In a real world, Abbott faces a big challenge

Promises on spending may be hard to keep

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IT'S hard to judge the prospects for defence spending under the new government. Caught between fiscal reality and an innate conservative instinct for strong defence, the Abbott government risks making promises they will find difficult to keep — if they haven't already. The long-term promise made during the election to boost defence spending to 2 per cent of GDP "within a decade" might turn out to have been a step too far.

In opposition, the Coalition was strongly critical of the Rudd and Gillard governments for failing to properly fund their ambitious plans for the Australian Defence Force set out in the 2009 and 2013 defence white papers. And rightly so; over a three-year period more than $20 billion of promised defence funding was ripped out in a futile attempt to achieve a politically expedient budget surplus.

The result is that the Gillard government has left defence between a rock and a hard place. It's not that Australia's defence spending is set to decline or even remain static, as is the case in many other developed countries dealing with the fallout from the 2008 financial crisis. To the contrary, the 2013 budget outlined significant real increases to defence spending over the period 2013 to 2022. The problem is that the increases are almost certainly going to be inadequate to deliver what's planned.

Here's the situation. The 2013 white paper effectively preserved all of its predecessor's capability goals. Thus, all the ambitious plans set out in the 2009 white paper — including a doubling in size of the submarine fleet — remain on the books. Yet future defence funding was set substantially below that promised in 2009. For the period 2009 to 2022 the gap amounts to about $33bn.

Of course, it's open for the Abbott government to further increase defence spending in the future and they've promised to do so. However, the Treasury estimates the new government is working with are based on the previous government's reduced commitment to defence spending. Every extra dollar for defence will erode an already unfavourable fiscal outlook.

Things are unlikely to get better anytime soon. In the past 24 months there have been repeated and substantial downgrades of expected government revenues. Two interrelated factors have been at play: an ongoing deterioration in our terms-of-trade, and a slowing of activity in the resources sector. At the same time, downside risks in the global economy stand ready to exacerbate both factors, and the Australian economy has slowed and unemployment has risen to a level not seen since the height of the financial crisis. None of this bodes well for an incoming government committed to balanced budgets and low debt.

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In the short term, the Abbott government will want to get the budget back into surplus as soon as possible. Doing so before the next election in 2016 would allow the Coalition to reinforce the political narrative of superior economic management. With no Labor government having delivered a surplus in almost a quarter century, the political prize is ready for the taking. Consequently, the prospects for substantial additional defence funding over the next few years are limited.

In the longer term, Abbott has set himself a difficult target. The promise to increase defence spending to 2 per cent of GDP within a decade probably hasn't received the attention it deserves. In comparison, the Rudd government's 2009 funding scheme would have resulted in defence spending amounting to 1.85 per cent in a decade, while Gillard's 2013 promise would have delivered only 1.64 per cent — a little above the 1.59 per cent it is today.

Increasing defence spending by 0.4 per cent of GDP over a decade is no mean feat. It would require steady real growth in funding of about 5.3 per cent a year over the period. While it's possible to achieve the target through a shorter period of more rapid growth later in the decade, experience shows this would almost certainly exceed Defence's capacity to absorb the extra funds. Indeed, Defence handed back hundreds of millions of unspent dollars in the 2000s as it struggled to spend the more modest 3 per cent funding growth granted by the Howard government. But before anyone worries too much about Defence's capacity to consume taxpayer dollars, the question is whether the money will be there to spend in the first place.

Here's where things get interesting. For several years before the last election, the goal of spending 2 per cent of GDP on defence was described as an "aspiration" by the Coalition, something to be achieved if and when economic circumstances allowed.

All that changed at the official campaign launch when Abbott made an unequivocal commitment to the 2 per cent target along with — and this is critical — delivering a surplus of 1 per cent of GDP while simultaneously reducing the size of the federal government as a share of GDP over the same period.

If all three promises are to be kept, it will require the economy to grow more quickly than government spending in non-defence sectors such as health, education and welfare. While that's not impossible, it will require some politically difficult decisions, especially given emerging costs such as the national disability insurance scheme.

With a new defence white paper promised in the next 18 months, there'll be ample opportunity for the government to examine the balance between their ambitions for the defence force and the many competing fiscal priorities. If they remain true to the charter of budget honesty introduced by the Howard government, a critical step will be the intergenerational report due with next year's budget. Setting out the prospects for government revenues and expenditure to 2054, the intergenerational report will make clear the scale of the challenge Abbott has set himself.

Although thecoming defence white paper and intergenerational report will shape government thinking, history shows real world developments are much more likely to have an influence. A strategic crisis would predispose any government to redouble efforts to strengthen Australia's defence, while another financial meltdown would soon put a stop to accelerated defence investment. As has always been the case, the size and shape of the ADF in a couple of decades will owe more to events between now and then than it does to what's on paper today.

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