which had been allocated to logistics would, over time, have to be redirected to personnel costs thereby sowing the seeds of future budget pressures.

A turning point

On 11 March 1999 the Minister for Defence announced that by 30 June 'Defence will have units ready to be deployed in 28 days, which can deliver forces of up to two brigade or task force size groups with associated naval and air units'. This was not idle posturing, but rather a considered response to the deteriorating regional security environment including the looming challenge of East Timor. As the press release went on to say, this represented 'the most significant level of forces readiness for two decades'. No longer was the ADF being maintained against the far-off possibility of an attack on Australia. Instead, the Government wanted to be able to deploy large numbers of combat-ready troops offshore at short notice.

The problem was not that the ADF was unable to deploy offshore prior to this. Just because the ADF had a force structure developed for the defence of Australia does not mean that it could not be employed in other ways. Both Cambodia in 1991–93 and Somalia in 1992–93 involved forces in excess of a thousand personnel. Rather, the problem was that the scale of possible deployment increased by a factor of two or more, and the likely role expanded from discretionary participation in UN operations to more fully embrace the ability to respond quickly to a crisis in the region, and lead a major operation.

The seemingly endless bounty of the DRP was invoked as the source of the money to fund the enhanced preparedness levels. But it didn't take too long for the reality to emerge: money previously earmarked for capital investment was siphoned off to pay for increased personnel and other operating costs. This is separate from, and in addition to, the supplementation provided for the East Timor operation that occurred later in 1999.

The deployment to East Timor confirmed something that had already been alluded to in the 1997 Strategic Review: it was possible for Australia's vital national interests to be at stake in a contingency that had a short warning time and that did not involve the defence of the continent. The deduction was that the ADF needed to be able to respond more quickly, and to a broader range of possibilities, than had traditionally been admitted. At the same time, the many equipment deficiencies that arose in East Timor reaffirmed the priority to modernise the force and added new items to the shopping list.

With efficiencies seemingly exhausted by the DRP, and with the pressure on to boost preparedness and expand the investment program, the Government had to do what it had been avoiding for more than a decade—increase the Defence budget.

More Aussie troops on war footing

By IAN McPHEDRAN in Canberra

THE Australian Army would have 11,000 combat troops ready for war at 28-days' notice under a $300 million initiative announced yesterday.

The 5500-strong Darwin-based 1st Brigade would be placed on the higher state of readiness but the Government denied the move was directly related to tensions in East Timor.

The troops will add to the 5500 troops in Townsville cur-

That will give the army up to 11,000 soldiers, plus naval and air force elements on short notice to deploy the highest figure since the Vietnam War.

The Australian Defence Force will spend $271 million immediately and $100 million each year to place another 5500 troops on a war footing.

It will allow for large-scale deployments at short notice to East

and beyond.

The Defence Minister, Mr Moore, said co "blow up" from at present the was limited to "Timor is the only factor beraid.

About infantry pla

announcement as an attempt by defence to win back the initiative on East Timor policy from foreign affairs. There are fears inside

Papua New Guinea could become unstable in July when the Government of the Prime Minister, Mr Skate, faces its first test.

The Opposition's defence

Double war capability

war capability LIA will double its for rapid deployment ready military

Townsville would be in place by June, based in Darwin

600km

Defence: a short order

The decision to increase the readiness of additional elements of the Australian Defence Force is to be applauded. However, our ability to do this is open to question with our manpower deficiencies and shortage of equipment and war stocks, particularly ammunition.

The Chief of Army, like his colleagues, the Chiefs of Navy and Air Force, is doing the best he with what he has, but he does

enough of the appropriate equipment.

Unlike the open, rolling plains and deserts of Australia, the Middle East and Europe, our most likely areas of deployment are the Indonesian archipelago and Papua New Guinea. Due to the mountains, jungle and the paucity of roads in these areas, surface movement is restricted and operations in these areas require air mobility.

Unfortunately, our current tactical airmobile capacity, in one lift, is restricted to two companies of infantry in Black Hawk helicopters, two field artillery pieces with ammunition, and fuel for the Black Hawks in Chinook helicopters.

While this may be enough for one activity, it would certainly not be enough for a deployment to both the archipelago and PNG and, at the same time, assisting in security for the Olympic Games.

Brigadier Brian H. Cooper (Ret).

Readiness born of necessity

By ROBERT GARRAN

JOHN Moore would like you to believe the decision to lift defence readiness to its highest level in a generation was the result of efficiency savings under the Defence Reform Program.

The savings are welcome but much more critical to the decision was the looming pressures on Defence from regional trou-blespots -especially, but not only, East Timor.

The Government won't make a final decision on sending troops to East Timor until the pro-inde-

with the present readiness, Australia could not support the 150 troops now in Bougainville and, at the same time, mount an East Timor peace-keeping operation and deal with any evacuation emergency in Jakarta, Ambon or Port Moresby.

Importantly, all the immediate "contingencies" facing the defence force are low-intensity, peace-keeping and civil defence operations, not the expensive, high-intensity wars that would be a threat to Australian or world security.

Resources will be stretched further if the Government ful-

Army doubles troops placed on war footing

By IAN McPHEDRAN

The army will have 11,000 combat troops ready for war at 28 days notice under a $300 million initiative announced yesterday.

The 5500-strong Darwin-based 1 Brigade will be on the higher state of readiness - but the government denied the move was directly related to tensions in East Timor.

The troops will add to the 5500 troops already on 28 days notice to move in Townsville. That will give the army up to 11,000 soldiers, plus naval and air force elements - the highest figure since the Vietnam War.

The defence force will spend $271 million immediately and $100 million each year to place another 5500 troops on a war footing.

It will allow for large- scale deployments at short notice to East Timor or elsewhere in Indonesia, PNG and beyond.

Defence Minister John Moore said contingencies did "blow up" from time to time. "Timor is a factor but it is not the only factor by any means," he said. There are grave fears inside defence and foreign affairs that Indonesia could descend into chaos following democratic elections there on June 7.

If that happened, large-scale forces would be needed to evacuate up to 10,000 Australians and to defend our strategic interests in Indonesia.

Vice-chief of the Defence Force Air Marshal Doug Riding said: "We will be ready to declare an increased readiness state as directed by the government on June 30 this year."

Headlines March 1999

The 2000 Defence White Paper

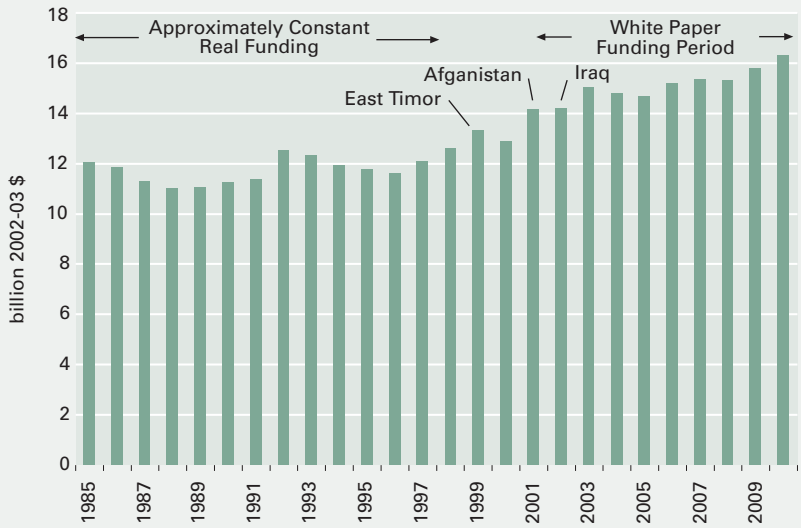
The decision to increase the Defence budget was not taken lightly. The Government set in train an extensive community consultation process in 2000 to gauge the public's acceptance of increased spending and their priority for employment of the ADF. This confirmed the long-held sympathy of the community towards robust defence spending, and revealed an acceptance of having the ADF ready to contribute to operations in support of regional and global interests while retaining the underlying core rationale of defence of Australia.

The White Paper that was published in late 2000 translated the results of the community consultation and the NSC's own extensive review of strategic priorities and capability needs into four concrete outcomes:

- a decade-long commitment to increased defence spending resulting in average real annual growth of 3%
- a prescriptive decade-long program of capability development underpinned by a year-by-year program of major capital equipment projects set out in a public Defence Capability Plan (DCP)
- the recognition that the ADF could again be called upon to deploy in large numbers to support our regional interests, as it had in East Timor, and make niche contributions to coalition and global operations, and finally
- a clear direction that the ADF should be made up of 'fully developed capability' ready to undertake near-term tasks rather than an embryonic force designed for slow mobilisation.

In raw dollar terms the White Paper provided a very substantial boost to defence funding. Figure 2 shows actual and planned defence funding from Government over the period 1985 to 2010 expressed in constant 2002–03 dollars. The figures include funding changes made since the White Paper including supplementation for operations in Afghanistan and Iraq.

Figure 2: Real defence funding, 1985–2010.



Source: 2001–02 Defence Budget Brief and various Defence budget papers and annual reports. Inflation based on historical data and Treasury projections that have been extrapolated for 2007 and beyond.

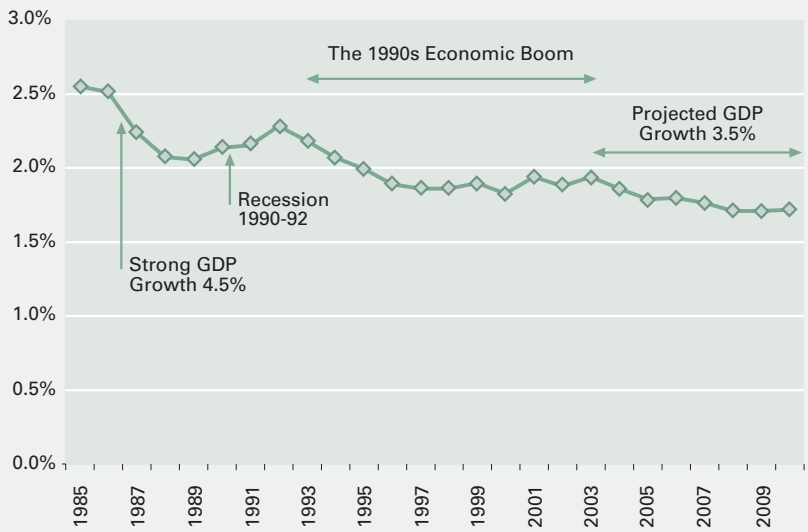
Not all of the new money promised by the White Paper was earmarked for capital investment; some of it was provided for the additional personnel and operating costs needed to translate equipment into usable military capability. Defence developed a model called the Capability Resource Model to estimate the cost of delivering existing and new ADF capabilities over time. But no model is perfect and this year's budget has had to make some significant adjustments.

Despite the generous funding boost due to the White Paper, the long-term trend of declining GDP share continues today. In 1985 Defence consumed over 2.5% of GDP; today the figure stands at 1.9%; and by the end of the decade it will have fallen to 1.7%, given current economic projections and planned Defence expenditure (see Figure 3). Current and past figures include supplementary funding for overseas deployments, but this has little effect on the overall trend.

At the risk of stating the obvious, defence funding as a percentage of GDP is every bit as sensitive to changes in GDP as it is to changes in defence funding. The significant decline in the figure from 1985 to 2000 was the result of continuing real GDP growth at a time when defence funding remained largely static. The ongoing decline is because economic growth is projected to outpace the planned increases to defence funding.

The percentage of GDP that a nation devotes to defence says nothing about whether the level of defence spending is adequate or otherwise. The answer to that question involves many factors and judgements that cannot be captured in any single number.

Figure 3: Defence funding as a percentage of GDP, 1985–2010.



Source: 2001–02 Defence Budget Brief and various Defence budget papers and annual reports. GDP based on historical data and Treasury projections that have been extrapolated for 2007 and beyond.

At best, the percentage of GDP is a measure of a nation's capacity to devote a greater share of its national wealth to defence spending and the seriousness with which it views its strategic circumstance. With this in mind Table 1 compares Australia's defence spending as a percentage of GDP with other nations possessing developed free-market economies. It is probably safe to conclude that Australia would be able to spend more on defence without distorting the economy, notwithstanding that this conclusion is ultimately an implicit judgement about the electorate's preferences. Of course, whether more money needs to be spent is a separate question.

Table 1: Defence spending as a percentage of GDP.

National defence spending as a % of GDP [2001]	
United States	3.2%
United Kingdom	2.5%
Australia	1.9%
Canada	1.1%
Japan	1.0%
NATO Average	2.1%
Sweden	1.9%

Source: The Military Balance 2002–03, International Institute for Strategic Studies, Oxford University Press, 2002

Having reviewed the journey that led to the White Paper we now turn to examine its implementation over the past two years and the plans set out for subsequent years in this year's budget. We begin by looking at spending on the current force and the rising costs involved.

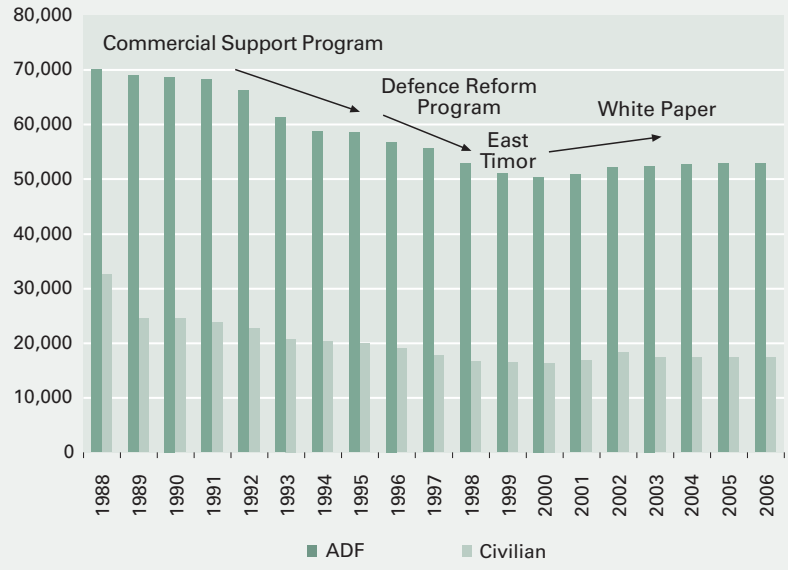
Rising costs for today's force

Around three out of every four dollars spent on defence goes to maintaining the current force. This includes the 42% of defence spending devoted to personnel and the 32% expended on other operating costs. In terms of actual dollars, personnel and other operating costs consume $6.5 billion and $4.9 billion per annum respectively. Spending in both these areas is now rising faster than White Paper estimates.

Personnel

The 2000 White Paper included a staged plan to increase the strength of the permanent ADF from about 50,000 to around 54,000 personnel by the end of the decade. This allowed for those additional personnel needed as part of new capabilities like the airborne early warning and control aircraft as well as an additional 3,500 Army and Air Force personnel identified as necessary for sustained deployments (which was one of the key lessons from East Timor). This reversed a decade-long trend of declining ADF numbers that began with the Force Structure Review in 1991. Figure 4 plots actual and historical workforce numbers from 1988 to 2006.

Figure 4: Past and planned Defence workforce.



Source: 2001–02 Defence Budget Brief and various Defence budget papers and annual reports.

Military

Full-time ADF numbers are growing faster than planned in the White Paper so that in 2003 there will be almost 1,100 more personnel than originally anticipated. There are two reasons for this.

First, specific measures, post September 11 and the Bali bombing, to boost Australia's domestic security and Special Forces account for around 300 extra positions (growing to 600 over the next four years). This includes personnel for the second counter-terrorist Tactical Assault Group for the east coast, the Incident Response Regiment to deal with nuclear, chemical and biological incidents, and the Special Operations Command which includes an additional company for the regular Commando Regiment. Funding for these three initiatives totals around half a billion dollars over five years for both personnel and operating costs.

Second, after several years of poor recruitment and retention, personnel numbers in Army and Air Force have been growing strongly. Rather than arrest this positive trend, the Government provided $103 million in this year's budget over three years to capitalise on it. In 2003 this will fund close to an additional 800 positions. Navy numbers, however, are not increasing as quickly as desired and this has prompted a four-year $40 million naval personnel retention scheme in the budget.

It's important to recognise that ADF recruitment and retention has improved against a background of a strong economy, which traditionally has made it more difficult to recruit and retain personnel. This has undoubtedly been helped by the $400 million over four years provided to address personnel issues in the first budget after the White Paper. And it's possible that recent high-profile ADF operations have made the military a more attractive career to many young Australians.

Reserve numbers have also been growing. There are probably many reasons for this, not least of which is the more immediate and relevant role allocated to the Reserves to sustain and support the permanent ADF on operations such as East Timor. In addition, the Government has been active in providing improved legislative protection for Reservists and financial support for their employers.

…a small differential could quickly build into a budget pressure given the scale of military personnel spending and the inescapable algebra of compounding interest

Historically, growing military personnel costs have been a pressure on the Defence budget. Not because the growth was out of step with community outcomes, but because the budget was not increased to accommodate this growth. The White Paper recognised this and provided for 2% real growth in per-capita military personnel costs above inflation. All indications are that per-capita military costs are being held within this projection. If this fails to be true, a small differential could quickly build into a budget pressure given the scale of military personnel spending and the inescapable algebra of compounding interest.

Civilians

Although civilian numbers fell quickly under the DRP they have grown back very rapidly in the last two years—three times faster than military numbers. What is more, this growth has been largely unplanned, with the rises in both years exceeding budget estimates by more than 5%.

While various reasons have been given for this rapid growth, the fact that Defence instituted a hiring freeze early in 2003 confirms the suspicion that at least some of the growth reflected lax management control. Indeed, the latest budget papers say that increasing civilian numbers contributed to an unsustainable growth in overheads and, accordingly, outlined plans to reduce civilian numbers by 920 over the next year.

Not only have civilian personnel numbers grown, but recent increases in per-capita civilian personnel costs have exceeded both the indexation provided under the budget process, and broader community wage outcomes. This may average out over the coming years. If not, these two factors will become an additional cost pressure on the budget.

Operating costs

Operating costs include a mixture of overheads like travel, consultants and facilities costs, and the direct cost of maintaining the ships, aircraft and weapons systems of the ADF. We concentrate below on the latter category, which is usually referred to somewhat imprecisely as logistics, and defer our analysis of overheads to the next chapter.

Logistics

The White Paper took account of the cost of operating existing capabilities through the Capability Resource Model and also made specific provision for the cost of supporting new capabilities as they entered service across the decade. Yet in every budget paper and annual report since then, the Services have complained of what has become known as the 'logistics shortfall'—often in alarming terms. Thus it came as no surprise when this year's budget allocated an extra $1.1 billion over five years to logistics. In rough terms this equates to a 10% boost to current spending on repair, maintenance and inventory, the core components of logistics. The causes of increasing logistics costs are threefold.

First, the cost of operating existing capabilities has grown. Much of the ADF's equipment is ageing pending replacement. The venerable F-111 strike aircraft and the Boeing 707 air-to-air refuelling aircraft are two examples. With age comes increased costs due to more frequent equipment failures and rarity of parts and expertise. This factor was not taken into account at the time of the White Paper so that any real growth in costs generates pressure on the logistics budget. More generally, given the fractured state of Defence's logistics and financial information systems, it is unlikely that the cost of ownership was well understood to begin with.

Second, the cost of operating new equipment has often turned out to be more than originally estimated. There are several reasons for this. In the past only cursory attention was paid to the future operating cost of equipment at the time of the acquisition. If anything, the tendency has been to underestimate future costs to make a proposal more attractive. On top of this, the ADF is increasingly maintaining a range of Australian-unique platforms. Not only do these unique capabilities often cost more to operate that off-the-shelf alternatives, but also the full cost of ownership is only revealed once the platform enters service. For example, until the initial mid-cycle docking of *HMAS Collins* was undertaken there was no way to be certain what the periodic refits of this new class of vessel would cost.

Despite the additional funding in this year's budget, Navy in particular continues to describe their situation in dire terms.

Finally, some of the increase in logistics costs is due to higher operational tempo and force preparedness. However, these marginal additional costs are probably nowhere as important as the increased costs driven by the previous two factors. Remember, under current arrangements the cost of operational deployments is funded separately from the annual budget through supplementation. And in any case the actual rates of effort of many platforms have not grown substantially in recent years, despite frequent deployments. A helicopter on active service may not fly any more hours than one used in training and exercises at home.

We probably haven't heard the last of logistics costs. Despite the additional funding in this year's budget, Navy in particular continues to describe their situation in dire terms. And recent operational experience has highlighted the need for more modern, integrated and interoperable logistics systems that will themselves have a cost. However, while there is no denying that proper logistics funding is integral to the combat effectiveness of the ADF, some care needs to be taken in assessing this year's boost to funding and any future bids.

The unanticipated logistics costs revealed to date show that the cost of operating military equipment has been poorly understood in the recent past. It would be foolish to assume that Defence has suddenly become omniscient in this area. Moreover, it remains unclear just how much of the logistics shortfall reflects a simple failure to allocate funds to priority areas within the Defence budget. As we will discuss in the next chapter, in 2001–02 administrative overheads grew to what Defence described as 'unsustainable levels' and at the same time the Services were complaining loudly of inadequate logistics funding while, paradoxically, more than $777 million accumulated in the bank. A shortfall in a particular part of the internal Defence budget does not necessarily mean that Defence is underfunded.

Deployment costs

As has been the case for some time Defence is supplemented for the net additional cost of deployments. Over the period 1999–2000 to 2004–05 deployments to Timor, Afghanistan and Iraq will together cost in the vicinity of $2.8 billion. Although these costs have often included a significant slice for capital investment specifically for the deployment, most of the spending goes on personnel and operating costs. This does not add to the underlying recurrent cost of maintaining Defence because operations are funded through supplementary budget allocations. Still, the regular frequency of deployments has become a routine additional impost on the Government that has to be found from somewhere.

Slipping investment in tomorrow's force

In the past, investment in capabilities for the future has been repeatedly put on hold to meet the costs of the day. This became particularly acute in the years immediately preceding the White Paper. To avoid a repeat of this, the White Paper provided specific funding for the schedule of new capabilities in the DCP. But in this year's budget, only two years later, the Government has 'rescheduled' $642 million of previously planned capital investment over the next four years. No projects have been cancelled; instead the money available for the current program of projects has been reduced.

What makes this deferral of investment funds different from the previous reallocation of the investment budget to cover personnel and logistics costs is that it does not appear to be the result of a zero sum calculus. All signs are that the Government has reluctantly rescheduled investment because Defence will simply not be able to spend the money because of delays to projects. This explanation accords with the fact that Defence has been unable to spend around $200 million of capital investment funds in each of the last two years—despite having had $210 million of investment spending deferred over that same period. There appear to be three factors at work in causing these delays.

First, the White Paper set ambitious goals for the commencement of new projects and the sheer amount of money to be spent. And it did so at a time when Defence was undertaking a wide-ranging restructure of the acquisition bureaucracy along with a revamping of acquisition processes. This combination of an unprecedentedly high level of planned activity and a disruptive reorganisation was very optimistic. In retrospect, it may have been better to provide some of the money on a contingent basis given the risks inherent in boosting spending at such a time.

Second, delays in existing projects continue just as they have for many years past. As always this has its origins in the performance of both Defence and Industry. Whether things are getting better or worse is difficult to judge from public information, but with many large projects still years behind schedule this is undoubtedly a contributing factor.

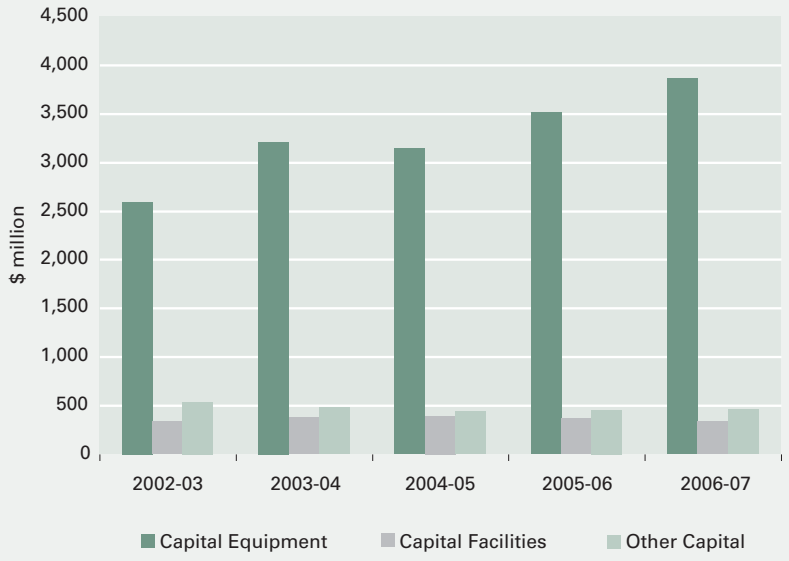
We can only hope that this more cautious approach will result in better risk management that justifies the mounting delays

Third, substantial delays have arisen in the approval of new projects by Government. Previously, new projects were approved all together at the time of the budget, with perhaps a second block of projects coming later in the year. Now the National Security Committee (NSC) of Cabinet considers each project individually and in detail. This process of closer scrutiny takes time and has delayed the approval of new projects especially because the current Minister demands strong assurances before passing projects on for NSC consideration. We can only hope that this more cautious approach will result in better risk management that justifies the mounting delays.

The magnitude of the deferred funds is only in the vicinity of 5% of the total capital budget, but coupled with previous deferrals and the unused funds from the last couple of years the cumulative impact will be a growing list of delayed projects. Of particular concern is the slow approval of new projects which will have a snowballing effect in coming years. There is no avoiding the conclusion that the delivery of many capabilities will be delayed and that industry planning predicated on the timely execution of the DCP will be disrupted.

And it may be that the challenges are far from over. Even with the money deferred in this budget, the program of capital investment retains very aggressive targets for increased spending on new projects (as shown in Figure 5) where the entire growth is concentrated in major capital equipment projects. Given recent performance it remains to be seen how realistic this is.

Figure 5: The challenge of increasing levels of investment.



Source: 2003–04 Defence budget papers.

The Minister has promised a new DCP in October this year. The challenge will be to ensure the timely delivery of priority projects within the practical capacity of what Defence can achieve. This in itself will require some hard decisions, but it is only one of several challenges in revising the DCP. Two other factors greatly complicate the picture: rising costs and uncertain strategic guidance.

Rising costs

The estimated cost of many DCP projects has escalated over the last two years to the point that the funds assigned in the White Paper are less than what's needed (notwithstanding that the projects may eventually be delayed for other reasons). The widening gap between the original and currently estimated cost of projects reflects the difference between Defence as optimistic salesman of the DCP and Defence as demanding customer of the projects in the DCP. In many cases emerging technologies and changing strategic circumstances may have upped the ante on what's required, but good old-fashioned gold plating and increases to the scope of projects cannot be discounted. The delivery of the DCP within budget was always going to require a lot of discipline in Defence force planning processes, discipline that has not always been evident.

Whatever the cause, the impact is the same. Within a static funding envelope, escalating costs require the deferral of projects and/or reduced purchases, as occurred recently with the Bushranger Infantry

Mobility Vehicle project. An unhealthy accommodation can easily arise where the impact of deferred projects and rising costs cancel each other at the expense of the delivery of combat capability to the ADF.

This problem is not unique to Australia. A recent Congressional Budget Office analysis of the US Defense Budget predicted substantial growth in project costs between 10% and 20% of current estimates. Historically the US system has responded by purchasing reduced unit numbers and accepting deferred delivery—the same mechanisms that we employ.

…the greatest handicap to the DCP in its current form is the growing perception that the Government is no longer committed to it.

Uncertain strategic priorities

The second factor complicating the revision of the DCP is the translation of Australia's emerging strategic posture into concrete decisions about capability priorities. In January this year the Government released its long-awaited strategic review *Defence Update* 2003. It identified terrorism and the spread of weapons of mass destruction as real and immediate threats to Australia. At the same time it highlighted problems in the immediate region and downplayed the threat of a direct military attack. It also raised the spectre of a ballistic missile attack by a rogue state and announced that Australia would explore cooperation with the US on developing ballistic missile defence capabilities. These changes in emphasis have not yet been translated to the DCP. Certainly there were no signs of a change in this year's budget. Of course, the paucity of new project approvals may indicate that things are being held in abeyance while the Government sorts out what it wants to do.

Arguably the *Defence Update* only raised limited expectations for changes to the DCP. It refers to 'some rebalancing of capabilities and priorities' and elsewhere talks about 'important niche capabilities' for coalition operations. In releasing the update the Minister said that the rebalancing would not fundamentally alter the size, structure and role of the ADF. None of this signals a wholesale shift to the underlying rationale for the ADF's force structure. But some commentators disagree, arguing that the 2000 White Paper has been entirely overtaken by events and that a watershed change is occurring, or is urgently needed. Yet few see the *Defence Update* as having set out a comprehensive new strategy, and at least one commentator has argued for a new White Paper. The perception that there are still fundamental issues to be resolved has been reinforced by the Minister who has often spoken in terms somewhat bolder than anything in the *Defence Update*. As a result, the greatest handicap to the DCP in its current form is the growing perception that the Government is no longer committed to it.

It is difficult to escape the conclusion that the Government has not yet decided the extent to which events since September 2001 require changes in the DCP, and indeed for defence policy more broadly. It will be hard to reach clear Defence budget decisions until these issues are resolved.

CHAPTER

3

Turning the ship around

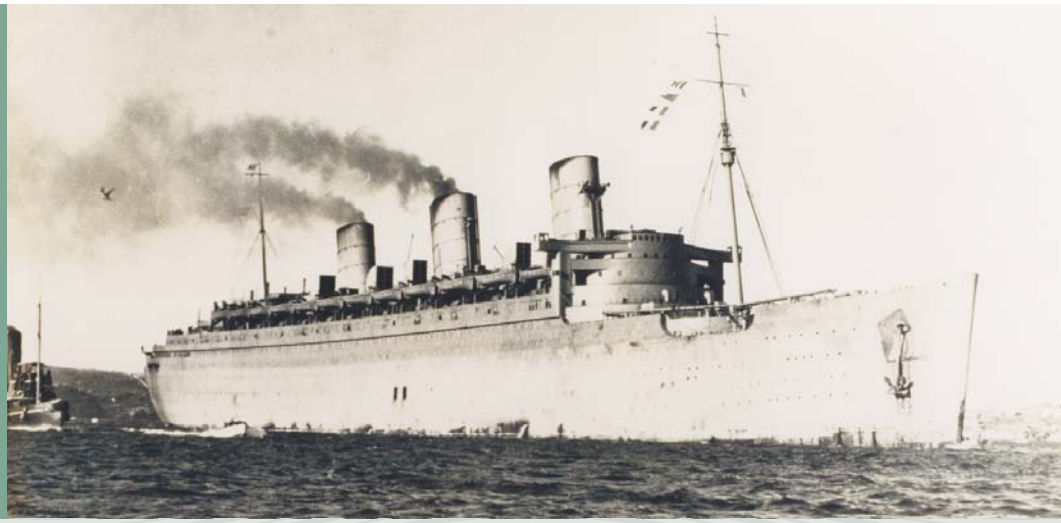
Much like a ponderous luxury cruise liner from the last century it takes a lot to change the direction of a leviathan like Defence. Not only does its sheer size impart considerable momentum but also its diversity of function and geographical dispersion makes it particularly difficult to navigate. Such a powerful and unsteerable beast is dangerous. Just as the *Queen Mary* cut through its escort, the light cruiser *HMS Curacoa*, in 1942 leaving 338 men to drown in the North Atlantic, Defence has left a string of would-be reformers in its wake. And like the *Queen Mary* on that fateful night it is yet to show much sign of turning around.

In this chapter we explore the recent history of Defence management and examine the attempts that are being made to set it on a more efficient course. Our focus will be on financial and administrative management to the exclusion of military operational issues. One of the happy paradoxes of Defence is that it continues to deliver a high level of professional military capability against a background of uncertain administrative management. That is not to say that we should be too complacent about the ADF's military performance. Recent deployments have been challenging for those individuals and units involved, but they do not amount to the most demanding sorts of tasks that the ADF could be called upon to do.

...Defence has left a string of would-be reformers in its wake.

More than just rearranging the deck chairs

Defence has undergone rapid and profound changes in the last seven years that form the background to understanding its recent management performance. These include the changes due to the DRP, the introduction of accrual accounting and new management information systems, and an ongoing struggle to ensure the timely delivery of capability.



RMS Queen Mary. Photo courtesy of Cunard Line.

A new organisation

The DRP, discussed in the last chapter, did far more than just sell off a swag of properties and outsource a range of functions. It was also a far-ranging and fundamental restructure of the Defence organisation.

Prior to the DRP the three Services were effectively separate fiefdoms that only came together through the central control of the Capital Investment Program. This was more or less the arrangement set in place in the 1970s through the formation of the single department drawing together the three separate Service departments, and strengthened by the subsequent introduction of program management and budgeting at the end of the 1980s.

This multiple stove-pipe arrangement had the advantage that each Service managed its own logistics, personnel and corporate support matters, so that the Service Chiefs had direct control over most aspects of the inputs required to deliver their results. But it had the disadvantage that many functions were duplicated and potential economies of scale were not exploited. For example, each of the Services ran duplicate training programs across many areas and maintained parallel facilities like hospitals, warehouses and colleges. Unlike commercial businesses subject to market pressures, the support functions within the Services were often inefficient and entrenched in their way of doing business. Moreover, there was a real concern that this distributed way of doing business impeded the development of closer arrangements between the Services that were needed to ensure a truly joint multi-Service approach to military operations (a priority goal for the ADF that was already being pursued separately through joint command and control arrangements).

The DRP set out to change this in two ways. First, it restructured Defence by stripping the Services of direct control of functions like

personnel, logistics, training and corporate support and created new central agencies to undertake these roles. Second, it imposed a detailed program of 'micro-economic' reform including extensive outsourcing especially within the newly created support agencies. When the dust had settled the DRP left two legacies that remain important today.

One was the blurring of accountabilities with the Service Chiefs—now relabelled as output executives (see Annex)—having incomplete control over the inputs needed to deliver their results. Of course, this is not impossible to correct. Business routinely use internal pricing arrangements to give managers control over, and accountability for, resources provided from within the broader organisation. Yet more than six years after the announcement of the DRP, Defence continues to grapple with the challenge of establishing so-called customer-supplier arrangements between output and enabling executives. This is probably due in equal parts to inadequate management information systems and a simple failure to drive through the necessary bureaucratic changes. Defence has shown itself to be surprisingly blithe about providing free goods and services to its managers.

The second was that the DRP made many bold assumptions about those functions and skills needed to be retained in Defence. The process of testing these assumptions and making the necessary adjustments is still occurring and it appears likely that the Defence workforce will continue to evolve over the coming years. Fortunately, Defence has been focusing over the last several years on improving its workforce planning capability. But the recent, rapid unplanned growth in civilian numbers shows that planning is not enough.

A new way of accounting for business

The introduction of the outcomes and outputs framework was accompanied by the full adoption of accrual accounting across the Commonwealth public sector. This was a major change for many agencies but none more so than Defence whose diversity and size put it in an entirely different class.

Take for example the apparently simple task of accounting for the assets held by Defence. With an ageing logistics information system, designed for managing inventory rather than accounting for its value, this represents a major challenge. Ongoing tussles between the Auditor-General and Defence over accounting for assets finally led to the qualification of Defence's financial statements at the end of the last year. With some $50 billion of assets in Defence hands the Auditor-General's concern can be easily understood.

But asset accounting is only one of the challenges facing Defence financial management. The question is not simply 'how much are the parts in the warehouse worth?' but also, 'how much does it cost to operate a ship, aircraft or tank?' Indeed, Defence needs management information to inform decisions at least as much, if not more, than it needs accounting information to satisfy auditors. Unfortunately, the implementation of accrual accounting in Defence missed this point.

...by the beginning of this decade Defence had a poorly developed and largely uncoordinated set of administrative information systems that barely satisfied the auditors let alone the demand for timely management information.

In the late 1990s two major administrative information system projects were initiated: one to replace the old cash-based financial system with a new system that could handle accrual data, and another to consolidate the four previously separate personnel information systems. These projects suffered from two shortcomings. First, they paid inadequate attention to the need for management information as opposed to the mechanical tracking of transactions and, second, they were developed in isolation so data sharing was far from assured. In the process, problems soon emerged with data integrity—hardly surprising given the scale and diversity of Defence business. Meanwhile the ageing logistics information system limped along with increasing demands for it to link into the financial accounting system. The result was that by the beginning of this decade Defence had a poorly developed and largely uncoordinated set of administrative information systems that barely satisfied the auditors let alone the demand for timely management information. This was despite the investment of several hundred million dollars on the three systems.

Over the last couple of years Defence has been slowly tackling the problem of its diverse and poorly planned administrative information systems through the creation of a chief information officer position. On the financial side projects are now in place to improve the costing of capability and develop a corporate information control facility. These are welcome developments but ones that will take several years to make up for the opportunity squandered by the hasty and uncoordinated initiatives commenced at the end of the last decade.

A new way of acquiring and supporting capability

The acquisition organisation escaped the restructuring of the DRP, but in late 2000, acting on a consultant's report, the Government decided to amalgamate the acquisition and logistics functions through the creation of the Defence Materiel Organisation (DMO). The hope was that this would ensure a more seamless integration of acquisition and through-life support—a key gap in past practice.

The creation of the DMO also saw the physical dispersal of staff to system project offices co-located with, and hopefully responsive to, the capabilities they support. It's been accompanied by a raft of initiatives under the Defence Materiel Reform Program that seeks to improve performance through things like better contracting practice, cultural change and improved staff training. It's too early to judge the success or otherwise of this program although a recent report by a Senate committee was cautiously supportive. As we shall see later, this is unlikely to be the final word on changes to the DMO.

Two years in troubled waters

So the implementation of the White Paper began two years ago against a background of inadequate administrative information systems, a wholesale restructure of the DMO and, most importantly, an organisational structure and financial processes that divorced ownership of resources from responsibility for delivering results. Add to this the approval of almost 40 major capital equipment projects (many that had been kept in abeyance pending the 2000 White Paper) and a hike of $1.4 billion in funding in a single year, and you have the challenge faced by Defence in mid-2001. Three things typify the two years that followed.

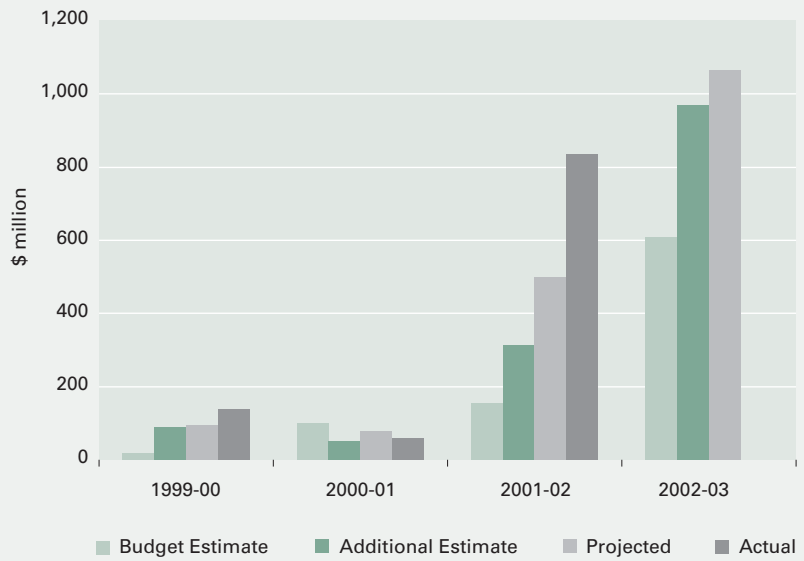
First, administrative overheads rose sharply. In 2001 civilian personnel costs went up by 13%, overseas travel went up by 22% and spending on consultants and professional service providers went up by 53%. This last result continues a worrying trend that has seen a more than threefold increase from $84 million to $280 million in only three years. What makes these rising costs particularly alarming is that reductions were anticipated in all these areas, with the latter two actually identified as sources for efficiency savings in that same year. High spending appears to have continued in these areas through into 2002, with Defence conceding unsustainable growth in these and other administrative overheads.

Second, as we have already discussed, the ambitious program of new capital investment set out in the White Paper faltered. And it did so even before a dollar was spent. A simple comparison of the projected spending on military equipment prior to and after the first budget of

the White Paper shows that additional spending on military equipment was well below that promised. Right from the start, the current force had won out over equipment modernisation.

Third, Defence accumulated cash. Lots of cash. By the end of 2001 an additional $777 million had made its way to the bank—the bulk of it not planned for. Figure 6 shows how successive estimates of the end of year cash holding have consistently underestimated the final result for the last two years. Some of the money was unspent capital funds, and some represents unused price paid for outputs. During 2002, a further accumulation occurred due to the $200 million in capital funds that went unspent. There would have been more but for the $49 million devoted to the Iraq conflict and an additional $101 million allocated to logistics. Nevertheless, the bulk of the money accumulated in 2001–02 as defence funding increased and several disruptive factors conspired. Up until that time, Defence had a record of spending most or all its cash, just as it is more or less projected to do this year.

Figure 6: A penny saved is a penny earned.



Source: various Defence budget papers and annual reports. The 2002–03 data has been adjusted for the planned pay back of borrowed funds promised in 2003–04.

The bulk of Defence's cash reserves are now held as an 'appropriation receivable' within consolidated revenue for the stated purpose of covering future employee liabilities. While this is a plausible rationale for this nominal cash holding, it is in reality more a sad reminder of a difficult period of financial management.

At the same time as cash accumulated in the bank and unsustainable growth occurred in administrative overheads, the Services were complaining of insufficient logistics funding and non-financial performance was below par in many areas (see Annex). It is hard to escape the conclusion that the last couple of years have seen both lax financial controls and a failure to allocate money to where it is needed most.

A firmer hand at the wheel

The 2003 budget has some strong signals that tighter financial management is now in place with, for example, the planned reduction in civilian numbers and action being taken to rein in spending on contract professional service providers. In this context the rescheduling of $642 million from the capital program across the next four years represents a hard decision, but one that will reduce the risk of the cash reserve growing further due to surplus investment money.

This year's budget also announced a program of administrative savings beginning with $50 million per annum and progressively growing to $200 million in future years. These savings will come from within Defence's internal budgets and be redirected to growing overheads elsewhere in the internal budget. This will cut the excess out of internal budgets that grew fat over the last two years. But we should not confuse the reinstatement of disciplined financial management with long-term efficiency gains—that remains a challenge for the future. It's also important to get the scale in perspective. A $200 million per annum saving for Defence is the same as a $500 a year saving for a family earning $40,000. Nice to have, but not a life saver.

HMS Curacoa. © National Maritime Museum, London

There may also be reason for cautious optimism that management reforms are finally gaining traction. It appears that real progress has been made in the area of output budgeting and reporting as demonstrated by the detailed financial information in the 2003 budget papers, and initiatives are in progress to improve decision support information. This is important. A firm hand at the wheel is one thing, but without reliable information to guide the way we are unlikely to have a safe voyage. The information required will include both financial and non-financial performance information. It is not enough to know how money is being spent. You also need to know what is being delivered as a result.

There may also be reason for cautious optimism that management reforms are finally gaining traction.

It's hard to say exactly how things are going until we have the opportunity to look back at the current financial year and see how well the planned financial performance has gone. In all likelihood the 2002–03 financial year will be a transition towards tighter and more effective financial management. No one should think that Defence financial management can be turned around quickly. But turn around it must. Unlike the *Queen Mary* that is now tied up alongside as a tourist attraction in Long Beach, California, Defence has a job to do.

CHAPTER 4

Three imperatives

There are three clear imperatives arising from our exploration of the Defence budget. These imperatives are to some extent interdependent so we present them in no particular order.

Imperative 1: Deliver new capabilities on time

The Defence Materiel Reform Program has been in place around two years and as a result it's early days yet for such a wide-ranging restructure and accompanying initiatives. Notwithstanding this, in late 2002 the Government appointed an external 'Procurement Task Force'. This demonstrates impatience if not dissatisfaction with the current approach. This high-level task force includes members with experience in the private sector, Defence and the Department of Finance. It is believed to be looking at Defence's procurement processes from conception onwards, and is scheduled to report later this year. The Government would be well advised to move quickly to consider its recommendations. With projects already slipping, action is called for.

In the meantime there is an easy way to help the timely delivery of projects: don't stop approving projects until the promised review of the DCP is complete. The last White Paper saw an effective freeze on new projects for more than 12 months. This directly delayed projects and created a challenging 'bow wave' of new projects immediately after the White Paper, which probably then led to still further delays. Fortunately, many of the projects in the present DCP are essential components of any credible force structure, and do not need to be held in hiatus pending the review. The fact that no new projects were foreshadowed in this year's budget is a worrying sign, although progress may be occurring behind the scenes. In any case, Industry must be dismayed at the growing delays in project approvals and the apparent pause that has begun.

'The budget should be balanced. Public debt should be reduced. The arrogance of officialdom should be tempered, and assistance to foreign lands should be curtailed, lest Rome become bankrupt.'

Marcus Tullius Cicero, 1st century BC.

Imperative 2: Continue to improve Defence management

Defence continues to face management challenges in many areas, most of which are recognised, and there are initiatives in place to work towards solutions. The improvement of Defence's administrative information systems and the continuing refinement of output reporting in terms of both financial and non-financial performance are good examples, as is the development of better workforce planning. But much remains to be done. The following three areas are of particular importance.

Understanding the cost of capability

Many of the problems faced today by Defence result from an incomplete understanding of the cost of ownership of military capabilities. Both rising costs for projects in the DCP and the need for additional logistics funding have much more to do with poor initial cost estimates than any emerging external factors. The inability to understand costs impedes forward planning and justifiably undermines confidence in Defence's ability to manage its business.

While improved administrative information systems are an essential component of developing a better understanding of costs, they are far from the whole story. Ultimately, the solution will not lie with the creation of an omniscient computer system or a Soviet-style central planning process, but rather in making managers down the line responsible for understanding and controlling the cost of doing business.

Establish financial discipline then move to increase efficiency

Defence is in the process of imposing greater internal financial controls and better output-focused budgeting arrangements. This is welcome given the problems of the last couple of years. But until the current initiatives are complete, we have few assurances that Defence is allocating its resources to priority areas, and even less that it has a sound understanding of what it costs to maintain capabilities, or even of what its workforce requirements are. Until this changes, any bid for further money to maintain the current force must be treated with caution.

Hopefully the current initiatives are only the first stage in an ongoing program of improvements that will eventually see Defence delivering true efficiency gains—just as any private sector business that wants to survive does. While many areas of Defence activity have undergone big changes in terms of outsourcing and the way they do business over the last decade or more, others have remained relatively unassailed. Defence's very own private university and extensive science and technology organisation come to mind. And it remains an unanswered question as to just how cost-effective the current dispersed Defence facilities disposition is or isn't. In any case, and as a matter of course, Defence should aim to measure the efficiency with which it delivers its outputs, and to set public goals for ongoing improvement.

Enable and demand accountability

Defence's current organisational and output structures demand matrix management on a grand scale. This all too often separates accountability for delivering outputs from the control of the resources needed to do so. This is a fundamental impediment to both accountability and performance. For more than six years now, Defence has pegged its hopes on the development of internal customer-supplier arrangements that will forge the necessary links to correct this. But progress has been very slow in implementing this key aspect of the Defence business model. Defence needs to make a concerted effort to implement these arrangements or else devolve resources directly to output executives and lessen its reliance on central control. Whatever mechanism is chosen it will also be necessary to develop ways to measure the delivery, or otherwise, of the goods, services and military capabilities being produced.

At the very least, any uncertainty about where Australia stands strategically must be resolved.

Imperative 3: Sort out the DCP and the strategic policy that underpins it

The review of the DCP, or the Defence Capability Review as it has come to be known, needs to do far more that just juggle the current set of projects into a new package. A fundamental shift in our strategic outlook (if that's what's occurring) requires more than just a focus on investment in new capability. To be credible the review must deliver three things:

- a clear explanation of the implications of recent events for our strategic policy, including any changes to our force structure priorities and the implications for both the ADF's preparedness and geographic disposition,
- an achievable program of capital investment that reflects a coherent force structure aligned with the Government's strategic priorities, and
- a renewed funding commitment that covers the cost of both the current force and investment in the future force, which is based on credible (and hopefully enduring) cost estimates.

When it's put in these terms it begins to look more like a full-scale strategic review, or even White Paper, than a review of the investment program. But if a fundamental change to Australia's strategic policy is needed, as some have argued, then that's what will be required. At the very least, any uncertainty about where Australia stands strategically must be resolved.

ANNEX

The business of Defence

Defence has an annual budget in the vicinity of $16 billion and holds assets in excess of $51 billion. Its workforce comprises some 52,000 military personnel and 18,000 civilians. Leaving aside military capabilities, Defence is a major provider of education and training, health services and accommodation. It runs its own airports, hospitals and training schools, and even has its own private university. Each year Defence generates some $300 million of revenue through the sale of goods and services. This is big business by any measure. With such a diverse range of activities the challenge for the Government is to make sure they get what they want in exchange for the billions of dollars provided.

In macro terms the Government wants two things from Defence. First, the maintenance of armed forces prepared to be deployed on operations and, second, the ongoing development of new military capabilities for the future. To those not familiar with defence this second goal might seem a secondary endeavour, but it is not. With some $3 billion of annual investment it consumes a big slice of the budget. Moreover, the decade-long projects that are necessary to deliver new capabilities are a long-term and at times risky business that has vexed successive Governments.

These two goals—the maintenance of the current force and investment in the future force—are dealt with more or less separately in the current budget arrangements. The former through the outcomes and outputs framework, and the latter through the capital budget.

Defence Department, Russell Offices. © Defence Public Relations

Outcomes and outputs

At the core of the Defence budget is a framework of outcomes and outputs. This framework was introduced by the Commonwealth in 1999, and is applied to all Commonwealth agencies. It works like this:

- Outcomes are the results or benefits that the Commonwealth aims to deliver to the community through the work of its agencies. They are specified for each agency, and are meant to express the purpose or goal of each agency's activities.
- Outputs are the goods and services that each agency produces to achieve its outcomes.

Under the framework, the performance of agencies is measured to assess both how much output they are generating, and the extent to which that output is actually delivering the outcomes intended. So the aim is to show not only how much an agency is *doing*, but how much it is actually *achieving*.

The outcomes and outputs framework is not just an accounting device. It is intended to provide a structure for management decision making and resource allocation throughout Commonwealth agencies. So the way the framework is applied in an agency like Defence is very important to its management and performance.

The Defence outcomes

The key to the effective application of the framework is the specification of the outcome or outcomes. The current outcomes defined for Defence are:

1. Command of Operations in defence of Australia and its interests.
2. Navy Capability for the defence of Australia and its interests.
3. Army Capability for the defence of Australia and its interests.
4. Air Force Capability for the defence of Australia and its interests.
5. Strategic Policy for the defence of Australia and its interests.
6. Intelligence for the defence of Australia and its interests.

A seventh outcome covers superannuation payments for current and former ADF personnel, and housing subsidy provided under the *Defence Force (Home Loans Assistance) Act 1990*. These matters fall outside the control of Defence and constitute funds appropriated as an administrative convenience. We shall not consider them further.

With the intent of the framework in mind it's fair to observe that the six Defence outcomes are little more than semantic restatements of what one would expect to be outputs. There is little indication of what is to be achieved aside from the generic and vague qualifier 'for the defence of Australia and its interests'. This is a shortcoming of the current implementation of the framework to Defence, but not one that can be easily rectified given the complexities of what Defence does.

The Defence outputs

There are 29 separate outputs delivered by Defence. These are grouped under the six outcomes as shown in Table A1. Each of the outputs, and in turn the outcomes, has a price. A fuller description of each of the outputs can be found in the 2003–04 ASPI Budget Brief, *The Cost of Defence*.

In principle, the notion of price introduces a business-like arrangement between the Government as customer and Defence as provider of outputs. But in the absence of a market for Defence outputs it is very difficult to say if the 'price is right' or not. When the framework was first introduced it was intended that periodic output–price reviews by the Department of Finance would confirm the efficiency and effectiveness with which outputs were delivered. No such review has been conducted or is currently planned for Defence. In practice, the prices simply reflect the expenses incurred by Defence in delivering the outputs.

What the framework does achieve, however, is a much clearer understanding between Defence and the Government of what is to be delivered than was ever the case in the past. Prior to the current framework Defence enjoyed a one-line global budget and with it a very great deal of discretion as to how the money was to be spent and what was to be delivered. This was a product of both the shortcomings in the old budgeting framework and a decidedly relaxed approach by Government, given the relatively benign strategic circumstances of not so many years ago.

Table A1: Defence outcomes and outputs.

Outcome	Output		Price 2003 $m
1. Defence Operations	1.1	Command of Operations	409
	1.2	Defence Force Military Operations and Exercises	418
	1.3	Contribution to National Support Tasks	18
	Total Defence Operations		845
2. Navy Capabilities	2.1	Capability for Major Surface Combatant Operations	1,487
	2.2	Capability for Naval Aviation Operations	472
	2.3	Capability for Patrol Boat Operations	261
	2.4	Capability for Submarine Operations	774
	2.5	Capability for Afloat Support	215
	2.6	Capability for Mine Warfare	334
	2.7	Capability for Amphibious Lift	366
	2.8	Capability for Hydrographic and Oceanographic Ops	178
	Total Navy Capabilities		4,087
3. Army Capabilities	3.1	Capability for Special Forces Operations	445
	3.2	Capability for Mechanised Operations	801
	3.3	Capability for Light Infantry Operations	1020
	3.4	Capability for Army Aviation Operations	450
	3.5	Capability for Ground-based Air Defence	93
	3.6	Capability for Combat Support Operations	408
	3.7	Capability for Regional Surveillance	87
	3.8	Capability for Operational Logistic Spt to Land Forces	433
	3.9	Capability for Motorised Infantry Operations	574
	3.10	Capability for Protective Operations	535
	Total Army Capabilities		4845
4. Air Force Capabilities	4.1	Capability for Air Combat	1,780
	4.2	Capability for Combat Support of Air Operations	424
	4.3	Combat Support for Strategic Surveillance	369
	4.4	Maritime Patrol Aircraft Operations	535
	4.5	Capability for Air Lift	896
	Total Air Force Capabilities		4,004
5. Strategic Policy	5.1	Strategic & International Policy, Activities & Engagement	170
	5.2	Military Strategy and Strategic Operations	43
	Total Strategic Policy		213
6. Intelligence	6.1	Intelligence	403
	Total Capability Outcomes		14,398

Source: 2003–04 Budget Papers.

Output performance targets

A key purpose of the outcomes and outputs framework is to provide a basis for setting targets and measuring performance. While no attempt is made to measure the delivery of the Defence outcomes, three broad performance measures are reported publicly at the output level: preparedness, core skills and quantity.

Preparedness

Preparedness refers to the readiness and sustainability of the ADF to undertake operations, be it national support tasks, peacekeeping or war. In some way or another each of the 29 outputs is expected to meet various preparedness targets. Naturally, the details of these preparedness targets are secret, although the broad goals are not. For example, many of the Army outputs have as a goal the ability to field one or more battalion groups at 90 days notice. And the Army as a whole is expected to be able to deploy and sustain a brigade offshore indefinitely, while retaining the ability to deploy a battalion elsewhere at short notice.

The ADF's preparedness targets are underpinned by the Government's strategic guidance, which is set out in the 2000 White Paper and 2003 Defence Update. These documents set out the broad strategic tasks that the ADF needs to be prepared to undertake—for example 'contributing to the security of our immediate neighbourhood'. A rather involved planning process within Defence then translates this broad guidance into prescriptive directives on what levels of preparedness are to be maintained by the outputs. Central to this process is the *Chief of the Defence Force's Preparedness Directive* that directs which options will be available to the Government over the next 12 months.

Core skills

The preparedness targets set for outputs are driven by possible contingencies with an anticipated warning time of less than 12 months. To take account of possible longer-term tasks and the requirement to retain broad expertise in the three Services, an enduring performance target for nearly all the outputs is to 'achieve a level of training that maintains core skills and professional standards across all warfare areas'. The assessment of what is to be achieved, and whether it has been achieved, is ultimately based on the professional military judgement of the Service Chiefs.

Quantity

Most of the outputs include one or more 'quantity' measures that try to capture some aspect of *how much* capability will be delivered. Each of the three Services uses a different type of measure. The basic measure used by Navy relates to the availability of ships and their crew to undertake a mission. Army, with the exception of Army Aviation, simply measures the presence of adequate numbers of trained personnel and equipment within an output. Finally, the quantity measure used by Air Force and Army Aviation is the number of flying hours undertaken by the output.

Table A2: 2001–02 Performance of the Defence outputs. *Source:* Defence annual reports.

	Output	Preparedness	Core Skills	Quantity
1.	**DEFENCE OPERATIONS**			
1.1	Command of Operations		-	▼
1.2	Military Operations		-	▲
1.3	National Support Tasks		-	▲
2.	**NAVY**			
2.1	Major Surface Combatants			▲
2.2	Naval Aviation			▲
2.3	Patrol Boats	▲		▼
2.4	Submarines			▼
2.5	Afloat Support	▲	▲	▼
2.6	Mine Warfare	▲	▲	▼
2.7	Amphibious Lift		▼	▼
2.8	Hydrographic	▲		
3.	**ARMY**			
3.1	Special Forces	▼	▼	
3.2	Mechanised Ops			
3.3	Light Infantry Ops	▼	▼	▲
3.4	Army Aviation Ops	▲		▲
3.5	Ground-Based Air Defence			
3.6	Combat Support Ops			
3.7	Regional Surveillance			
3.8	Operational Logistics Spt			▼
3.9	Motorised Ops			
3.10	Protective Ops			
4.	**AIR FORCE**			
4.1	Air Strike*			
4.2	Tactical Fighter Ops*			
4.3	Strategic Surveillance			
4.4	Maritime Patrol	▼		▲
4.5	Air Lift			▲
4.6	Combat Spt of Air Ops			
5.	**STRATEGIC POLICY**			
5.1	Strategic Engagement			
5.2	Military Strategy & Cmd			
6.	**INTELLIGENCE**			
		Achieved / Partially Achieved		

Key

Improved since 2000-01: ▲ Declined since 2000-01: ▼

Achieved Substantially Achieved Partially Achieved

Quantity: Above 95% = Achieved,
95% to 75% = Substantially Achieved,
Below 75% = Partially Achieved

*These two outputs have now been merged into the single Air Combat output.

Recent performance

The last two Defence annual reports have maintained a largely consistent format of reporting against performance targets so that year-by-year comparisons are possible. Table A2 summarises the results from the 2001–02 annual report and tracks the changes from the year before. Defence uses a four-point performance scale for preparedness and core skills: Achieved, Substantially Achieved, Partially Achieved and Not Achieved. We have colour-coded the raw numerical 'quantity' results—see key at the bottom of the table.

Aggregate performance against targets remained largely unchanged between 2000 and 2001. There were improvements in 15 areas, and declines in 16. In many areas this is an understandable result of the ADF's high operational tempo. Nevertheless, with only 41% of outputs only partially meeting their preparedness targets, 46% only partially meeting their core skills targets and 41% only partially meeting their quantity targets, performance is too often below target.

Navy did the best of the three Services with some solid improvements. Army had mixed success with declines in Special Forces and Light Infantry due to operational demands. And Air Force continues to have the least success with only one output meeting its preparedness targets and only one maintaining core skills. Defence Operations, Strategic Policy and Intelligence continue to meet their targets

The failure to meet targets in 2001–02 was ascribed to a mixture of operational demands, equipment problems including ageing and logistics funding shortfalls, ammunition and personnel shortages, and delays due to both maintenance and projects. However, as we discussed in Chapters 2 and 3 the failure to effectively allocate funds to priority areas probably played a big part in some of the problems.

The capital budget

The focus of the outcomes and outputs framework is on the short-term delivery of capability. The investment in new capabilities for the future is handled separately by the capital budget. The goals of the capital budget are set out in two public documents.

First, the *Defence Capability Plan* sets out the major capital equipment projects that the Government plans to undertake across the decade. The first version of this document was published in mid-2001 and was followed by an update 12 months later. A revised version has been promised for October this year. Second, the *Green Book* outlines the capital facilities projects planned over the next five years. The last version of the *Green Book* was released in mid-2002 and another is expected this year.

Funds for the capital budget come from a variety of sources including an annual equity injection from the Government of around a billion dollars and about three times that amount taken from the revenues received

through the price of outputs. The price of the outputs is based on the accrual expenses incurred in their delivery; this includes money for non-cash expenses like depreciation of equipment and any net growth in liabilities. This means that substantial cash can be diverted to the capital budget from within the price of outputs. In recent years the capital budget has also benefited from the sale of assets, mainly property, the proceeds of which Defence has retained. In effect, the equity injection is a balancing item that makes up for any shortfall after capital receipts and unspent cash from the outputs is used.

Defence's organisational structure

The traditional concept of Defence's organisational structure is that it consists of three Services—Army, Navy and Air Force—and the Department of Defence. This impression is reinforced by the output structure, focused as it is on Army, Navy and Air Force capability outputs. But, in fact, Defence is not organised like this at all. It is divided into fifteen 'groups'; these are the actual entities between which the Defence budget is divided. Figure A1 (*page* 48) gives the actual organisational structure of Defence.

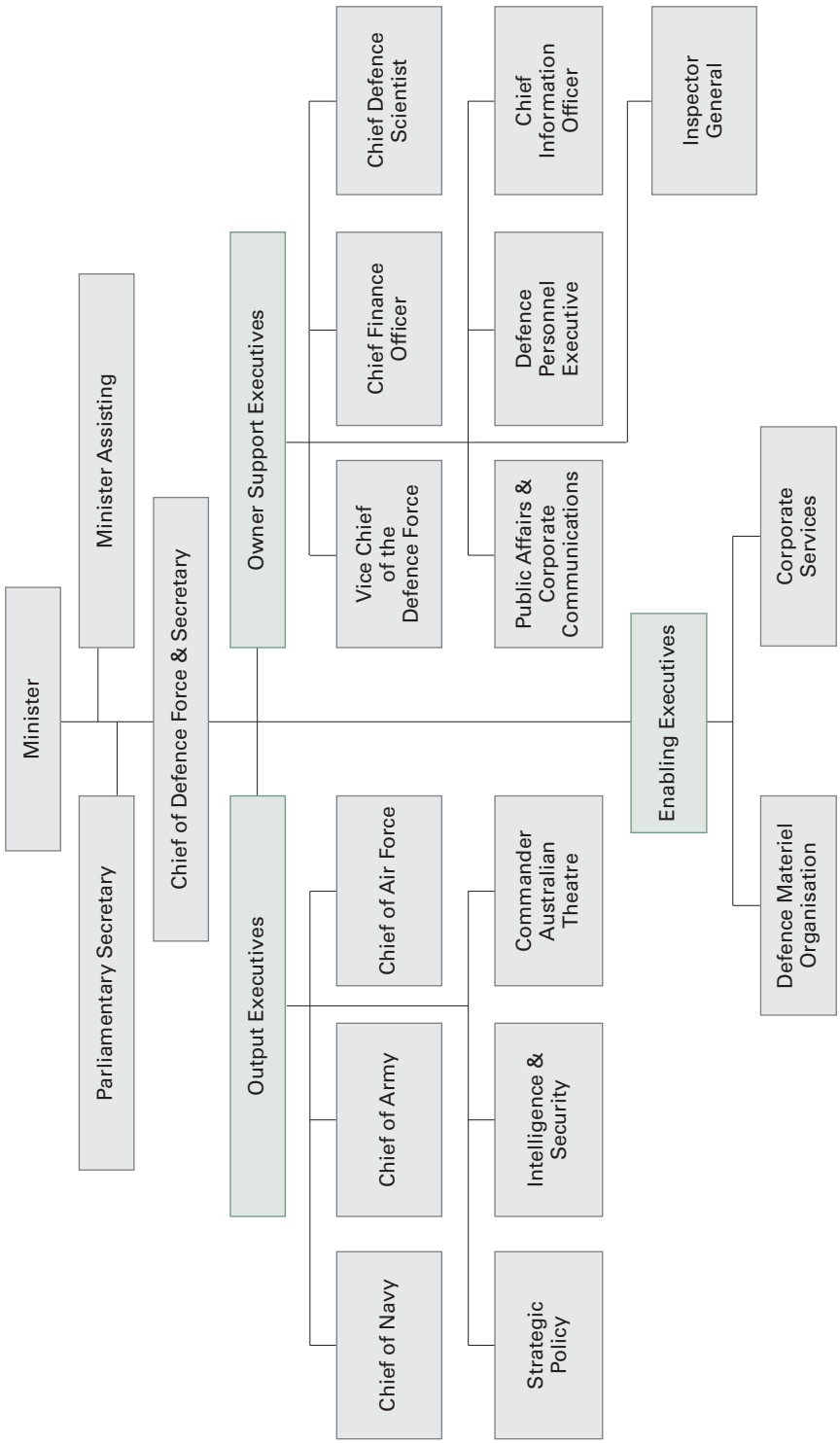
The Groups are divided into three categories:

- *Output Executives Groups* are (mostly) responsible for delivering Defence's outputs to the Government as the customer
- *Owner Support Executives Groups* are responsible for protecting the Government's interest as the owner of Defence, including ensuring its long-term viability, and
- *Enabling Executives Groups* are responsible for providing business services such as asset management to the other two types of groups.

Ultimately, the prices of the 29 outputs are estimated by adding together slices from each of the actual group budgets according to a set of attribution rules. As a result, the fundamental output-price transaction between Government and Defence is largely separate from actual spending and accountability. Some of these groups are larger than most Government agencies, yet under present arrangements their budgets, staffing and performance escape public scrutiny. In fact, Defence is highly secretive of the details and has declined to provide even basic information to a parliamentary committee.

Thus, while the new framework has done much to clarify what is to be delivered by Defence, it also obscures how the money is actually spent and who is accountable for doing so.

Figure A1: The Defence organisational structure.



Acronyms and abbreviations

ADF	Australian Defence Force
DCP	Defence Capability Plan
DMO	Defence Materiel Organisation
DRP	Defence Reform Program
GDP	Gross Domestic Product
INTERFET	International Force East Timor
NSC	National Security Committee
HMAS	Her Majesty's Australian Ship
HMS	His Majesty's Ship
NATO	North Atlantic Treaty Organisation
RMS	Royal Mail Streamer

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The Australian Strategic Policy Institute (ASPI) is an independent, non-partisan policy institute. It has been set up by the Government to provide fresh ideas on Australia's defence and strategic policy choices. ASPI is charged with the task of informing the public on strategic and defence issues, generating new ideas for government, and fostering strategic expertise in Australia. It aims to help Australians understand the critical strategic choices which our country will face over the coming years, and will help Government make better-informed decisions.

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Sinews of War

The Defence Budget in 2003 and How We Got There

This financial year the Government will spend $15.8 billion on Defence, which is an increase of $1.2 billion on the previous year. This includes additional funds for extra personnel, Special Forces, logistics and the cost of the Iraq deployment. These promises reflect an understandable determination by the Government that the ADF be ready and able to respond to immediate challenges.

But while more money is being spent on today's ADF, problems have emerged in the development of the ADF of tomorrow. The program of capital investment set out in the Government's Defence Capability Plan (DCP) is looking shaky. Projects are being progressed more slowly than planned, costs of new projects are escalating and the changing strategic environment has prompted the question of whether the force structure planned in the DCP is still relevant.

Defence has also had major problems managing its budget over the last two years. This year there are encouraging signs that steps are being taken to improve the situation but it will be some time before these initiatives take effect.

There are three imperatives arising from this year's Defence budget:

Imperative 1: Deliver new capabilities on time

An external 'Procurement Task Force' is scheduled to report to the Government later this year. The Government should move quickly to consider its recommendations.

Imperative 2: Continue to improve Defence management

There are three things to be achieved as a priority. The cost of capability needs to be better understood. Financial discipline needs to be established so that efficiency can be targeted. And steps need to be taken to improve accountability within Defence.

Imperative 3: Sort out the DCP and the strategic policy that underpins it

The Government is reviewing the DCP. To be credible the review must provide an achievable program of capital investment underpinned by a clear statement of our strategic and force structure priorities, along with a renewed funding commitment.