# STRATEGY

ASPI

# Your Defence Dollar:

## The 2004–05 Defence Budget

ASPI
AUSTRALIAN STRATEGIC POLICY INSTITUTE


July 2004

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Prior to joining ASPI, Mark Thomson held a number of positions in Defence working in the areas of capability development and resource management. In 1999 he was Political Military Adviser to Major General Peter Cosgrove during the INTERFET operation. Prior to his time with Defence, Mark held a series of academic research and teaching positions in theoretical physics.

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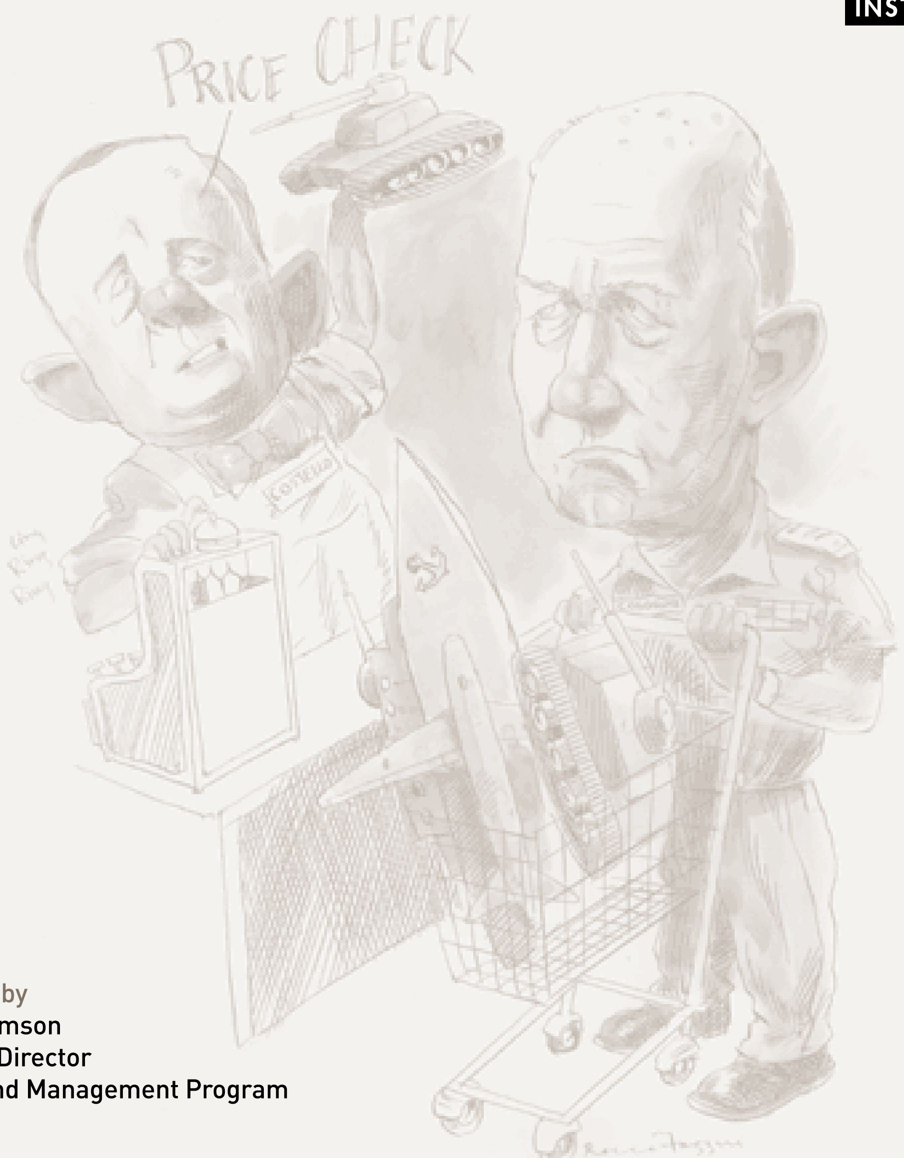


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# Director's introduction

This is the fourth ASPI policy report dealing with defence spending published in the past twelve months. To some, this might seem an inordinate focus on mere dollars at a time when war and terrorism fill the pages of our newspapers. But an informed defence policy debate cannot ignore the financial consequences of the options being considered. Now, more than ever, it's important that every defence dollar is spent to best effect.

This report, *Your Defence Dollar*, is a summary version of the *The Cost of Defence* that came out two weeks after the Federal Budget. Last year's summary, entitled *Sinews of War*, devoted a lot of space to the history of Australian defence spending over the past fifteen years. With that background firmly established, this year's summary focuses more on explaining and detailing this year's Defence budget, including the impact of the new Defence Capability Plan.

This report draws heavily on the work of those who helped make the *The Cost of Defence* happen. This included Ms Kate Freebody and associates from FreebodyCogent, who provided invaluable assistance on accounting matters and Messrs Dougal McInnes and Jock Tulloch from ASPI's staff. A special thanks goes to Rocco Fazzari for producing such a creative and topical cartoon for the cover.

Also, Defence was kind enough to look over a preliminary draft of the *The Cost of Defence* and provide valuable comments. This feedback has been incorporated into this report. Of course, this does not in any way imply that Defence endorses this document or even supports its conclusions.

My colleague Dr Mark Thomson, who is the manager of ASPI's Budget and Management Program, has written this report. As always, responsibility for the judgments contained herein lie with Dr Thomson and me alone.

Lastly, we should acknowledge that we at ASPI are not disinterested observers of the Defence budget. Our funding from government is provided through Defence at the rate of $2,499,276 per annum. Details can be found in our annual report.

**Hugh White**
Director

# Executive summary

This year's Defence budget is much like last year's. A lot more money has been provided to maintain today's ADF, while a significant chunk of planned investment in tomorrow's force has been deferred. In doing so, the 2004–05 Budget reflects the recommendations of the 2003 Defence Capability Review, which reassessed the plans set out in the 2000 Defence White Paper.

The biggest change is that $2.2 billion of previously planned investment in new equipment has been deferred to beyond 2007–08. This means that more than 20% of the additional funding provided for investment in the first seven years of the White Paper has been delayed. This was not done to free up cash for elsewhere in the Budget but arose simply because Defence has not been able to spend the money it has received.

The delayed investment schedule underpins the revised Defence Capability Plan for new equipment, released in February this year. Having less money available for investment in the short to medium term, and rising individual project costs, have caused delays in the planned delivery of projects. This is unavoidable—within a limited budget, rising costs must translate into delays. On top of this, further pressure has been added to the investment program by new projects designed to meet the extra challenges thrown up after 9/11.

The sixty-five projects carried forward from the original version of the plan will now arrive around a year later than originally planned, while thirty-four others have been delayed to beyond 2013–14 or cancelled. Thus, while the government retains a commitment to the total spending on new equipment planned in the 2000 White Paper, this should not be confused with a commitment to the original capability goals. There is no escaping the conclusion that we will have to wait longer for new capability, and in some cases get less than originally planned.

In the light of recent problems with delivering projects, the government has initiated a major reform of the Defence Materiel Organisation, re-establishing it as a quasi-independent 'prescribed agency' and providing much closer scrutiny of new proposals. This had better work. While the delayed investment will create a respite in the near term, it inevitably increases both the rate of growth and scale of investment near the end of this decade. Success or failure will be critical to Defence's long-term funding. The government is yet to decide whether to continue 3% real growth in Defence funding past the end of the decade. Until Defence can show that it can spend the money it gets, the question is moot.

The Defence Capability Review also looked at the current force structure and the cost of maintaining it. In the 2004–05 Budget, we get to see the results in detail. Over the next four years, Defence will make savings of $287 million by tying up two of the Navy's mine hunter vessels and retiring two FFG frigates. And at the end of the decade there'll be another $150 million per annum saved when the F-111 long-range strike and reconnaissance capability is retired early.

But these savings weren't enough to make up for growing operating and personnel cost pressures. Consequently, the Budget provided additional funding across the next four years: $816 million for logistics on top of $1.1 billion provided last year, $654 million for personnel (for improved pay and conditions, not extra numbers) and $300 million for estate upkeep. The net result of the increased funding and cuts to the force structure is that we are now paying more money and getting less military capability than previously planned.

So where does this leave us? Are we getting good value for money for our Defence dollar? On the one hand, a lot of work's been done to ensure that the revised program of new equipment purchases is both achievable and value-for-money. On the other hand, the situation is far less clear regarding the substantial extra funding that's been flowing into personnel and operating costs. This need not, and should not, be the case.

When the current accrual budget framework was put in place back in 1999, it was intended that there would be periodic reviews by the Department of Finance to examine in detail the cost of the twenty-eight capability outputs that Defence delivers. Although these 'price checks' were envisaged as a key element of the framework, they have fallen out of favour.

Given the rising cost of maintaining the current ADF, and the relaxation in its operational tempo, now seems as good a time as any to check the price of a few outputs. The argument for such a review is bolstered by the fact that, five years after the introduction of the framework, Defence is still struggling to work out the costs of its outputs. If you don't know what something costs, it's impossible to say if you're getting value for money.

Who knows what a review would find? There may be efficiencies to be harvested, or we may need to be spending more to ensure that the ADF has what it needs to do its job. Either way, it's worth knowing.

Chapter 1

# STRATEGIC CONTEXT FOR THE BUDGET

This year, after two years in the limelight, defence stepped back to something more like its traditional place on Budget night. In both 2002 and 2003, Peter Costello's Budget speech began with defence and security, and he spoke about them at length before turning to the economy and other issues. In 2002, he spent over a third of his speech on defence and security; in 2003, they took up something closer to a quarter. This year, the Treasurer mentioned them only in passing until around the middle of his speech. Sandwiched between retirement savings and health care, they received together about one page of the eleven in the speech.

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...voters are now less interested in hearing their leaders talk about security issues than they were over the past two years.

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## Aware but not obsessed

This reversion to a more typical lower profile for defence on Budget night reflects political and strategic realities. Politically, it suggests that after three years as the hot-button issue, defence is no longer the area that the government wants to project as its overriding Budget priority. Budget speeches are carefully crafted political documents, so we can infer that defence's sharp demotion reflects the government's sense, based no doubt on polling, that the voters are now less interested in hearing their leaders talk about security issues than they were over the past two years.

This in turn reflects a deeper trend. Politics and policy have now adapted to the world after September 11, 2001. We're not returning to a pre-9/11 'normality', but establishing a new post-9/11 one, and getting things more clearly into balance. In some ways this applies not just to new realities after 9/11, but to the lessons taught by events in East Timor in 1999 about our regional strategic environment and the demands that it might make of Australia's armed forces and wider national capacities.

The government's slogan, 'alert but not alarmed', never quite took root in Australia's national consciousness. But we have made our own accommodation with the more violent world we seem to find ourselves in. That state of mind might be better expressed as 'aware but not obsessed'.

## Coming home

One reason for this is that, at least for the time being, Australia's military commitments overseas are falling to their lowest levels since before Interfet was deployed to East Timor in 1999. In East Timor itself, our troop deployment is falling to a little over a hundred as the UN passes responsibility for security to the East Timorese themselves. In Solomon Islands, the Australian Defence Force (ADF) component is being wound back, with the task of reconstruction firmly in the hands of police and other civil agencies. And in Iraq and the Gulf, the government seems committed to sustaining the current levels of deployment, but not to be contemplating any substantial increase, while the Opposition is committed to bringing our forces home by Christmas.

...armed force isn't necessarily the most effective response to many security challenges...

Iraq of course remains a major focus of public attention and concern, but it's reminded people that armed force isn't necessarily the most effective response to many security challenges, especially the complex challenges of terrorism. And the Bush Doctrine seems to have been overtaken by reality. The expectation, raised by the Bush Administration in 2002, that the War on Terror would entail a series of major military operations against the Axis of Evil, and that Australia would be called upon to join these operations, has been dimmed by the experience of Iraq. The recognition that the US itself lacks the military capability, especially in land forces, and perhaps also the political will to undertake more operations on this scale suggests that Iraq, rather than being the new paradigm, is an exception, and possibly an aberration, in US strategic policy.

Australia's strategic attention was already returning to our own neighbourhood when, a few weeks after last year's Budget, the government committed Australia, including the ADF, to a major regional operation in Solomon Islands.

## Sustained spending

None of this means that defence and security hasn't been generously treated in the 2004 Budget. The government has more than fulfilled its long-term commitment to sustained and substantial growth in defence spending, and thrown in a bit more besides. And it has provided more big funding increases to intelligence and domestic security agencies. Indeed these agencies have been the main focus of new Budget measures, with proportionately very large increases in intelligence budgets in particular. This reflects the government's recognition that intelligence is the key to an effective long-term campaign to reduce the chances of a successful terrorist attack against Australia or Australians.

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The government has more than fulfilled its long-term commitment to sustained and substantial growth in defence spending...

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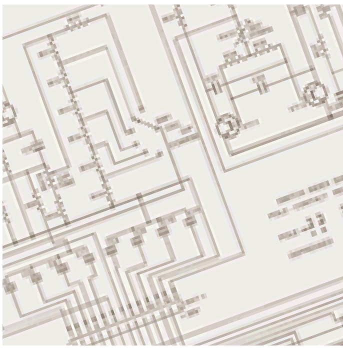
Likewise, the government has treated the Australian Federal Police (AFP) generously in the Budget, recognising that in meeting the demanding security challenges of Australia's immediate neighbourhood—in Solomon Islands and Papua New Guinea (PNG), for example—it is the AFP that is often on the front line. Today, a higher proportion of the AFP than of the ADF is deployed overseas on operations.

A member of the Iraqi Army Training Team about to leave from Baghdad on a visit of training locations in Iraq, 3 May, 2004. © Defence Department

The government spent two years reviewing how Australia's long-term defence capability needs would be affected by the war on terror. The results were released in the Defence Capability Review late last year, and in the revised Defence Capability Plan published in February this year. Some important new capabilities were added to the plan, and some older ones were retired early, but overall the review process concluded that Australia's defence capability needs had not been transformed by 9/11.

The government still sees Australia needing to develop and maintain two key kinds of capability: a set of high-technology air and naval forces to defend Australia and provide strategic weight in the maritime strategic theatre of the Western Pacific, and a set of light, highly deployable land forces for operations offshore, especially in our immediate neighbourhood. These are both long-term priorities, and the extent to which they are achieved will be the real measure of the adequacy of the government's defence budgets.



Chapter 2

# FUNDING, ORGANISATION AND COMMAND

Defence is a complex beast, not just because it's a vast entity with more than 90,000 employees spread from one end of the continent to the other, but because it's organised, funded and commanded through three largely separate arrangements. This chapter takes on the daunting task of describing these three frameworks and how they work in concert.

## How Defence is funded: outcomes and outputs

The Defence budget is set out according to a framework of 'outcomes' and 'outputs'. This framework was introduced by the government in 1999, and is applied to all Australian Government agencies. It works like this:

- **Outcomes** are the results or benefits that the government aims to deliver to the community through the work of its agencies. Outcomes 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 isn't just an accounting device. It's intended to provide a structure for management decision-making and resource allocation throughout national agencies. So the way the framework is applied in an agency, such as Defence, is very important to the agency's management and performance.

...the aim is to show not only how much an agency is doing, but how much it is actually *achieving*.

The key to the effective application of the framework is the specification of the outcome or outcomes. Defence has six outcomes:

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.

There is actually a seventh outcome, mainly covering superannuation payments for current and former ADF personnel, and housing subsidies provided under the *Defence Force (Home Loans Assistance) Act 1990*. This money is channelled through Defence as an administrative convenience, and we shan't consider it further.

Underneath each of these outcomes is one or more outputs that contribute to its delivery. The cornerstone of defence funding is the so-called 'output appropriation' that gives Defence enough money to cover the net cost of delivering the twenty-eight outputs that the government 'buys' from Defence. These are listed in Table 1, along with the budgeted net costs for 2004–05.

The funds appropriated annually for the net cost of the outputs exceeds the amount of cash spent to deliver them by around three billion dollars every year. This is because Defence is funded on the basis of an accrual budget that recognises non-cash expenses like depreciation. Put simply, Defence gets cash revenue for non-cash expenses. But don't worry, this cash surplus doesn't go to waste. Instead, it's used to partially fund Defence's Capital Investment Program; the remainder is made up through an additional 'equity injection' appropriation, counterbalanced as necessary by a 'capital withdrawal'. In recent years, Defence has also supplemented its investment program through the sale of assets, including (especially) property. If you want to grapple with the intricacies of how this complex arrangement works, our annual budget brief *The Cost of Defence* has an extended discussion.

At first glance, all this accounting gymnastics can seem contrived and artificial, but it's really a serious attempt to make visible the true cost of delivering military capability. It would be wrong to ignore the depreciation on billions of dollars worth of equipment as it is used. The accrual approach tries to capture everything that's being consumed—in terms both of cash spent and assets used up.

**Table 1: The Defence outputs**

| Outcome | Output | | Cost $m |
|---|---|---|---|
| 1. Command of Operations | 1.1 | Command of Operations | 358 |
| | 1.2 | Defence Force Military Operations and Exercises | 326 |
| | 1.3 | Contribution to National Support Tasks | 10 |
| | | subtotal | **694** |
| 2. Navy Capability | 2.1 | Capability for Major Surface Combatant Operations | 1,425 |
| | 2.2 | Capability for Naval Aviation Operations | 508 |
| | 2.3 | Capability for Patrol Boat Operations | 289 |
| | 2.4 | Capability for Submarine Operations | 858 |
| | 2.5 | Capability for Afloat Support | 223 |
| | 2.6 | Capability for Mine Warfare | 404 |
| | 2.7 | Capability for Amphibious Lift | 372 |
| | 2.8 | Capability for Hydrographic and Oceanographic Operations | 247 |
| | | subtotal | **4,326** |
| 3. Army Capability | 3.1 | Capability for Special Forces Operations | 322 |
| | 3.2 | Capability for Mechanised Operations | 864 |
| | 3.3 | Capability for Light Infantry Operations | 1,019 |
| | 3.4 | Capability for Army Aviation Operations | 624 |
| | 3.5 | Capability for Ground-based Air Defence | 182 |
| | 3.6 | Capability for Combat Support Operations | 488 |
| | 3.7 | Capability for Regional Surveillance | 160 |
| | 3.8 | Capability for Operational Logistic Support to Land Forces | 504 |
| | 3.9 | Capability for Motorised Infantry Operations | 584 |
| | 3.10 | Capability for Protective Operations | 540 |
| | | subtotal | **5,287** |
| 4. Air Force Capability | 4.1 | Capability for Air Combat | 1,959 |
| | 4.2 | Capability for Combat Support of Air Operations | 557 |
| | 4.3 | Capability for Strategic Surveillance & Response Operations | 1,228 |
| | 4.4 | Capability for Air Lift | 976 |
| | | subtotal | **4,620** |
| 5. Strategic Policy | 5.1 | Strategic & International Policy, Activities & Engagement | 195 |
| | 5.2 | Military Strategy and Capability Analysis | 48 |
| | | subtotal | **243** |
| 6. Intelligence | 6.1 | Intelligence | **435** |
| TOTAL | | | **15,605** |

*Source: 2004–05 Defence Budget Papers. Figures have been rounded.*

So, despite all the complications, the output framework makes some sense. The only problem is that Defence is still trying to work out the net cost of the outputs it provides to the government, notwithstanding that the framework is now entering its fifth year. The latest refinement in early 2004 saw some big reassessments. The net cost of ground-based air defence grew by almost 90% and the cost of regional surveillance by 70%, while the net cost of the Navy's major surface combatants fell by 15%—all unrelated to any substantive changes to overall Defence spending.

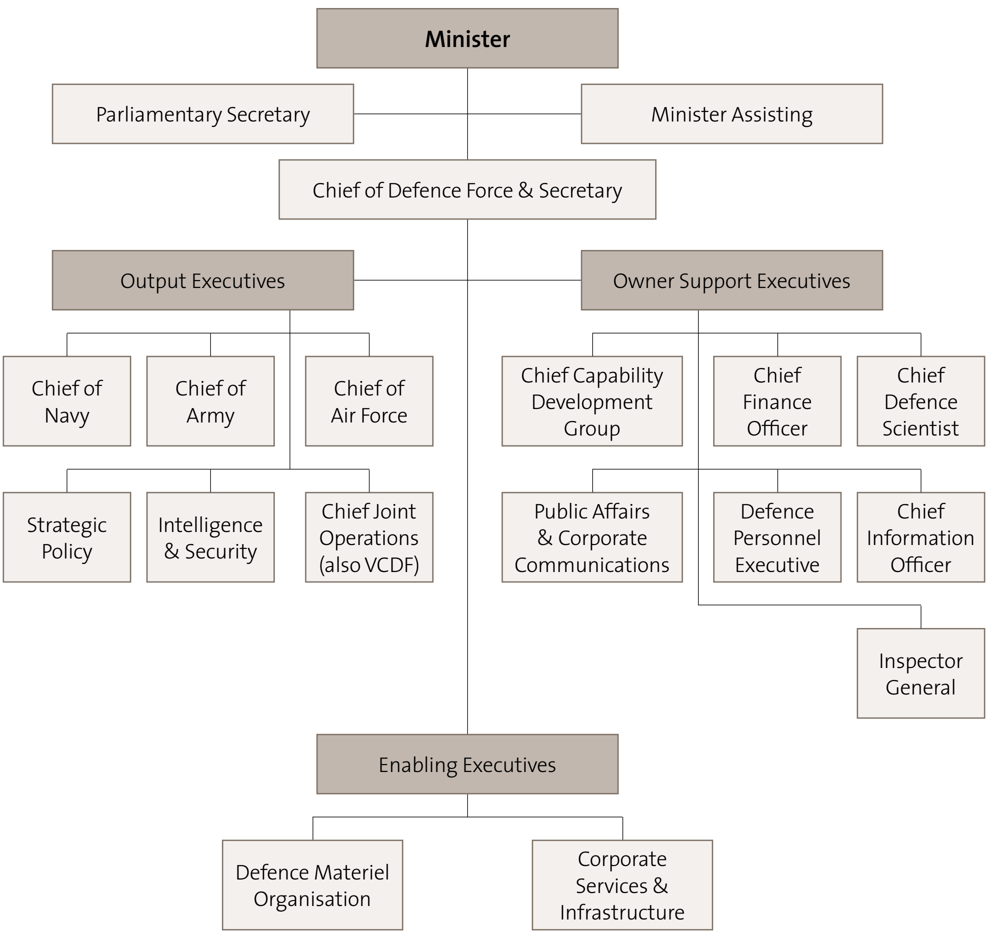
Until such time as Defence's output costing methodology stabilises, the output costs will remain of limited use. So it's not surprising that, in practice, both Defence and the Department of Finance remain as focused as ever on the cost of inputs like personnel, facilities and logistics, with only scant regard to the cost of outputs.

...below the Minister no single person is in charge.

## How Defence is organised: groups

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, the Defence organisation is not organised like this at all. It is divided into sixteen 'groups'; these are the entities between which the Defence budget is divided. The arrangement of the groups is set out in Figure 1. Perhaps the most striking feature is that below the Minister no single person is in charge. The Secretary and the Chief of the Defence Force share control of Defence through a diarchy in which they each have separate and overlapping responsibilities.

**Figure 1: The Defence organisation**




*Source: 2004–05 Defence Budget Papers.*

The groups fall into three categories:

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

The groups and their executives are responsible for spending Defence's money and doing its business. Consequently, it is within the group structure that financial accountability occurs. Unfortunately, there is no simple correspondence between the groups where money is actually spent and the outputs that form the basis of Defence funding. This fundamental 'disconnect' is why Defence has trouble determining the net cost of its outputs. Ultimately, the net costs of outputs are entirely derived figures that don't correspond to the allocation of funds within Defence.

Table 2 gives the breakdown of the total attributed net cost of the Defence outputs across the sixteen groups for 2004–05.

**Table 2: Allocation of the cost of outputs to groups**

| | | 2004–05 $ million | 2004–05 % of total |
|---|---|---|---|
| **Output Executives** | | | |
| HQ Joint Operations | | 85 | 0.54% |
| Navy | | 1,254 | 8.03% |
| Army | | 2,293 | 14.69% |
| Air Force | | 1,364 | 8.74% |
| Intelligence | | 303 | 1.94% |
| Strategic Policy | | 144 | 0.92% |
| | Subtotal | **5,442** | **34.87%** |
| **Owner Support Executives** | | | |
| Defence Personnel Executive | | 689 | 4.41% |
| Defence Science and Technology | | 287 | 1.83% |
| Vice Chief of the Defence Force | | 52 | 0.33% |
| Chief Finance Officer | | 338 | 2.16% |
| Chief Information Officer | | 24 | 0.15% |
| Secretary/CDF Force | | 4 | 0.02% |
| Public Affairs and Corporate Comms | | 12 | 0.07% |
| Inspector-General | | 11 | 0.07% |
| | Subtotal | **1,416** | **9.07%** |
| **Enabling Executives** | | | |
| Defence Materiel Organisation | | 4,683 | 30.0% |
| Corporate Services and Infrastructure | | 2,615 | 16.75% |
| | Subtotal | **7,298** | **46.76%** |
| Portfolio | | 1,448 | 9.27% |
| **TOTAL** | | **15,605** | **100.0%** |

*Source: 2004–05 Defence Budget Papers. Figures have been rounded.*

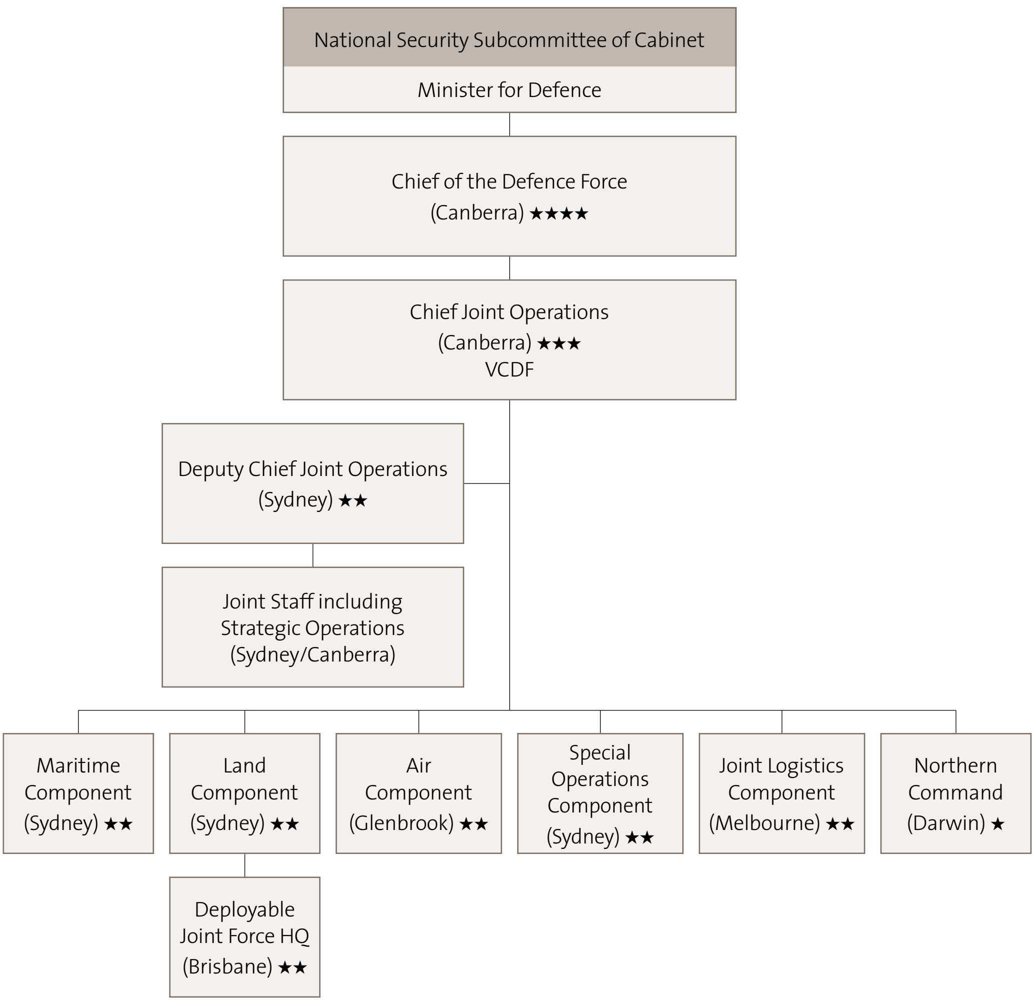
The most interesting thing about the breakdown in Table 2 is that the Output Executives (who are responsible for delivering Defence's outcomes and outputs) control less than 40% of the budget, with almost half the money going to the two Enabling Executives. Note that, in 2004–05, $1.4 billion remains in a portfolio fund and is yet to be allocated.

## ADF command structure

It's important not to confuse the day-to-day management of the Department of Defence with the command of military operations. The former occurs through the diarchy and group/output arrangements, the latter through a formal command chain and dedicated headquarters structure. In this parallel arrangement, units are temporarily re-assigned from the services to be commanded on operations and exercises as required.

In early 2003, the ADF command arrangements were revised through the creation of Joint Operations Command under the Chief of Joint Operations, who also happens to be the Vice Chief of the Defence Force. In this rearrangement, the old Headquarters Australia Theatre became part of the Joint Staff. Figure 2 outlines the arrangement.

**Figure 2: Defence command arrangements**



...control of the ADF resides with the executive government through the National Security Committee of Cabinet.

Two points are worth noting. First, notwithstanding what a naive reading of the Australian Constitution might imply, the actual control of the ADF resides with the executive government through the National Security Committee of Cabinet. The Governor-General's role of commander-in-chief is entirely titular. Second, while many aspects of the management of Defence are shared between the Chief of the Defence Force and the Secretary of the Department, the Secretary plays no role in the command of the ADF.

## How does this all hang together?

At the risk of oversimplification, Defence is funded and reports on the basis of twenty-eight outputs, organised and budgeted internally on the basis of sixteen groups, and is commanded on operations through an entirely separate arrangement of cascading headquarters.

Viewed this way, it's surprising that things work as well as they do. But of course there's a price to be paid. All these overlapping arrangements require both orchestration from above and lateral co-ordination. This means that a lot of energy is devoted to keeping Defence's internal bureaucratic processes ticking over, and that accountabilities are clouded and communications impeded.


Treasurer Peter Costello delivers his 9th budget, May 11, 2004.  AAP/Mark Graham © 2004 AAP

Chapter 3

# THE 2004–05 DEFENCE BUDGET

In the arcane world of Commonwealth finances, several different figures are given for the size of the Defence budget, with each measuring different things. The one that's most useful is that for *Total Departmental Funding* given in the Defence budget papers. It represents the funds available to Defence to deliver the six departmental outcomes and maintain the ongoing program of investment in new equipment and facilities. It's also the figure commonly used to measure movements in Defence's funding and is therefore the one to focus on. For 2004–05, it is $16.3 billion dollars. This is an increase of $725 million, or 4.6%, on last year's figure. After inflation is taken into account, the real growth comes out at 2.1%.

As a share of national wealth, Defence spending is budgeted at 1.9% of gross domestic product (GDP) for 2004–05. This will fall slowly in the next couple of years, as projected strong GDP growth outstrips the rate of increase in the Defence budget. In 2004–05, Defence spending will account for 8.5% of overall Commonwealth payments. These statistics and those for recent years appear in Table 3, along with the projected figures out to 2007–08.

The White Paper committed the government to a decade-long program of 3% real growth in the underlying level of Defence funding. This is not apparent in Table 3 for two reasons. First, substantial extra funding has been provided in the early years of the decade for logistics, personnel, overseas deployments and security initiatives since 9/11. This reduces the rate of growth from what it would otherwise have been. Second, some of the originally planned spending on new capital equipment has been deferred until 2007–08. Although the total amount of money to be spent on new equipment remains unchanged, this means that some of the originally planned growth in funding has been deferred until near the end of the decade.

**Table 3: Defence budget statistics**

| | 00–01 | 01–02 | 02–03 | 03–04 | 04–05 | 05–06 | 06–07 | 07–08 |
|---|---|---|---|---|---|---|---|---|
| Funds (nominal) $m | 12,648 | 14,501 | 14,738 | 15,623 | 16,348 | 16,511 | 17,295 | 18,310 |
| Growth (nominal) | 1.6% | 14.6% | 1.6% | 6.0% | 4.6% | 1.0% | 4.8% | 5.9% |
| Growth (real) | –2.8% | 12.5% | –1.2% | 1.9% | 2.1% | –1.0% | 2.7% | 3.8% |
| % of GDP | 1.89% | 2.03% | 1.96% | 1.92% | 1.90% | 1.82% | 1.83% | 1.82% |
| % payments | 8.17% | 8.87% | 8.74% | 8.65% | 8.52% | 8.25% | 8.30% | 8.39% |

*Note: real growth is calculated relative to the implicit non-farm GDP deflator.*

## What's new in this year's Budget?

The Budget process is all about marginal changes to pre-existing funding levels. These take the form of Budget 'measures' and funding adjustments. This year's Defence budget contained twenty-nine such items, which can conveniently be grouped as shown in Table 4. All figures refer to the total budget impact over the next four years.

In big numbers, the story is simple. A total of $884 million of previously planned capital investment has been rescheduled to later in the decade, while cuts to capability in the current ADF reduce spending by a further $287 million. On the other hand, Defence gets an additional $816 million for logistics, $654 million for personnel-related spending, an extra $374 million for the Defence estate, $168 million in supplementation for deployments, $85 million for improved domestic and regional security, and $33 million to improve Defence procurement. In addition, supplementation for inflation and foreign exchange variations totals $593 million, while miscellaneous transfers and adjustments remove $716 million. We explore these changes in more detail below.

**Table 4: Changes in the 2004–05 Defence budget**

| | Total 2004–05 to 2007–08 ($ million) |
|---|---|
| Delayed capital investment | –884 |
| Cuts to capability | –287 |
| Logistics | 816 |
| Personnel | 654 |
| Estate | 374 |
| Deployments | 168 |
| Regional and domestic security | 85 |
| Procurement review | 33 |
| Price and exchange | 593 |
| Transfers and adjustments | –716 |
| **TOTAL** | **835** |

*Source: 2004–05 Defence budget papers.*

### Delayed capital investment

The largest initiative in the 2004–05 Budget is the reprogramming of $884 million previously committed to the Capital Investment Program across four years. This comes on top of $642 million rescheduled last year, and $700 million of investment funds acknowledged as being unspent from the previous two years. This amounts to $2,226 million of planned capital investment that has been deferred. As a consequence,

$2,226 million worth of equipment acquisitions will now arrive years late. We explore the consequences of this delayed investment in Chapters 4 and 6.

The good news, if there is any, is that the capital program was not cut to provide funds for use elsewhere in the Budget. Instead, the government reluctantly rescheduled major capital equipment projects because it's become clear that the original schedule of expenditure won't be met. This was done through the 2003 Defence Capability Review, which underpinned the revised Defence Capability Plan published in February 2004.

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...$2,226 million of planned capital investment has been deferred.

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Mindful of the recent problems in delivering new equipment, the government provided $32.5 million over four years for the implementation of the recommendations of the 2003 Defence Procurement Review (see Chapter 7) to improve the delivery of new capability.

**Cuts to capability**

The Defence Capability Review also made cuts to the force structure, resulting in savings in this Budget of $286.5 million over the next four years. This includes the paying-off of two FFG frigates, the laying-up of two newly acquired mine hunting vessels, and the early retirement of the F-111 fleet at the end of this decade (see Chapter 6).

**Logistics**

There are two measures for increased logistics funding in this Budget. The first provides an extra $205 million in 2007–08, continuing last year's boost of $1,145 million to the end of the current forward estimates period. As a result, a total of $1,350 million has been provided over six years to help the ADF 'sustain current levels of operational tempo and to meet specific preparedness targets'. This funding covers a range of platforms including the F/A-18 fighter aircraft, C-130J transport aircraft, Collins Class submarines and explosive ordnance.

The second logistics measure provides an additional $610.3 million over four years for 'enhanced maintenance, refits and/or planned upgrades'. This measure will fund work on ADF platforms, including HMAS Success, AP-3C maritime patrol aircraft, Anzac frigates, PC-9 training aircraft, Army and Navy aviation, C-130H transport aircraft, and Army surveillance and battlefield combat-support systems.

Thus, in the last two years an extra $1,960 million has been provided for logistics. The magnitude of the boost averages over $404 million per annum from this year onwards, or around 20% of expenses reported for repair and overhaul and inventory consumption in 2002–03.

**Personnel**

Back in 2001–02, the government allocated $500 million over five years (from within the Defence budget) to deal with high-priority personnel issues. These measures appear to have worked, with strong improvements in ADF recruitment and retention.

This year, there's an additional $654 million of spending over four years on personnel-related items, including:

- An expansion of the rental assistance program by $243 million over three years to allow single ADF members to live 'off base' in private rental accommodation. This will increase the number of members receiving rental assistance from 4,500 to 10,600 by 2006.
- $113 million over four years to be spent on the renewal and repair of Defence-provided accommodation for members without dependants. Defence is currently exploring the use of private financing initiatives to help provide improved accommodation.
- An additional $196 million so that Defence can meet increased rental costs associated with commercialising the Defence Housing Authority. However, this is expected to be budget-neutral from a whole-of-government perspective once increased dividends and tax equivalent payments from the authority to the government are taken into account.
- An extra $80 million over four years to supplement increasing ADF personnel costs. Overall, this means that Defence is now receiving annual supplementation for 2.5% real growth in military per-capita personnel expenses and 2% real annual growth for civilian personnel. This is an arrangement that other national agencies can only envy, since the default expectation is that any increases beyond indexation will come from productivity gains.
- A $21 million continuation of personnel initiatives to improve conditions for ADF members and their families over two years, commencing in 2006–07. This includes the provision of childcare places and support to spouses.

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Defence is now receiving annual supplementation for 2.5% real growth in military per-capita personnel expenses and 2% real annual growth for civilian personnel.

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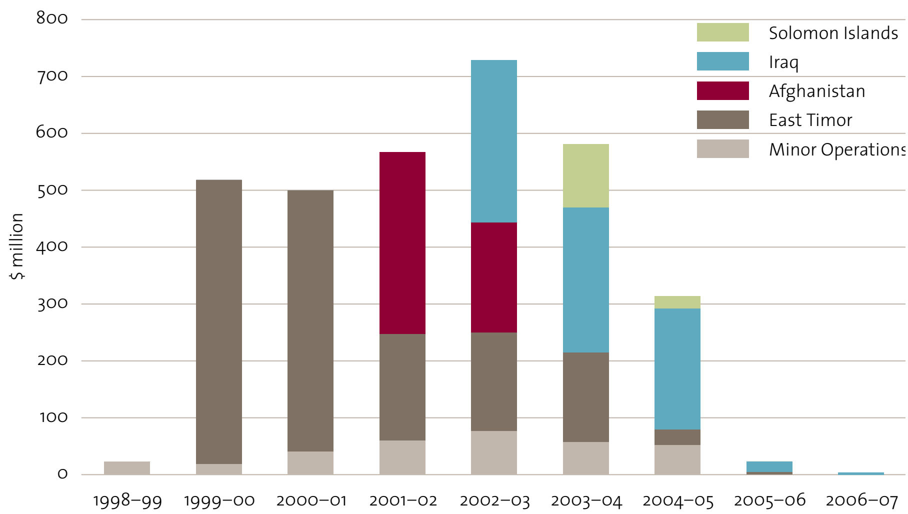
### Estate

Aside from a single payment of $5 million to establish the Point Nepean Community Trust and $57.3 million to cover the cost of selling Defence property, there's an extra $300 million over three years from 2005–06 to help meet the cost of maintaining the Defence estate. Defence has buildings valued at $9.8 billion dollars. An extra $100 million per annum represents just over 1% of this amount. Defence will also receive $11.7 million in 2004–05 to cover a Comcover premium increase for, among other things, insurance on parts of the estate.

### Deployments

Additional funding has been provided for the net additional costs of one more year in Iraq ($132 million) and the same in East Timor ($20 million), as well as a one-year extension of the elevated ADF contribution to coastal surveillance that began in late 2001 ($16 million). The cost of Defence deployments in recent years is compared in Figure 3.

**Figure 3: The cost of war**




*Source: Defence annual reports and budget papers.*

## Domestic and regional security

The Federal budget once again delivered big money for domestic security. In total, $755 million has been provided over five years in a package of measures entitled *Investing in Australia's Security*. The money is spread across a large number of portfolios—not just Defence. This means that since the 2002–03 Budget, around $3.1 billion has been committed over seven years for national security initiatives across agencies. This year's extra funding includes $270 million to strengthen Australia's intelligence capabilities, including the Australian Secret Intelligence Service and the Australian Security Intelligence Organisation, $207 million for protective security measures, including funding for air marshals through the Attorney-General's Department, and critical infrastructure protection in a number of portfolios. And an extra $87 million has been provided to enhance security capacity and cooperation in our region. This includes $36 million for the AFP to develop a rapid deployment capability and $26.3 million to establish a Jakarta Centre for Law Enforcement Cooperation.

Within this funding, Defence gets $47.4 million over four years to create 229 new intelligence positions, and $7.1 million over four years for critical infrastructure protection. In addition, they'll get $17.3 million over four years to assist with the downsizing of the PNG defence force. And finally, there's $13 million over three years to fund Defence's contribution to security at the 2006 Commonwealth Games—part of an overall $272.5 million contribution by the Australian Government to the staging of the games. There are also three self-funded measures to improve various aspects of regional counter-terrorism cooperation ($3.1 million), for which no funds are provided.

## Price and exchange

Defence will receive an extra $917.5 million over four years as a price adjustment, and will hand back $324.1 million in 2004–05 for foreign exchange movements. These changes don't represent more or less spending, but are simply adjustments to maintain the buying power of the Defence budget.

### Transfers and adjustments

From 1 July 2004, the Department of Veterans' Affairs will take responsibility for all forms of ADF compensation. Since Defence will no longer be liable for compensation claims from ADF members, funding for the administration and payment of benefits has been transferred to the DVA. This amounts to $721 million over four years. Other miscellaneous adjustments totalling $4.8 million over four years have also been made.

## What's the bottom line?

If we ignore the adjustments due to price and exchange variations and the transfer of funds to the DVA, the total new money provided by the Budget over the next four years comes to $2.13 billion. Against this, cuts of $1.17 billion have been levied, leaving a net increase of $960 million. However, $884 million of the cuts results from rescheduled capital investment, which the government promises to return to the Budget after 2007–08.

## Efficiencies

The White Paper set goals for Defence efficiency savings. Last year's Budget added another aggressive set of targets for further savings from administrative areas to offset costs elsewhere in the portfolio. The savings targets are listed below in Table 5. The White Paper savings were declared achieved last year through a re-baselining of group administrative budgets, although it's not known how this money has been redirected.

**Table 5: Planned savings measures (million $)**

| | 2001–02 | 2002–03 | 2003–04 | 2004–05 | 2005–06 | 2006–07 | 2007–08 | ongoing |
|---|---|---|---|---|---|---|---|---|
| White Paper savings initiatives | 50 | 200 | 200 | 200 | 200 | 200 | 200 | 200 |
| Administrative savings targets | | | 50 | 100 | 150 | 175 | 200 | 200 |
| **TOTAL** | **50** | **200** | **250** | **300** | **350** | **375** | **400** | **400** |

*Source: Various Defence budget papers.*

The Budget papers say that the remaining administrative savings will be achieved in four ways:

- reductions in overheads, including numbers of civilian personnel, contract personnel and personnel posted overseas
- structural changes to Defence to remove overlapping common services
- business process improvements, including financial transformation and more efficient back-office functions
- further outsourcing, where feasible in terms of military workforce structures.

By and large, the savings appear to be coming from administrative areas (the exception is the savings from the withdrawal of the three P-3B training aircraft from service in 2005–06). But perhaps this should have been obvious. There was never any question of cutting non-administrative costs to achieve an efficiency dividend.

There are two observations to make about this.

First, the scale of savings is significant by any standards. Annual recurrent savings of $400 million are fully comparable with the roughly $600 million annual saving claimed by the Defence Reform Program—but that was a detailed program of initiatives that caused very substantial disruption to Defence for some years.

Second, the new program of administrative savings is going to be used to offset unavoidable funding pressures elsewhere in the Budget. In effect, 'avoidable' overheads are being cut to fund 'unavoidable' overheads. There is no net gain in capability; to put it another way, there is no increase in productivity.

In effect, 'avoidable' overheads are being cut to fund 'unavoidable' overheads.

## So what will we get for our money?

The Budget is not just about money: it's equally about what's going to be delivered for the money. In the case of Defence, this comes down to performance targets for the twenty-eight outputs. The Budget papers set broad targets for the preparedness, core skills and quantity of the outputs. Understandably, much of the detail of Defence's military capabilities and performance targets are kept secret.

### Preparedness

Preparedness refers to the readiness of the ADF to undertake and sustain operations, be they national support tasks, peacekeeping or war. For example, the light infantry output might be required to 'be prepared to deploy a battalion at 90 days notice to assist in a regional peacekeeping operation and to maintain the deployment for twelve months' (this is a figurative example, not a real one).

### Core skills

To take into account 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'.

### 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. For the Navy, it's usually the availability of ships and their crew to undertake a mission; for the Army, it's the presence of adequate quantities of trained personnel and equipment; and for the Air Force (and Army and Navy aviation), it's the number of hours flown.

Overall, this year's publicly disclosed performance targets are not appreciably different from recent years.

## Recent performance

The past three Defence annual reports have consistently reported against performance targets at the output level, making year-to-year comparisons possible. Table 6 summarises the results from the 2002–03 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*. To aid presentation, we've mapped the numerical 'quantity' results according to the key at the bottom of the table.

Between 2000–01 and 2001–02, performance levels remained largely static. But in the latest data, aggregate performance against targets improved substantially. Indeed, there were improvements in twenty-five areas, and declines in only six. Performance in the remaining forty-seven areas remained static. Nevertheless, problems remain in some areas, with 21% of outputs only partially meeting their preparedness targets, 29% only partially meeting their core skills targets and 12% only partially meeting their quantity targets.

...in the latest data, aggregate performance against targets improved substantially.

The Navy's already good performance remained largely unchanged, while both the Army and the Air Force posted solid improvements compared with the previous two years. Defence Operations, Strategic Policy and Intelligence continued to meet their targets.

So, notwithstanding the high operational tempo in 2002–03, including the major deployment to Iraq, Defence managed to achieve big improvements in its delivery of outputs.

**Table 6: Recent performance**

| 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 Reconnaissance | ↔ | ↔ | ↑ |
| 4.2Tactical 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/Substantially Achieved ↑ | |

Improved since 2001–02: ↑ Static since 2001–02: ↔ Declined since 2001–02: ↓

| Achieved | Substantially Achieved | Partially Achieved |
|---|---|---|

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

*Source: Defence budget papers.*

Photo courtesy Australian Picture Library

Chapter 4

# CAPITAL INVESTMENT

An essential component of Defence spending is the investment made in new equipment, facilities and upgrades that allows the ADF to maintain credible military capabilities while other nations continue to modernise their forces. Table 7 shows Defence's planned Capital Investment Program. The table does not include the provision of around $325 million per annum held in reserve for foreign exchange exposure in the final three years.

**Table 7: The Capital Investment Program ($ million)**

| | 2003–04 Projected | 2004–05 | 2005–06 | 2006–07 | 2007–08 |
|---|---|---|---|---|---|
| Major capital equipment | 2,469 | 2,913 | 3,150 | 3,462 | 3,785 |
| Capital facilities | 421 | 469 | 404 | 349 | 343 |
| Other capital | 518 | 473 | 427 | 458 | 443 |
| **Capital Investment Program** | **3,408** | **3,854** | **3,981** | **4,268** | **4,571** |

*Source: 2004–05 Defence budget papers.*

There are three components to the Capital Investment Program.

**Major capital equipment projects** are worth more than $20 million each and mostly involve the purchase of military equipment. They range from small projects to acquire specialist communications equipment through to massive undertakings, like the $10 billion plus project to replace the F/A-18 tactical fighter fleet.

**Capital facilities projects** include everything from new barracks to upgrades of existing facilities. With around 25,000 individual buildings, the upgrading and development of the Defence estate never ends.

**Other capital** includes minor capital equipment (projects costing less than $20 million), repairable items, non-capital facilities, plant and equipment, software and intangibles.

These three items together make up the total capital program. But not all of this money actually represents capital investment. Around 10% is used in the process of acquiring the assets (13% for major capital equipment). This includes project office costs, studies, research and development, travel, professional service providers and other overheads. This is in addition to the overhead represented by the infrastructure division in the Corporate Services and Infrastructure group and Defence Materiel Organisation (DMO), who are responsible for the acquisition processes.

## Major capital equipment projects

In 2004–05, the government plans to consider for approval twelve major capital equipment projects valued at around $1 billion in total. These include the follow-on stand-off weapon project for the Air Force, valued at around $400 million, and the study phase of the combat identification project for the land forces, worth about $225 million.

In this year's Budget, the government also announced that it would exercise its option to increase its purchase of airborne early warning and control aircraft from four to six, at an additional cost of $326 million. This was a bargain waiting to be taken: it delivers a 50% increase in the number of aircraft for less than 10% of the total price, because the original contract included enough radar and mission equipment for six aircraft.

So where does the $326 million come from? Either money has been cut from one or more of the projects in the major capital equipment program, or the extra spending will be accommodated through slippage (delay) in the overall program. Whatever the mechanism, however, this project was worth making room for.

Whatever the mechanism, however, this project was worth making room for.

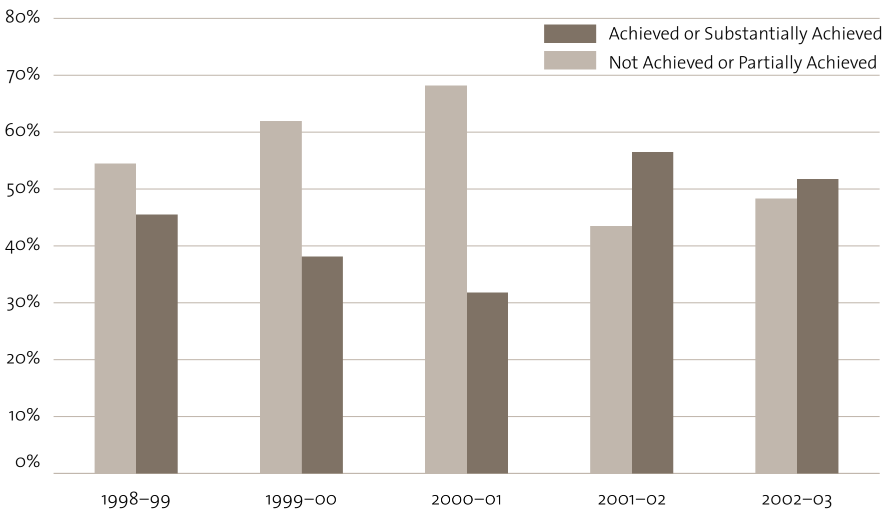
### Delivering the goods?

According to recent Defence annual reports, there has been a dramatic improvement in delivery of the 'top twenty' individual projects against performance forecasts in the past two years. Figure 4 plots the number of projects reported as being *achieved* or *substantially achieved*, as opposed to being only *partially achieved* or *not achieved*. It's important to remember that this is a measure of achievement of goals set in that year, rather than long-term progress, and it only applies to the top twenty projects. It's an encouraging sign, nevertheless.

Yet, looking back at the most recent data from 2002–03, it's still very much a mixed bag. Newer projects like the armed reconnaissance helicopter are doing well, as are some of the older tried and true successes like the Anzac ship project. Some old problem projects like the FFG upgrade remain behind schedule, and the high frequency modernisation project continues to be a matter for concern. The long-term question that remains unanswered is whether the current crop of well-performing recent projects are simply enjoying the benefits of youth or whether the new ways of doing business in the DMO are leading to better results. Only time will tell.

In any case, while the delivery of some individual projects may have improved, the aggregate performance of the major capital equipment program has fallen behind expectations.

**Figure 4: Defence Materiel Organisation delivering the goods**




*Source: Defence annual reports.*

### Why was investment rescheduled?

The White Paper added a lot of money to the Defence budget, and most of it in the early years was earmarked to boost investment in major capital equipment. But over the past three years it's become very clear that the planned program of investment can't be achieved.

We estimate that in 2001–02 around $200 million of major capital equipment funding went unspent. In 2002–03, another $200 million went unspent, prompting the government to defer $642 million from the Capital Investment Program across the forward estimates at the time of the 2003–04 Budget. Following this, the Defence Capability Review led to the new Defence Capability Plan, which deferred another $884 million of major capital equipment spending to beyond 2007–08. Once again, the aim was to create a deliverable investment program. The reduction in the targets for major capital equipment investment in the revised capability plan was not before time. This year, the projected shortfall has grown to $500 million.

In total, some $2.2 billion of previously planned investment has been cut from the early years of this decade and reprogrammed to the period 2008–09 to 2013–14. This amounts to just on 20% of the planned additional investment in major capital equipment in the first seven years of the White Paper. The danger is that the deferred spending is at least two elections and at least one economic cycle away. The government can't guarantee that the rescheduled dollars will be there when the time comes, but this the strongest commitment it can make. We explore the changes to the original White Paper plan in Chapter 6.

The first flight of the Royal Australian Air Force's new "Wedgetail" Airborne Early Warning and Control aircraft, 21 May 2004. © Defence Department

The reasons for the continuing struggle to deliver the capability goals of the White Paper include the following.

- The White Paper set ambitious goals for the delivery of new capability, well above anything previously achieved.
- The DMO has been undergoing a major restructure involving the amalgamation of the previously separate logistics and acquisition organisations, concurrent with the establishment of geographically dispersed system program offices around the country.
- The government is now reviewing individual projects one at a time, rather than in an annual omnibus submission. This adds time to the process, although it has the added benefit that projects are much more closely scrutinised.
- Finally, it must be acknowledged that some responsibility for the delivery of capability rests with those contracted to deliver it.

Finally, it must be acknowledged that some responsibility for the delivery of capability rests with those contracted to deliver it.

The ongoing failure to deliver projects was one of the reasons the government commissioned the Defence Procurement Review in 2003, the results of which we explore in Chapter 7.

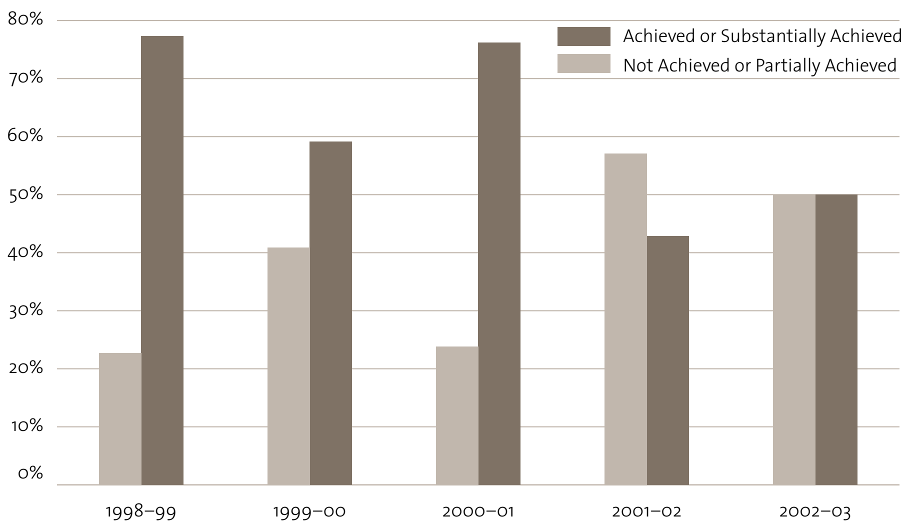
## Major capital facilities projects

There are currently sixty-four approved capital facilities projects, of which fifteen are major projects worth more than $6 million each and forty-nine are medium projects worth between $25,000 and $6 million. Expenditure in 2003–04 is planned to be $469 million, compared with $421 million in 2003–04.

The largest of these is the barracks redevelopment in Townsville ($171 million), followed by the development of facilities for the airborne early warning and control aircraft capability at Williamtown ($129 million), the redevelopment of HMAS *Albatross* at Nowra ($110 million), and the RAAF Townsville redevelopment ($72.5 million). In the 2004–05 Budget, the government has foreshadowed eleven new major capital works projects for parliamentary consideration.

The Defence Annual Report assesses the achievement or otherwise of significant facilities. The results for the past five years appear in Figure 5. The performance over the past two years has not been nearly as good as that delivered in the previous three.

**Figure 5: Recent achievement in significant facilities projects**

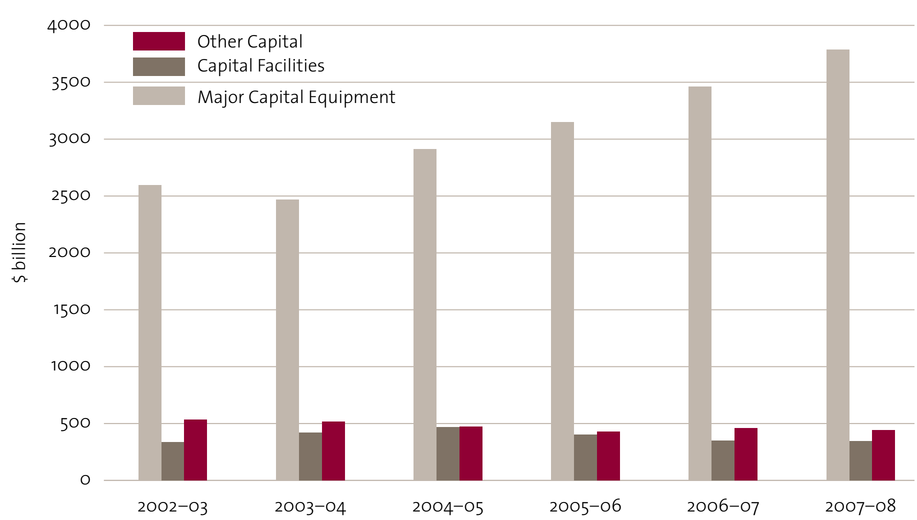



*Source: Defence annual reports.*

## What are the trends in the Capital Investment Program?

The trend across the next four years is for a steady increase in the Capital Investment Program from $3.8 billion in 2004–05 to $4.6 billion in 2007–8 (in nominal dollars). Within these amounts, expenditure on capital facilities and other capital falls slowly while the total spending on major capital equipment grows (Figure 6). Clearly, even after the reprogramming of capital investment funds, significant growth in spending on major capital equipment is still planned. This will not be an easy task for DMO, given recent performance.

**Figure 6: Planned trends in the capital budget**




*Source: 2004–05 Defence budget papers.*

Chapter 5

# PERSONNEL

In recent years, Defence has pursued a range of initiatives to improve the development, care, recruitment and retention of personnel. Most of these initiatives began in 2001–02, when $500 million over five years was allocated to deal with high-priority personnel matters. In this year's Budget, a further $654 million was allocated to personnel spending.

In this chapter, we look at the raw numbers and cost of the Defence workforce. This is an unashamedly limited view of the complexities of Defence personnel, but one that is appropriate for a budgetary report. The good news is that it looks like the recent personnel initiatives have improved the recruitment and retention of ADF personnel.

## Changing personnel numbers—the J curve

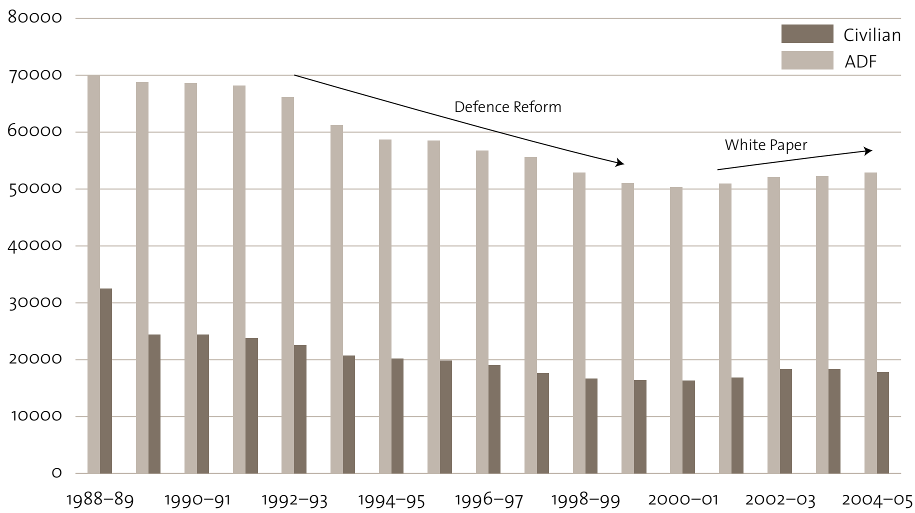
In the decade following the Force Structure Review in 1991, ADF numbers dropped from around 70,000 to 50,000 permanent personnel, as shown in Figure 7. Over the same period, civilian numbers dropped from around 25,000 to 17,000.

> ...the initial goal of the Defence Reform Program was to reduce the strength of the ADF to 43,500, but this was soon revised up to 50,000, thereby arresting the decline.

The bulk of these reductions were due to outsourcing under the Commercial Support and Defence Reform programs. In fact, the initial goal of the Defence Reform Program was to reduce the strength of

A Defence family at an Anzac Day service. © Defence Department the ADF to 43,500, but this was soon revised up to 50,000, thereby arresting the decline. The 2000 White Paper subsequently set permanent ADF numbers on a growth path towards 54,000. However, following the 2003 Defence Capability Review, a new (but as yet undisclosed) personnel target is in place because of planned cuts to capability later this decade. Recent personnel numbers appear in Table 8, along with the estimates for 2004–05.

**Figure 7: Defence workforce, 1988–89 to 2004–05**




*Source: Defence annual reports, 2001–02 Defence budget brief and 2004–05 Defence budget papers.*

**Table 8: Workforce summary—average funded strengths**

| | 2000–01 Actual | 2001–02 Actual | 2002–03 Actual | 2003–04 Projected | 2004–05 Budget |
|---|---|---|---|---|---|
| Navy | 12 396 | 12 598 | 12 847 | 13 121 | 13 167 |
| Army | 24 488 | 25 012 | 25 587 | 25 623 | 26 035 |
| Air Force | 13 471 | 13 322 | 13 646 | 13 481 | 13 670 |
| **TOTAL** | **50 355** | **50 932** | **52 080** | **52 225** | **52 872** |
| Reservists | 19 835 | 18 868 | 19 620 | 20 864 | 20 710 |
| Civilian | 16 292 | 16 819 | 18 385 | 18 356 | 17 841 |

*Source: Various Defence annual reports and 2004–05 Defence budget papers.*

## What are the recent trends?

### Permanent ADF numbers

Army and Air Force numbers are increasing more or less in line with planned goals; the Navy has exceeded its target for 2003–04. This latter result is excellent news because the Navy has had some trouble in recent years. For the individual services, Army numbers will increase by 412, Air Force by 189 and Navy by a modest 46 additional personnel from 2003–04 to 2004–05. These increases are the net result of recruitment and separations.

### *Recruitment*

Table 9 shows the percentages of recruitment targets that have been met over the past eight years. Following solid improvements earlier this decade, which saw the overall figure grow from 76% to 93% by 2001–02, performance in 2002–03 dropped back to 84%.

According to this year's Budget papers, both the Navy and the Air Force enjoyed favourable recruiting during 2003–04.

**Table 9: Percentage of recruitment targets met**

| | 1995–96 | 1996–97 | 1997–98 | 1998–99 | 1999–00 | 2000–01 | 2001–02 | 2002–03 |
|---|---|---|---|---|---|---|---|---|
| Navy | 98% | 92% | 98% | 76% | 57% | 74% | 85% | 84% |
| Army | 99% | 98% | 94% | 78.5% | 83% | 79% | 100% | 79% |
| Air Force | 86% | 93% | 101% | 90.5% | 83% | 88% | 87% | 94% |
| **ADF** | **96%** | **94%** | **97%** | **80%** | **76%** | **80%** | **93%** | **84%** |

*Source: Various Defence annual reports and Defence submission to the Foreign Affairs, Defence and Trade References Committee inquiry into ADF recruitment and retention, May 2001.*

### *Separation*

Table 10 shows the percentages of ADF personnel who separated from full-time military service over the past eight years. Separation rates have fallen steadily since 2000–01, and 2002–03 gave the best result across the entire period. The latest Budget papers say that the Air Force has enjoyed low separation rates during 2003–04, but make no comment on those of the other two services.

Some care must be taken with this data because figures for earlier years reflect the deliberate reduction in the size of the ADF between 1997 and 2000 under the Defence Reform Program. Nevertheless, separation rates in 2002–03 were better than in 1995–96, before the cuts to personnel began.

**Table 10: ADF separation rates**

| | 1995–96 | 1996–97 | 1997–98 | 1998–99 | 1999–00 | 2000–01 | 2001–02 | 2002–03 |
|---|---|---|---|---|---|---|---|---|
| Navy | 13.0% | 11.5% | 11.1% | 12.6% | 13.3% | 13.2% | 11.5% | 11.6% |
| Army | 12.5% | 10.4% | 10.9% | 12.9% | 13.0% | 13.2% | 11.5% | 9.8% |
| Air Force | 9.0% | 9.0% | 10.0% | 11.9% | 11.6% | 15.6% | 10.4% | 8.1% |
| **ADF** | **11.6%** | **10.3%** | **10.7%** | **12.6%** | **12.7%** | **13.8%** | **11.2%** | **9.8%** |

*Source: Various Defence annual reports and Defence submission to the Foreign Affairs, Defence and Trade References Committee inquiry into ADF recruitment and retention, May 2001.*

Given Australia's recent low unemployment, things are looking good. Personnel are remaining in the ADF rather than seeking opportunities elsewhere. And the ADF is having more success in recruitment than it did several years ago, especially for the Navy.

### Civilian Numbers

Civilian numbers grew rapidly in the first two years of White Paper implementation—three times more quickly than military numbers grew. What's more, the growth was largely unplanned: the rise in 2001–02 exceeded Budget estimates by almost 6%, and 2002–03 showed a similar gain.

In January 2003, a freeze on civilian hirings was imposed after it became clear that the number of civilian personnel would exceed the revised estimate given less than two months earlier. The freeze was lifted in April 2003, but a direction was given to maintain civilian numbers at current levels. In last year's Budget, a programmed reduction plan was put in place to cut civilian numbers by 1,008 in 2003–04, from 18,385 to 17,377.

As things turned out, the projected result of 18,356 for 2003–04 is only twenty-nine positions below last year's result. But there are reason for this. Delays in outsourcing

Defence's integrated distribution system account for 638 positions. An extra twenty-five staff were added because of government decisions and, as an efficiency measure, an extra eighty-four civilian personnel have been employed to take the place of more expensive contract personnel. These increases have been offset by a slippage in recruitment in 2003–04 of 129 positions. On top of all this, a new round of unanticipated increases in civilian numbers added an additional 350 people.

…new round of unanticipated increases in civilian numbers added an additional 350 people.

In the longer term, the target size for the civilian workforce is 17,667 by 2007–08. This would have been smaller but for the addition of 229 personnel through new intelligence measures announced in the Budget, and the strategy of replacing costly contract employees with 222 more cost-effective civilians.

### Reserve numbers—turning the corner

Reserve numbers increased by 752 and 1,244 in the past two years respectively. This compares favourably with the declines of around 1000, 2000 and 3000 in the years immediately before. The recent increases are a welcome reversal of a persistent, adverse trend.

There are probably many reasons for this, not least of which is the more immediate and relevant role allocated to the Reserve of sustaining and supporting the permanent ADF on operations. This has already taken effect, with over 670 reservists having been deployed to East Timor since March 2002. In addition, the government has been active in providing improved legislative protection through the *Reserve Services (Protection) Act 2001* and substantial support to employers of reservists through the Employer Support Payment Scheme.

## How much do personnel cost?

Personnel expenses in 2004–05 will be around $6.7 billion, rising to $7.2 billion in 2007–08.

In the past, growth in military personnel costs has created a pressure on the Defence budget not because growth in remuneration has been out of step with community outcomes, but because Defence did not receive indexation to cover real growth in personnel costs. This was supposed to be remedied in the White Paper when a provision for 2% real growth in per-capita personnel costs was built into the ten-year funding projection. However, because this extra funding does not begin until 2004–05, Defence has had to find the real additional cost of personnel from elsewhere in the budget for the past three years. Following this year's Budget, the additional supplementation for military personnel cost growth has been increased to 2.5% per annum.

In contrast, most other agencies only get price index adjustments for personnel expenses. They are expected to make up the difference between inflation and wages growth through productivity gains.

### Military per-capita trends

Table 11 shows the changing average per-capita costs of the permanent ADF. Unfortunately, no estimates of ADF numbers are available past 2004–05.

**Table 11: Per-capita permanent ADF personnel expenses**

| | Military numbers | Expense $ 000's | Per capita | Nominal growth |
|---|---|---|---|---|
| 2000–01 | 50,355 | 4,044,923 | $80,328 | |
| 2001–02 | 50,932 | 4,284,241 | $84,117 | 4.72% |
| 2002–03 | 52,080 | 4,455,890 | $85,559 | 1.71% |
| 2003–04 | 52,225 | 4,957,106 | $94,918 | 10.94% |
| 2004–05 | 52,872 | 5,158,166 | $97,560 | 2.78% |
| | | | **average** | **5.04%** |

*Source: Defence annual reports and 2004–05 Defence budget reports.*
*Pre-2003–04 expenses adjusted to take account of Reserve component.*

To ensure consistency, we've adjusted the historical data in Table 11 to remove military compensation, which has been transferred to the Department of Veterans' Affairs, and removed one-off expenses incurred in 2004–05. In addition, we've done our best to adjust for the impact of Reserve expenses in previous years. This ensures a like-with-like comparison between the years.

Comparing the average nominal growth with the average indexation received by Defence over the same period, the average real increase in military personnel expenses comes out at just on 2.2%, a little below the 2.5% provided for in the 2004–05 Budget.

To try to explain the surprisingly large 11% increase in per-capita expenses in 2003–04, we've looked in detail at the various components of military employee expenses. As nearly as we can determine, the large increase in military per-capita expenses in 2003–04 is due to a 17.5% increase in salaries and allowances.

While total employee expenses can be skewed by large accrual adjustment (such as leave liabilities after a salary rise), this is probably not the case for salaries and allowances. Consequently, a 17.5% increase is difficult to understand. ADF salary growth in the period was modest, amounting to increments of only 3% in 2002–03 and 5.58% in 2003–04. Moreover, the payment of high allowances on operations would have peaked in 2002–03 and declined in 2003–04. Nor has there been much in the way of an increasing proportion of higher ranking personnel. Perhaps the difference reflects a substantial increase in allowances. From the available data, we can't say.

### Civilian per-capita trends

Table 12 shows our calculation of the changing average per-capita costs of the defence civilian workforce using available data (data for 2007–08 is currently being revised by Defence). The average increase in per-capita expenses over the seven years comes out at 6.2%, or a real rate of growth of 3.7% after taking into account the indexation Defence receives.

| Table 12: Per-capita civilian personnel expenses | | | | |
|---|---|---|---|---|
| | Civilian numbers | Expense $ 000's | Per capita | Nominal growth |
| 2000–01 | 16,292 | 956,661 | 58,720 | |
| 2001–02 | 16,819 | 1,086,118 | 64,577 | 9.97% |
| 2002–03 | 18,385 | 1,235,752 | 67,215 | 4.09% |
| 2003–04 | 18,356 | 1,333,499 | 72,646 | 8.08% |
| 2004–05 | 17,841 | 1,415,281 | 79,327 | 9.20% |
| 2005–06 | 17,646 | 1,432,503 | 81,180 | 2.34% |
| 2006–07 | 17,665 | 1,486,291 | 84,138 | 3.64% |
| | | | **average** | **6.22%** |

*Source: Defence Annual Reports and 2004–05 PBS.*

As with military per-capita expenses, our attention was drawn to the surprisingly large increase in per-capita costs in both 2003–04 and 2004–05. Once again, the cause is the rapid increase in per capita salaries and allowances (8.4% and 18.4% respectively), and once again we're at a loss to explain it. The salary increments for civilians were only 6.1% in 2002–03, 2% in 2003–04 and 6.1% in 2004–05. And the increased proportion of civilians in more senior positions seems unlikely to offer an explanation (although the 8% increase in senior officer numbers in 2002–03 would have helped).

## Is there enough money to pay for Defence's personnel?

We have a curious situation. Defence currently receives supplementation to cover real growth in per-capita military personnel expenses of 2.5% per annum, and 2.0% for per-capita civilian personnel expenses. Yet on the basis of the available data, military per-capita costs have only been increasing by 2.2% while civilian personnel costs are going up by an alarming 3.7%. At the same time, the recently reported rapid increases in Defence salaries and allowances seem significantly larger than the underlying increments awarded to employees. Given this confusing data, we're unable to draw any conclusion about the adequacy of personnel funding.

Defence force personnel past and present take part in the Anzac Day march in Perth, 2004. © Defence Department

Chapter 6

# WHITE PAPER UPDATE

Last year, we said that the ten-year program of capital investment that underpinned the White Paper—the Defence Capability Plan (DCP)—was unaffordable, undeliverable and uncertain. By this we meant that:

- increases in the estimated cost of future projects made the original program of investment in the DCP unaffordable within the allocated funds
- the ambitious pace of new investment envisaged by the original DCP was undeliverable by Defence and industry
- the government's priorities were uncertain following the 2003 *Defence Update* statement, which described a changed strategic environment without saying what this meant for the ADF's force structure.

Our bold assessment ruffled a few feathers at the time, but in the intervening months the government moved to address this trinity of woes through the 2003 Defence Capability Review (DCR), which led to the release of a revised DCP earlier this year. In this chapter, we examine the results.

## A new plan

It was originally planned that the DCP would undergo annual revisions to take new information and changing strategic priorities into account, but the first full revision of the plan wasn't released until February 2004. The new DCP reflected the detailed decisions taken by the government in the DCR in late 2003. Two ASPI Insights, *The Defence Capability Review 2003* and *Reviewing the Defence Capability Plan 2004–2014*, deal at length with the capability aspects of the DCR and the subsequent revised DCP. Accordingly, we'll avoid the details and focus on the aggregate changes.

Before we proceed, it's worth emphasising that with some initial exceptions the DCP only covers the *unapproved* capital investment program. That is, those projects that the government plans to consider for approval at some point in the future. Since the White Paper in December 2000, the government has approved around 110 projects or phases of projects with a total value of around $18 billion. This includes almost all of the projects scheduled for approval over that period, a number of extra projects conceived after 9/11 to improve our domestic security, and rapid acquisitions to build ADF capabilities for operational deployments in recent years.

## Comparing the old and new

It's difficult to be precise about the difference between the two DCPs because of the renaming, amalgamation and splitting of projects. However, with a little work and using common sense to sort out the ambiguities, the following picture emerges.

The new DCP includes sixty-five projects or phases of projects carried over from the original version. The estimated total cost of these projects is around $38 billion. In addition, the revised plan has forty-four new entries valued at around $11 billion. Some thirty-four projects or phases of projects from the original DCP, valued at around $3 billion, don't appear in the revised version. Defence has said that the bulk of these projects have been deferred past 2014, rather than abandoned.

The comparison of costs between the two DCPs is complicated by the intervening changes to price and exchange rates. However, Defence has said that the effect is small and that broad comparisons are nonetheless possible, while cautioning that small changes could sometimes tip a project from one cost band to another.

Looking in detail at the individual projects, we found that the average delay in the sixty-five projects carried forward from the original to the revised plan was between nine and fifteen months. This is not counting those thirty-four projects that have been deferred to beyond the end of the current ten-year planning horizon. At the same time, the overall cost of those projects carried forward has grown by around 20% in the three years since the original plan.

### Abandoned capability—is that all it's worth?

The DCR did more than revise the DCP; it also re-examined the current force structure. To the surprise of many, this led to the decision to cut capability from the ADF's order of battle. The cuts involved retiring the F-111 strike fleet early in 2010, paying off our two oldest FFG frigates over the next few years, and tying up two of the new mine hunter vessels. Over the next decade, these cuts to capability will deliver savings of over $1.35 billion in personnel and operating costs. These savings are nominally returned to the government, but recent increases elsewhere in the personnel and operating budget more than compensate for them.

The surprising thing about these cuts is just how little money is freed up. For the Navy's part, the savings are around $90 million for the frigates and $21 million for the mine hunters. These savings roughly accord with known costs and personnel numbers, especially when it's remembered that the fixed cost of operating the remaining vessels of those classes must still be met.

This is not the case for the F-111 strike fleet, which will be abandoned in total. Surprisingly, the resulting savings are less than $150 million per annum. In fairness, it must be said that the F-111 has life-of-type spares available that will reduce its inventory costs compared with other aircraft. But then, we're at a loss to understand why costs are increasing so quickly as to make the retention of the F-111 unaffordable. What this all adds up to is that Australia's long-range strike and reconnaissance capability is going to be exchanged for a recurrent annual saving of less than 1% of the Defence budget. Even though this does not include the savings from foregone projects involving the F-111, it still seems something short of a bargain.

…Australia's long-range strike and reconnaissance capability is going to be exchanged for a recurrent annual saving of less than 1% of the Defence budget.

## Revised White Paper funding

The 2000 White Paper provided $28 billion in additional funding to Defence (as measured in 2004–05 prices), which was to be delivered through 3% annual real growth in the Defence budget over ten years. The rescheduling of previously planned investment in military equipment has resulted in changes to the timing of some of the additional funding.

### What's in the White Paper money?

For the most part, the revision of the White Paper funding amounts to a rearrangement of when money is spent, rather than any change to the overall amount. This allows us to discuss the composition of the funding without worrying too much about whether it's from the original or the revised DCP. According to the 2004–05 Budget papers, the White Paper provided money in three categories (all figures are in 2004–05 prices):

***Major capital investment: $19.5 billion***

The original White Paper funding provided $19.2 billion for spending on major capital equipment. The revised plan does the same, but deferral of some of the spending means that inflation adds another $321 million in the out-turned (i.e. inflation-adjusted) spending, which has been kept constant in real terms. This money provides the bulk of the funds that underwrite the DCP's new major equipment acquisitions.

***Operating and personnel costs: $3.8 billion***

There's an extra $2.8 billion to cover the through-life support costs of new capabilities that will enter service as a result of the DCP. Because of delays in the delivery of projects, some of this spending has been deferred in the revision of the funding. In addition, the White Paper provides $1 billion to adjust the operating cost baseline in the Defence budget. This includes offsetting shortfalls in Defence Reform Program savings, and fixing the logistics shortfall caused by redirecting the program's savings in 1999 to increase the target strength of the ADF from 42,500 to 50,000.

***2% real growth in personnel costs: $4.7 billion***

The Defence budget is indexed annually using the implicit non-farm GDP deflator, which tends to fall below the real increase in wages and salaries. Recognising this, the White Paper promised to make up the difference between the routine indexation received and the real cost of attracting and retaining personnel through a 2% increase in per-capita personnel expenses, beginning in 2004–05. The latest Budget has revised this figure up to 2.5% for military personnel.

**So what's changed?**

The original White Paper only extended out to 2010–11, whereas the new version extends to 2013–14. So, to allow a comparison between the two, we've produced graphs of the old and new funding out to that year (Figures 8 and 9).

We've assumed that the underlying Defence budget (exclusive of deferred spending shifted into the last three years in the revised plan) remains constant in real terms beyond the end of the decade. This is the working guidance given to Defence, pending a review of long-term funding in the 2005–06 Budget.

It's disappointing that the government has not fixed the long-term funding trajectory for Defence. The development of new military capability can take a decade or more from conception to entry into service. This demands long-term planning underpinned by firm, long-term funding. As we enter this mid-part of the 'golden decade' of 3% real growth in underlying Defence spending, it's time to start thinking about giving Defence planners the surety they need to do their job.

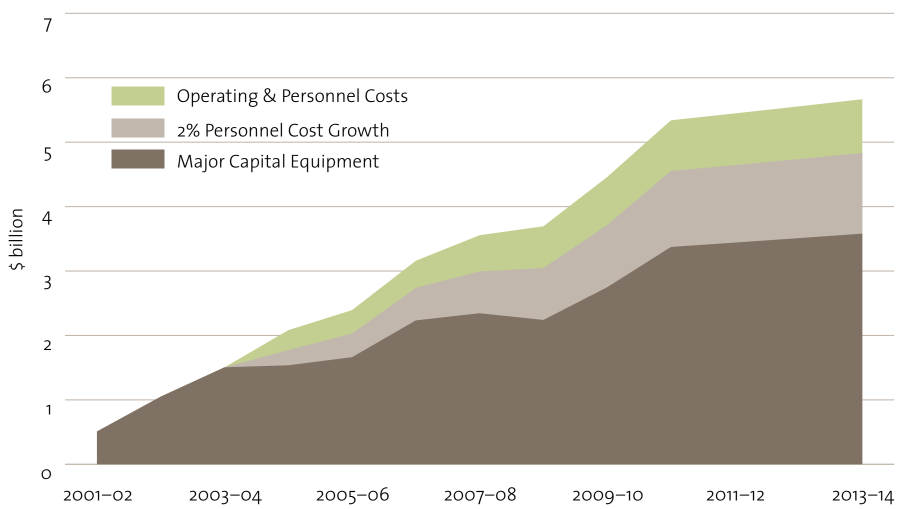
The development of new military capability can take a decade or more from conception to entry into service.

Photo courtesy Australian Picture Library

The last time Defence spending was 'held constant in real terms' was back in the 1990s, when increases in actual costs exceeded inflation across the board. This resulted in severe budget pressures, hollowed-out capability and delayed investment in future capabilities. The 2004 ASPI policy report *A Trillion Dollars and Counting* explains why the cost of maintaining a modern defence force has outpaced inflation and will likely continue to do so.

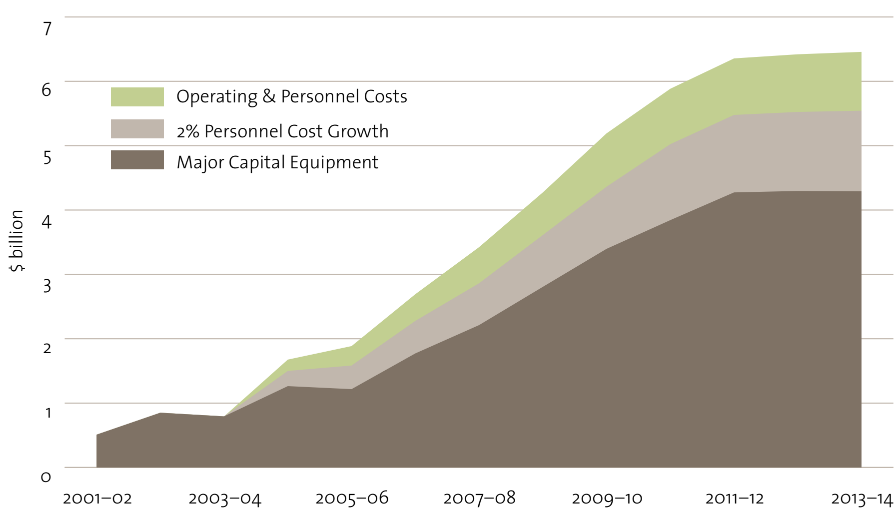
But let's not get too worried yet. The government is due to consider this issue in the formulation of the next Budget. And in any case, until Defence shows that it can actually spend the extra funds it's getting, the question is moot.

**Figure 8: White Paper funding as originally planned**




*Source: 2004–05 Defence budget papers. All values in 2004–05 prices.*

**Figure 9: Revised White Paper funding after the 2003 Defence Capability Review**



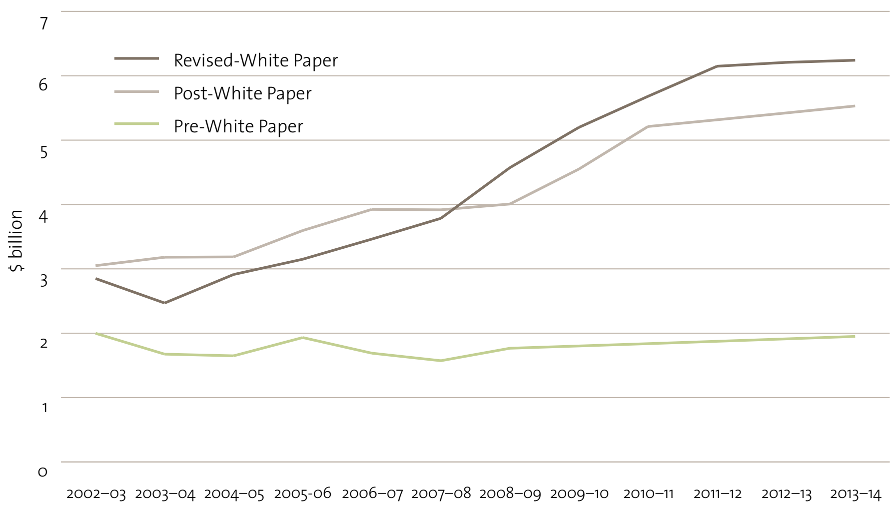

*Source: 2004–05 Defence budget papers. All values in 2004–05 prices.*

### Delayed capital investment

The main difference between the two funding profiles is that some of the planned spending on major capital equipment has been deferred from the first half of this decade until 2008–09 and beyond. The reason for this deferral is discussed in Chapter 4.

The new profile of funding for major capital equipment is steeper and more sustained than before. To see how this affects the overall major capital equipment program, we need to add in the pre-White Paper funding. Using the information available in the latest Defence budget papers, we've calculated the pre-White Paper, post-White Paper and revised White Paper major capital equipment funding for the period 2002–03 through 2007–08. Beyond this period the funding has been estimated by out-turning (adjusting for inflation) the average of the final three years of pre-White Paper spending through to 2013–14 by 2% per annum. The year 2001–02 is beyond analysis in this manner because no figures for major capital equipment spending are available. The results appear in Figure 10.

**Figure 10: Major capital equipment spending**




*Source: 2002–03 Defence annual report and 2003–04 Defence budget papers. All values in 2004–05 dollars.*

There are three interesting things about Figure 10. First, the White Paper provides a lot of money for major capital equipment; by the end of this decade, spending will have increased almost three-fold. Second, the reprogramming of major capital equipment spending results in a steeper and more sustained rise in new investment than was originally planned. Indeed, while DMO gets some respite in the near term, the medium and longer term challenge has grown. Third, the implied level of baseline (pre-White Paper) major capital equipment investment is less than $2 billion per annum. This is surprisingly small, given that this is inflation-adjusted data.

Indeed, while DMO gets some respite in the near term, the medium and longer term challenge has grown.

It's difficult to find hard data on major capital equipment investment in the years immediately before the White Paper, because it went unreported during that period. But from the early to mid-1990s the figure tended to be a bit over $2 billion per annum (and that's not accounting for inflation), and in the late 1990s the planned level exceeded $2.5 billion. So why is the pre-White Paper investment level so low? The simplest explanation is that mounting personnel and operating costs prompted a re-allocation of planned spending away from capital investment in the period immediately before the White Paper. This means that at least some of the additional funding for new capital equipment provided by the White Paper did nothing more than reinstate previously planned levels of investment. In this manner, the funds provided by the White Paper probably went more towards increased personnel and operating costs and less to additional capital investment than outlined earlier.

It's worth remembering what the White Paper document said. Of the $23.5 billion in additional funding (in year 2000 dollars), $16 billion was allocated to 'capability enhancements' (including $13.7 in capital investment and $2.3 billion in personnel and operating costs), and $7.5 billion was allocated to 'maintain existing capabilities'.

## What's the big picture?

The first point to make is that, despite the rescheduling of investment, the government is now spending more on defence than it planned to back in 2000 not just because of the cost of recent deployments, but because of big increases to the underlying level of defence funding for personnel and operating expenses.

Defence spending is no more or less sensitive to fiscal reality than any other area of government expenditure.

Yet, in another way, Defence is being made to live within its means. While the government remains committed to providing the full extent of the White Paper funding for new equipment (albeit some years late because of Defence's inability to actually spend the money) no new money has been provided to cover the increasing estimated cost of existing projects, or for the new projects added to the DCP to meet the additional strategic challenges thrown up since 9/11. This is why more than thirty-four projects valued at around $3 billion from the original DCP no longer appear in the revised version, and the projects that have been retained are delayed by an average of around one year.

To some extent, Defence has also had to live within its means in regard to recurrent spending. Although substantial extra money has been provided for personnel and logistics costs, serious cuts are being made to the ADF's order of battle, including the early loss of our unique long-range strike and reconnaissance capability.

All this is not surprising. Defence spending is no more or less sensitive to fiscal reality than any other area of government expenditure. As projects increase in cost, and new requirements arise because of emerging strategic challenges, priorities have to be re-examined to decide what gets funded, deferred and cancelled. The fact that Defence cannot spend its existing investment funds makes the latter two choices more likely. Similarly, as recurrent costs increase, the justification for existing ADF capabilities comes under tighter scrutiny. No doubt these are the sorts of considerations that the government went through in the DCR.

Chapter 7

# DEFENCE MANAGEMENT

## Introduction

The 2003 ASPI policy report *Sinews of War* charted the recent history of financial management in Defence, including the turbulent years of 2000 and 2001 when several factors conspired to cause nothing less than a serious breakdown in fiscal discipline and budgeting within Defence.

Things have improved a lot since then. And following last year's Defence Procurement Review headed by Malcolm Kinnaird, some big changes are also under way in how Defence invests in new military equipment.

In this chapter, we look at how Defence management is changing. On balance, the picture is encouraging, although we do think more could be done to ensure that we're getting value for money for the $16 billion plus spent each year

## Counting the pennies and sorting out the 'back office'

Defence is working hard to reduce administrative spending and improve day-to-day business processes. Secretary Ric Smith is driving a bottom-up approach to improve financial management. He has avoided high-profile initiatives, and instead favoured a relentless attack to get the basics right.

...tighter fiscal discipline imposed over the past couple of years has resulted in measurable progress.

In the area of administrative spending, tighter fiscal discipline imposed over the past couple of years has resulted in measurable progress. Previous alarming growth in spending on professional service providers has been arrested, and civilian numbers are back under control and heading downward. Meanwhile, the \$50 million annual administrative efficiency savings set out in last year's Budget have been delivered; future targets look likely to be met.

There's also a lot going on in the back office in Defence. The old wasteful system of travel allowances has been replaced by a modern system of charge cards, and work is under way to improve invoice processing and debt recovery. These measures are all part of a disciplined process improvement program that includes the progressive introduction of more efficient e-business technologies. In fact, the whole area of corporate information systems is being looked at closely to see where opportunities lie for consolidation and efficiency.

## Better planning and information

In a number of areas Defence is improving its medium and long-term planning, and revamping its management information systems to support this.

In the past twelve months Defence has completed two important planning exercises. The Strategic Workforce Planning Review examined the factors influencing the sustainability of the Defence workforce, including its military, civilian, and industry components. The Force Disposition Study examined the efficiency and effectiveness of the ADF's geographic spread. Both efforts were substantially better than previous ad hoc planning processes.

Perhaps the biggest planning development is the new arrangements being put in place for planning future capability following the Kinnaird review. We discuss these measures below in the context of procurement reform.

Sound planning requires reliable information, which is often hard to find within Defence. Initiatives to remedy this include the Force Element Product Costing Project, which looks at the cost of delivering outputs to help develop internal customer service agreements and assist long-term planning and budgeting. Progress is already being made, but recent changes of up to 90% in individual output costs are unnerving (see Chapter 2).

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> The two recurrent themes are the inadequacy of business systems and a lack of data integrity and ownership.

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Further improvements are on the horizon. Defence's plethora of management information systems remains inefficient and ineffective; the whole is somewhat less than the sum of the disparate parts. Between \$50 million and \$75 million has been set aside to fix it over the next three years, and a further \$60–100 million is pencilled in for the next decade. In addition, around \$125 million has been allocated specifically to improve the logistics information systems towards the end of this decade.

One of the inevitable consequences of Defence's poor management information systems is the trials and tribulations that surround the annual financial statements. Recent audit reports have highlighted a wide range of problems. The two recurrent themes are the inadequacy of business systems and a lack of data integrity and ownership. Defence has responded to this by establishing a financial statements board, chaired by the Secretary, to drive a reform program aimed at delivering auditable annual financial statements by 30 July 2004. Given recent performance, this is an ambitious goal.

## Tidying up the Q-store: procurement reform

Rapid action is being taken in procurement. Following last year's Kinnaird Review, a new head has been appointed to the DMO and a new three-star position (Chief of Capability Development Group) has been created to take responsibility for developing new capability proposals. They both have their work cut out for them.

The three-star capability supremo has to make sure that future acquisition proposals can deliver the capabilities the government wants on time, within budget and at acceptable risk (in Defence-speak, this is called 'capability definition'). Given the recent big increases to the cost of many projects, this is not before time. But while the estimated cost of future projects has been going up, the ability of the DMO (and industry) to deliver projects has been going down. In the past three years, more than $2.2 billion of planned investment in new capital equipment has been deferred because the money simply can't be spent. This is the challenge faced by ex-ASC chief Steve Gumley, who's taken on the forbidding task of turning the DMO into a more commercially orientated organisation.

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The acid test will be looming naval construction projects.

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Along with these organisational changes, the system of project approval has been revised and strengthened, and the roles of Service Chiefs have been clarified. As an added safeguard, the Department of Finance now has a more prominent role in project scrutiny and assurance. To oversee the reform agenda, a Defence Procurement Advisory Board has been established with high-level private and public sector membership.

Of the many aspects of the Kinnaird reforms, two stand out. First, there is the proposal to involve industry early in capability definition to help refine cost, schedule and risk. This makes good sense. It's hard to see how anyone is better placed than industry to answer these questions. Second, the DMO is being re-established as a separate financial entity, a so-called prescribed agency. In the short term, this major corporate de-merger will distract from getting projects back on schedule. But in the longer term it will allow Defence to be more businesslike in at least part of its affairs. We'll return to this opportunity below.

While these two moves make good sense on their own, they may create some tension. Getting industry involved early in capability definition means getting the DMO involved early in the work of Defence's capability supremo. This won't be made any easier by having the DMO as a largely separate entity. Even when the DMO was part of Defence, it had limited influence on projects. Unless the DMO is able to engage industry and influence the formulation of new projects, it runs the risk of being left once again holding the can for Defence's Australian-unique project specifications. The acid test will be looming naval construction projects. So far, there is little sign of Defence accepting anything less than substantially redesigned vessels. This does not bode well.

The challenge of the de-merger of Defence and the DMO should not be underestimated. Without due diligence on both sides the potential for future problems is great. With this in mind, the government was wise to extend the target date for the financial de-merger by twelve months to June 2005.

## What's next?

So far, we've seen that Defence is moving sensibly on a number of fronts to achieve its stated goal of becoming a 'respected financial manager'. Progress will be measured not in months but in years, if only because of the extended timeframe for fixing Defence's management information systems. What more should be done?

Our view, as set out in the ASPI policy report *A Trillion Dollars and Counting* earlier this year, is that Defence needs to move to a fundamentally different business model that gives the Service Chiefs control over the resources needed to deliver their outputs. It would be a big step for Defence to do this and abandon Soviet-style central control, but it's the surest and most direct way to establish clear lines of accountability. The de-merger of the DMO and Defence provides a perfect opportunity to move in this direction by establishing clear customer–supplier agreements between the two entities This would then be a prototype for similar arrangements within Defence that could eventually see those who deliver results controlling the means to do so.

…Defence's current approach is a solid and respectable one.

Defence's current approach is to consolidate and improve the various components of its centrally planned business model, and then to look at possible changes to the model in perhaps four or five years time. This is hardly surprising—bureaucracies like Defence rarely initiate big changes from within. The impetus and direction for change nearly always has to come from the outside, just as it did through the independent Kinnaird Review.

However, notwithstanding that we advise a more radical path, Defence's current approach is a solid and respectable one. So let's now look at what can be done under the current arrangements to improve the delivery of military capability.

## How much did you say it costs?

In the current business of Defence, there remains an untapped opportunity for improvement that has nothing to do with what goes on internally. Put simply, the government could finally get serious about the five-year-old output–price reporting framework and ask the fundamental question: Is the price right?

When the output–price framework was introduced in 1999–2000, it was envisaged that agencies would be subjected to periodic reviews by the Department of Finance to check the price (cost) being paid for outputs. It turns out that this was more easily said than done, with only very limited progress to date. In fact, the recent Budget Estimates Framework Review shifted the focus away from the price of outputs and back onto the cost of inputs such as salaries and wages (the move to reporting outcome *net costs* rather than *prices* is no accident). This is a pity, because the two perspectives are complementary. The government needs an assurance that the costs of inputs are constrained to sensible levels, and also that the overall cost/price extracted for an output is reasonable. Unfortunately, the latter is far harder to achieve.

It's fair to say that the costs/prices ascribed to the twenty-eight Defence outputs are currently nothing more than a useless artefact of the formal budgeting process. They certainly play no role in decision-making at any level: otherwise, how could they undergo the substantial revision of earlier this year without any impact on real decisions?

Consider this. In May last year, the cost/price of the Ground-based Air Defence output was $93 million dollars. In February this year, the price was revised up to $176 million. If the price twelve months ago was assessed as being good value for money, this certainly can't be the case today. What this shows is that nobody (not Finance, not Defence, and certainly not the government) has any idea whether the cost being paid for the individual outputs is a bargain or an exorbitant drain on the public purse.

The time has come to either get serious about the output–price framework or stop wasting time and relegate it to the scrap-heap of bureaucratic history.

## Price check!

Unlike a checkout-person in a supermarket, who can hold up a can of beans and call 'Price check!', the Department of Finance faces a daunting task in saying anything sensible about the price of a Defence output. But with more than $16 billion per annum of taxpayer's money being spent, it's worth having a go.

So what would an output price check involve? A range of things could be done, especially if we're not pedantic about the meaning of 'price' so that the efficient use of inputs is also put under scrutiny. Key elements could include:

- benchmarking the cost of activities within an output, like flying hours or steaming days, against commercial and foreign military comparators
- examining how well the capital assets are managed within an output for economic life and return on investment, compared with commercial and foreign military benchmarks
- looking at how efficiently the personnel component of capability is used within the output and determining the level of management overhead carried
- developing a set of measures that could be used to monitor future performance and efficiency.

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The only thing worse than paying too much for defence is paying too little and winding up with a hollow, ineffective and unsustainable force.

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It would be impractical to try to price check all twenty-eight Defence outputs at once. At best, a single output, or at very most a single outcome, should be chosen as a trial. Six months seems a good first guess for the duration of the initial exercise. This would then provide a template for a rolling program of price checks of the remainder. To properly undertake such an exercise would demand an independent and properly resourced multidisciplinary team. The skills required would be those of management accountants, military experts (perhaps brought in from overseas), operational analysts, management consultants and business people.

This would not come cheap—it could easily cost several million dollars to properly examine a single output—but it would be a small price to pay to know if the price is right. And remember that it could go either way. The only thing worse than paying too much for defence is paying too little and winding up with a hollow, ineffective and unsustainable force.

It's about time we had a close look and found out.

A 19th Century Chinese Mandarin, a civil servant from the Qing dynasty. Photo courtesy Australian Picture Library

# Acronyms and abbreviations

| | |
|---|---|
| ADF | Australian Defence Force |
| AFP | Australian Federal Police |
| CDF | Chief of the Defence Force |
| DCP | Defence Capability Plan |
| DCR | Defence Capability Review |
| DMO | Defence Materiel Organisation |
| DVA | Department of Veterans' Affairs |
| GDP | gross domestic product |
| PNG | Papua New Guinea |

# About ASPI

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.

For more information, visit ASPI's web site at www.aspi.org.au.

## ASPI's Research Program

Each year ASPI will publish a number of policy reports on key issues facing Australian strategic and defence decision-makers. These reports will draw on work by external contributors.

**Strategy:** ASPI will publish up to 10 longer studies, including a series of annual publications on key topics, such as the defence budget, regional capabilities and Australian Defence Force capabilities.

**Strategic Insights:** A series of shorter studies on topical subjects that arise in public debate.

**Commissioned Work:** ASPI will undertake commissioned research for clients including the Australian Government, State governments, foreign governments and industry.

## ASPI's Programs

There are four ASPI programs. They will produce publications and hold events including lectures, conferences and seminars around Australia, as well as dialogues on strategic issues with key regional countries. The programs are as follows.

**Strategy and International Program:** This program covers ASPI's work on Australia's international security environment, the development of our higher strategic policy, our approach to new security challenges, and the management of our international defence relationships.

**Operations and Capability Program:** This program covers ASPI's work on the operational needs of the Australian Defence Force, the development of our defence capabilities, and the impact of new technology on our armed forces.

**Budget and Management Program:** This program covers the full range of questions concerning the delivery of capability, from financial issues and personnel management to acquisition and contracting out—issues that are central to the Government's policy responsibilities.

**Outreach Program:** One of the most important roles for ASPI is to involve the broader community in the debate of defence and security issues. The thrust of the activities will be to provide access to the issues and facts through a range of activities and publications.

## ASPI Council Members

ASPI is governed by a Council of 12 members representing experience, expertise and excellence across a range of professions including business, academia, and the Defence Force. The Council includes nominees of the Prime Minister and the Leader of the Opposition.

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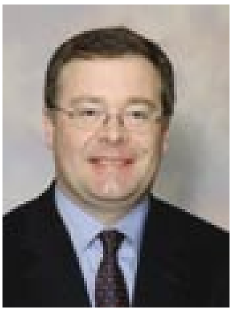

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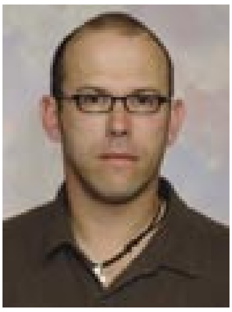

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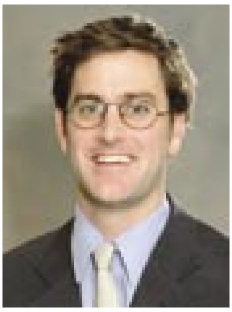

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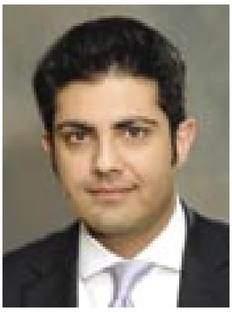

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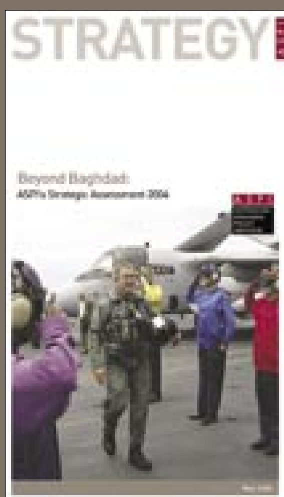
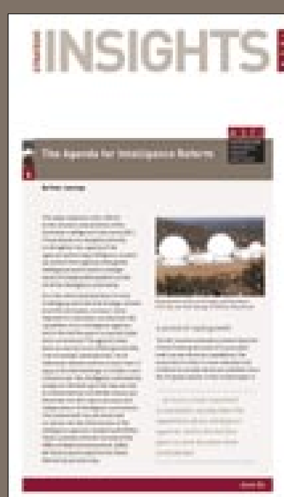
## Some previous ASPI publications







## Your Defence Dollar: The 2004–05 Defence Budget

This year's Defence budget is much like last year's. A lot more money has been provided to maintain today's ADF, while a significant chunk of planned investment in tomorrow's force has been deferred.

More than $2.2 billion of previously planned investment in new equipment has now been deferred to beyond 2007–08. This was not done to free up cash for elsewhere in the Budget but arose simply because Defence has not been able to spend the money it has received. Having less money available for investment in the short to medium term, and rising individual project costs, will cause delays in the planned delivery of projects. This is unavoidable—within a limited budget, rising costs must translate into delays. On top of this, further pressure (but no more money) has been added to the investment program by new projects designed to meet the extra challenges thrown up after 9/11.

And the cost of maintaining the ADF has been going up, notwithstanding cuts announced last year to the force structure. The 2004–05 Budget provided additional funding across the next four years: $815 million for logistics on top of $1.1 billion provided last year, $654 million for personnel and $300 million for estate upkeep. The net result is that we are now paying more money and getting less military capability than previously planned.

So where does this leave us? Are we getting good value for money for our Defence dollar? On the one hand, a lot of work's been done to ensure that the revised program of new equipment purchases is both achievable and value-for-money. On the other hand, the situation is far less clear regarding the substantial extra funding that's been flowing into personnel and operating costs. Now seems as good a time as any to ask for a price check. Who knows what it would find? There may be efficiencies to be harvested, or we may need to be spending more to ensure that the ADF has what it needs to do its job. Either way, it's worth knowing.

RRP $20.00

**Cover image:** Courtesy of Rocco Fazzari

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