CHAPTER TWELVE

EVALUATION

12.1 Evidence presented to the Committee in this inquiry provided a polarisation of views on the current level of Defence funding. Some submissions offered alternative priorities for Commonwealth funding, but provided little substantive evidence which might justify reduction of Defence funding below its present level. While other submissions presented reasoned arguments advocating Defence funding reductions, the Committee believed these were less convincing than the evidence addressing specific Defence funding deficiencies.

12.2 The evidence indicates that funding pressures are currently mounting on each of the three major areas of allocation within the Defence Portfolio. The most compelling arguments may be summarised as follows:

- The average cost of individual ADF personnel is increasing in real terms, to meet Defence's need to attract and retain quality personnel. While continued programs of efficiencies are reducing numbers and currently keeping overall personnel costs almost constant, the ADF will soon reach a limiting size below which reductions will reduce capability.

- New technologies are requiring investment in new areas of force structure, to minimise national vulnerability.

- The cost of major capital equipment is increasing by around four per cent per annum in real terms due to increasing technology levels, requiring additional funding to maintain current force capabilities.

- A combination of the above two factors is increasing the cost pressure on the Defence capital equipment budget. On current planning, this will preclude replacement of the F/A-18 fighters and the *Adelaide* class frigates when they fall obsolete around 2010.

- The third area of the Defence budget - operating costs - has suffered continued cuts to finance investment and personnel priorities, and this has resulted in low current preparedness levels, most noticeably within Army. There appears to be no scope for further major cuts from operating costs without adverse impact on already low capability levels.

12.3 The Committee accepts that Australia requires a balanced, modern, flexible defence force, and accepts that risk management is an inevitable part of force structuring. Australia cannot have all capabilities for all circumstances, foreseen and unforeseen. This will remain a valid qualification on the capabilities of the ADF. However, the need to forego essential capabilities, such as the F/A-18 replacement, would entail an unacceptable level of strategic risk and loss of Australia's influence in the Asia-Pacific region.

12.4 In the very dynamic environment of national security, there will always be potential for improved efficiency, particularly in an organisation as large as the Department of Defence. The DER was a major review of areas of inefficiency, and the DRP is an important step in seeking to reduce those inefficiencies. The Committee supports the broad direction of DRP, but believes that further intensive scrutiny needs to be maintained on all areas of Defence activity, to make sure that the Australian public is getting value for money.

12.5 While the Committee sees implementation of a culture of efficient management as a desirable objective, it also hopes that the current enthusiasm for efficiencies will not overshoot its aim. A military organisation requires latent capacity to react in times of national crisis. There is a need for caution in the stringent application of commercial principles.

12.6 The Committee did not accept arguments based on a proportion of GDP or of Commonwealth Budget Outlays as valid justification for fixing a level of Defence funding. However, it did accept that these measures give a broad indication of the level of importance that a nation places upon given areas of government spending.

12.7 Trend analyses show that maintaining Defence funding to zero real growth, while assuming average economic growth of three per cent for the Australian economy, would see Defence's allocation as a proportion of GDP diminish to around 1.45 per cent over the next 10 years. The Committee believes that any reduction in real terms to the current level of Defence funding would be detrimental to the security interests of future generations. Even in Australia's current strategic circumstances, the ADF currently has capability deficiencies which are not commensurate with national defence requirements.

12.8 The Committee considered the status quo option of maintaining Defence funding at zero real growth. This would force a choice:

- Apportionment of funding at current levels between personnel, investment and operating costs would sustain current force structuring initiatives, require increasing reductions in personnel numbers, maintain readiness at current marginal levels, and allow some acquisition to address arising deficiencies. It would do nothing to address the impending crisis when items of major capital equipment fall due for replacement at the end of the first decade of the next century. The capabilities which cannot be afforded within the current level of funding are also the capability areas in which Australia cannot afford to be deficient. These areas are the acquisition of front-line combat aircraft, a replacement for the FFG capability, and an Army based on a sufficient number of soldiers.

- If funding for capital equipment projects is given priority over operating and personnel costs, in order to overcome the problem of block obsolescence, this would entail further diminution in force readiness, decrease interoperability with allies, and place at risk the ability to regenerate or to expand the ADF in time of crisis. An already small force would have to be further reduced. This would result in detriment to Australia's ability to contribute to regional stability initiatives, and would decrease Australia's influence and status within the region.

12.9 Given these potential outcomes from maintaining the status quo, the Committee judged that option to be unacceptable. The credibility of the ADF, in terms of its ability to protect Australian interests and to assist regional friends, would suffer in real terms, and in comparison to a number of other regional powers.

Recommendation 3

The Committee recommends that Defence funding should be increased in real terms, to enable the ADF to remain a well-equipped, highly-trained force relying on technologically advanced weapons and support systems.

A Viable Mechanism for Setting Defence Funding

12.10 Throughout its evidence, Defence suggested a variety of means for defining the quantum of additional funding which might alleviate its looming financial problems. One judgement was that two percent of GDP sustained would much improve Defence's ability to invest in new capabilities into the next century.[1] A second suggested mechanism was to set real growth in the Defence budget to overall growth in the national economy, which would 'maintain the actual purchasing value of defence dollars'.[2] A third suggested device was that funding should be allocated a constant rate of around two per cent real growth, sustained over the long term.[3]

12.11 This report has previously considered and discarded the utility of fixing Defence funding as a proportion of GDP, as this mechanism bears no relationship to the actual requirements of national defence, nor does it consider the real spending power of the Defence organisation, which may be improved through achievement of efficiencies. This eliminates the first suggestion (fixing at two per cent of GDP) and the second suggestion (which effectively fixes Defence's allocation at its current proportion of GDP) as viable options.

12.12 The third Defence suggestion for quantifying funding - fixing a real growth rate - was the most sustainable in strategic terms. It isolates the Defence budget from GDP fluctuations resulting from the uncertainties of international trade. It accommodates Defence's perceived needs for funding in the longer term, and makes advance provision to meet that requirement. Most importantly, it provides the required degree of certainty which is needed for long term planning of strategic capabilities, providing the Government commits to this level of funding, and informs Defence planners of that level five years in advance, as recommended previously in this report..

Recommendation 4

The Committee recommends that the mechanism of fixing a rate of real growth be adopted as a means of defining the increase in Defence spending.

Timings

With careful management and rigorous prioritisation, the capabilities outlined in Australia's Strategic Policy *can be achieved without major increases in defence funding* ***in the short term***.[4]

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1 White, ibid, p. 219.
2 Tonkin, Dept. of Defence, Transcript, p. 232.
3 White, ibid., p. 233.
4 Dept. of Defence Submission, pp. S 319 and S 335 (emphasis added).

12.13 There is a limit to how much additional funding could be absorbed immediately by the Department of Defence. The importance of consistency was highlighted in Defence's submission, and has been discussed earlier in this report. The nature of Defence funding requirements, and hence of Defence financial planning, is such that reasonable warning time is required for fluctuations. Similarly, large increases in funding in the short term are difficult to accommodate efficiently.

12.14 Defence witnesses provided consistent evidence regarding timings for a potential funding increase. The Defence submission agreed that:

> ... over the next two years, Defence can meet its current planning requirements within the (zero per cent real growth) guidance provided in the 1997-2001 Forward Estimates.[5]

In light of the evidence received in this inquiry, the Committee was unconvinced of the adequacy of that current guidance level in the short term. Defence's 'current planning requirements' accept that readiness provisions may be maintained at their current minimal levels, enabling funding to be diverted to capital equipment and personnel costs, which are seen as more pressing needs. The Committee believes that this basis for planning is flawed. Reduced operational readiness and activity levels lower the motivation of Service personnel, further lowering ADF morale which has borne the impact of current extensive restructuring initiatives.

12.15 The Committee accepts that planning for a major increase in logistic support spending would require at least 18 months, and acquisition of capital equipment would be expected to 'take more than a couple of years' to step up, because of the processes involved.[6] However, the continued erosive effect of annual real cost increases, particularly in capital equipment and personnel costs, dictates that real growth should be applied to the Defence budget as soon as the additional funding can be used efficiently, and to the benefit of the ADF. For each year that commencement of the period of real growth is delayed, the effect of real cost increases will continue to reduce the potential gains achievable from the DRP. By commencing funding increases as soon as possible, the long-term effect of sustained real growth would be maximised. The Committee believes that increases in funding in the short term could be used to prevent the further decline in readiness levels, through improving training levels, activity rates, and ammunition stockholdings.

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5 ibid., p. 289.
6 McCormack, ibid., pp. 47-48.

Recommendation 5

Given that the recommendations made in this report can have no impact on the decisions taken in the 1998-99 Federal Budget, the Committee recommends that real growth in Defence funding should commence in FY1999-00.

How Much is Enough?

12.16 Defence suggested that fixing a rate of around two per cent real growth in Defence funding, sustained over the long term, made planning for future capability more manageable,[7] and that:

> a significant number of things we would like to be able to do start to become possible under a line at about two per cent real growth in the Defence budget.[8]

12.17 From Defence's explanations of the difficulties it would face, even given two per cent real growth,[9] the Committee was surprised at Defence claims that this level of increase would enable capabilities to be developed.[10] A real growth of two per cent falls below the levels of funding claimed as necessary minimums in the 1987 and 1994 Defence White Papers. In fact, two of the three options suggested fall below the 1994 White Paper's estimated requirement for a sustained allocation of two per cent of GDP.[11]

12.18 The Department provided no objective evidence specifically supporting its calculation of the need for two per cent real growth, and was generally unforthcoming on such detail throughout the inquiry. The Committee found this attitude disappointing, particularly as this inquiry provided the ideal forum for explaining the justifications for an increase in funding.

12.19 The Committee was left with the task of validating the increase required through use of other evidence. The need for planning to address the block obsolescence problem was accepted as the most compelling long-term factor. The F/A-18 replacement alone will require additional funding in the order of $5 to $12 billion, which Defence claims cannot be accommodated within long-term major capital investment planning. Allowance to make this sum available would require a real growth rate averaging between one and 2.5 per cent to the current Defence funding level, sustained over a decade. By including the requirement to replace the *Adelaide* class frigates, and to replace the F-111 in the longer term, a real growth rate significantly above 2.5 per cent would be required, and would need to be sustained across the longer term, to inject these estimated funding requirements into the Defence budget.

12.20 The problem of planning the required funding is further exacerbated by the real growth in the costs of personnel and capital equipment. Even given the two per cent real

7 White, Transcript, p. 233.
8 ibid., p. 253.
9 Tonkin, Transcript, pp. 256-257.
10 White, ibid.
11 *Defending Australia*, op. cit., p. 146, para. 14.5.

growth rate suggested by Defence, there may be as little as $2 billion left for new capability investment over a decade.[12]

12.21 The Committee also noted that the final outcome of efficiencies achievable under the DRP is not currently known. Other efficiency measures may emerge in the longer term which could increase the purchasing power of the Defence budget. In the absence of more definitive evidence, the Committee was unable to identify a specific rate of real growth by which Defence funding should increase to address extant deficiencies, particularly into the medium term and beyond.

12.22 The Committee calculates that a real increase in the order of 1.5 to 2.5 per cent, if sustained over a decade, would provide Defence with an additional $7 to 12 billion (in current year dollars) by the end of that decade, alleviating several areas of difficulty currently facing the Department, and the potential severity of the block obsolescence problem. Below 1.5 percent, there is a high probability that the increases will be largely consumed by real cost increases. The Committee believed that the increased burden on public funding imposed by a growth rate much in excess of 2.5 per cent would not be politically sustainable at present, particularly given that the problem does not arise until the period 2010-2020, which is where the peak in demand for major investment is expected to fall.[13]

12.23 The Committee was satisfied that a substantive case exists for an increase in Defence funding of the order suggested by Defence. However, the continuing emergence of new technologies, the evolution of strategic relationships, and the ongoing impact of efficiencies on the cost of capabilities, serve to undermine the basis for financial judgements beyond the medium term in defence matters. The Committee believes it would be imprudent to make definite predictions on financial requirements, or to recommend funding allocations, for a period more than five years into the future. The real benefits which accrue to the Defence budget over the medium to long term arise from the compounding increases of that growth. While there is a strong likelihood that similar growth in funding would be required after this period, the Committee limits its conclusions to the five year period to the end of FY2002-03.

Recommendation 6

The Committee recommends that the current level of Defence funding be increased by a real growth rate of between 1.5 and 2.5 per cent annually for the next five years.

12.24 Precipitate fluctuations in funding levels could invalidate the process of long term financial planning, so there is a need to determine the level of increase, and to provide advice to Defence of that increase, well in advance. This would be achieved by the Government's five year Budget commitment, as recommended earlier in this report.

12.25 The Committee also emphasises that, even if sustained at the recommended level, the real growth to the current level of funding is likely to be insufficient to overcome the block obsolescence problems. The Committee notes the magnitude of this problem, and foreshadows that a further, and significantly greater, real increase in Defence funding will be

12 Tonkin, ibid., p. 257.

13 Dept. of Defence, Submission, p. S332.

required as the period 2010-2015 approaches. Overcoming this crisis will require foresight, and careful management by Defence planners. It will also require recognition of the problem, and strong commitment by the Australian Parliament at that time.

Recommendation 7

The Committee is concerned about the substantial additional expenditure required to overcome block obsolescence in the 2010-2015 period. The Parliament and Expenditure Review Committees of successive Governments must be involved in the advance financial planning to overcome this problem.

Caveat

12.26 Defence clearly warns that there is a risk associated with those capability requirements which are currently unfunded or have been delayed due to other funding pressures. This risk can be accepted because present strategic circumstances remain favourable to Australia. Any deterioration in those circumstances would carry with it a concomitant and potentially urgent requirement to increase funding for defence, to address strategic risks to Australia's long-term interests.

Senator David MacGibbon
Chairman