Funding and Delivering the 2016 Defence White Paper

Mark Thomson

The 2016 Defence White Paper contains plans for the most ambitious expansion and modernisation of the Australian Defence Force since at least the Menzies build-up in the early 1960s. To back up the plan, the government has committed to a decade of explicit funding guidance, which will see defence spending reach 2 per cent of Gross Domestic Product in 2020-21 and rise to 2.2 per cent in 2026-27. The plan and its funding are not assured. Past defence funding commitments have tended to be unreliable, and future governments may struggle to balance a rising defence budget against competing demands to retire debt, reduce taxes and maintain government services in other areas. At the same time, the rapid increase in investment—especially in naval platforms to be built locally—will test the capacity of the Department of Defence and local industry to deliver capability on schedule, especially given the ongoing extensive, yet untested, reforms to the Department's processes and workforce.

Introduction

The 2016 Defence White Paper (DWP2016)[1] represents the most recent step for the ongoing modernisation and expansion of the Australia Defence Force (ADF), a process that began in 2000. It has been a troubled journey to get to where we are today, and further challenges lie ahead—in both securing the promised funding and turning that funding into operational capability. With that in mind, this article examines the affordability and deliverability of the plans for the ADF set out in DWP2016.

What follows is divided into four parts. First, the historical context for DWP2016 is briefly recounted.[2] Second, the funding promised in DWP2016 is examined in terms of the medium-term fiscal, economic and political outlook. Third, the ability of the Department of Defence (Defence) and industry to deliver the capabilities envisaged in DWP2016 is examined in light of ongoing reforms to Defence management and procurement practice. A concluding section analyses the overall prospects for DWP2016's goals in in the years ahead.

[1] Department of Defence, *2016 Defence White Paper* (Canberra: Commonwealth of Australia, 2016).

[2] For a more complete account of the past fifteen years of Australian defence funding, see Mark Thomson, *The Cost of Defence 2015-16* (Canberra: Australian Strategic Policy Institute, 2015), chapter 3.

How We Got to Where We Are Today

Towards the end of the 1990s, the Howard Government faced a quandary regarding the ADF. Following the long peace of the 1980s and much of the 1990s, the ADF was in a state of low preparedness, with hollow capabilities and looming block obsolescence. After a failed attempt to free up resources through outsourcing under the 1997 Defence Reform Program,[3] the government was faced with a stark choice: increase defence funding or scale back the size of the ADF. In the aftermath of the East Timor deployment in 1999, it was hardly surprising that it chose to boost funding.

The 2000 White Paper promised, and delivered, a decade of 3 per cent annual real growth. Key projects included the first tranche of naval modernisation—including patrol boats, landing helicopter docks and air warfare destroyers—and the longer-term replacement of the air combat capability. But all was not smooth sailing. By 2003, cost increases saw capability delayed and cancelled.[4] Soon after, it became clear that projects were slipping behind schedule due to mounting delays in government approval and widespread failure to deliver by industry. Money was handed back unspent. To complicate matters further, operations in Afghanistan and Iraq led to further new initiatives to bolster ADF expeditionary and counter-terrorism capabilities from 2001 onwards.

Around 2006 to 2007, the resource boom bolstered government finances and enabled (or at least encouraged) a series of major capability initiatives, including the initial $1.9 billion order of four C-17 transport aircraft, the $10 billion Enhanced Land Force initiative in 2006, and the $6.6 billion Super Hornet fighter acquisition in 2007. Despite the additional programming of new funding and the continuing 3 per cent real growth funding wedge from the 2000 White Paper, by the time the Rudd Government took office in late 2007, the affordability of plans for the ADF looked uncertain, if not unlikely. The problem was that ambitions for the future ADF appeared to have outstripped growth in funding. To address the gap, the newly elected government began work on a new defence white paper in 2008. As in 2000, the question was whether to trim plans or increase funding.

The 2008 global financial crisis saw the planned white paper delayed until May 2009.[5] To the surprise of many observers, the document embraced all pre-existing plans for the ADF and added a few new ones, including a doubling of the submarine fleet and a step up in capability for the frigates needed to replace the Anzac class in the 2020s. In terms of funding, the

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[3] Department of Defence, *Future Directions for the Management of Australia's Defence: Report of the Defence Efficiency Review* (Canberra: Commonwealth of Australia, 1996).
[4] Aldo Borgu, *The Defence Capability Review 2003* (Canberra: Australian Strategic Policy Institute, 2003).
[5] Department of Defence, *Defending Australia in the Asia-Pacific Century: Force 2030* (Canberra: Commonwealth of Australia, 2009).

2009 DWP promised a continuation of 3 per cent real growth out to 2018 followed by 2.2 per cent real growth out to 2030.

However, celebrations were short lived. Ten days after the 2009 White Paper was released, the 2009 Budget deferred around $8.8 billion of promised funding.[6] There followed further cuts and deferrals up to and including in the 2012 Budget. All up, around $20 billion of planned funding was lost or pushed into the future.[7] At the same time, the so-called Strategic Reform Program (SRP) was initiated, with the goal of saving around $20 billion over the forthcoming decade.[8] But, despite some initial success in cutting sustainment costs, the credibility of the SRP was compromised by exaggerated claims of savings. In 2012, the program was abandoned after budget cuts undermined any pretence of savings.

Subsequently, in late 2012, the Gillard Government began work on a new White Paper. Yet again, the same choice loomed: cut capability or increase funding. The resulting 2013 White Paper[9] did neither. Instead, it retained the goals of the 2009 White Paper but offered a manifestly inadequate decade-long funding stream. More so than any of its predecessors, the 2013 White Paper was manifestly unaffordable. When the Rudd Government lost office in September that year, the incoming Abbot Government inherited the problem.

The 2016 Defence White Paper

Around 2012, the notion of spending 2 per cent of Gross Domestic Product (GDP) on defence gained currency on both sides of politics, though largely as an aspiration for some future unspecified time. The dubious merits of basing defence spending on a share of GDP are well understood[10] yet, as the 2013 election campaign drew to a close, Mr Abbott committed the Coalition to boost defence spending to 2 per cent of GDP “within a decade” of being elected.[11]

The Abbott Government lost little time in commencing work on what was promised to be a 2015 defence white paper, but the shifting political fortunes of two Defence ministers and the replacement of Mr Abbott as prime minister saw the release delayed until February 2016. Speculation that the new

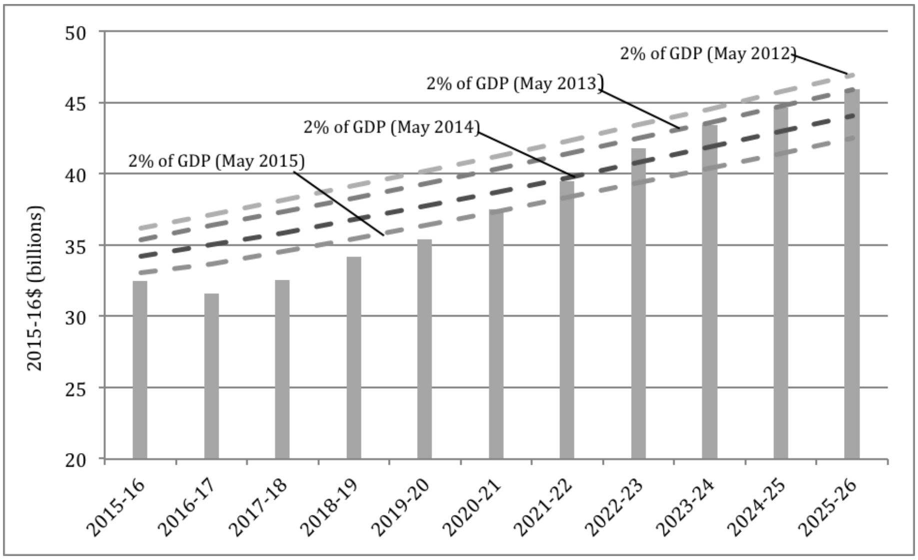
[6] Mark Thomson, *The Cost of Defence 2009-10* (Canberra: Australian Strategic Policy Institute, 2009), chapter 3.
[7] Mark Thomson, *The Cost of Defence 2012-13* (Canberra: Australian Strategic Policy Institute, 2012), chapter 3.
[8] Department of Defence, *The Strategic Reform Program: Delivering Force 2030* (Canberra: Commonwealth of Australia, 2009).
[9] Department of Defence, *Defence White Paper 2013* (Canberra: Commonwealth of Australia, 2013).
[10] Andrew Carr and Peter J. Dean, ‘The Funding Illusion: The 2% of GDP Furphy in Australia’s Defence Debate’, *Security Challenges*, vol. 9, no. 4 (2013), pp. 65-86.
[11] Tony Abbott, 2013 Election Campaign Launch Speech, 25 August 2013.

Prime Minister, Mr Turnbull, would not honour his predecessor's commitment proved unfounded. To the contrary, DWP2016 outlined a funding envelope that, if delivered, will see defence spending reach 2 per cent of GDP in 2020-21—fully three years earlier than promised by Mr Abbott.

FUNDING

Rather than link defence funding to volatile GDP, DWP2016 sets out explicit annual funding levels out to 2025-26 (Figure 1). No further adjustments are envisaged apart from preserving the buying power of the budget in light of foreign exchange variations. The early attainment of 2 per cent of GDP likely arises due to the funding being locked down (apart from foreign exchange variations) in 2014 when estimates of future GDP were higher. This conjecture is consistent with the GDP expectations prevailing at the time, as shown in Figure 1. As a practical measure, it would have made sense to fix a funding envelope early in the development of the White Paper so than planners knew how much they had to spend.

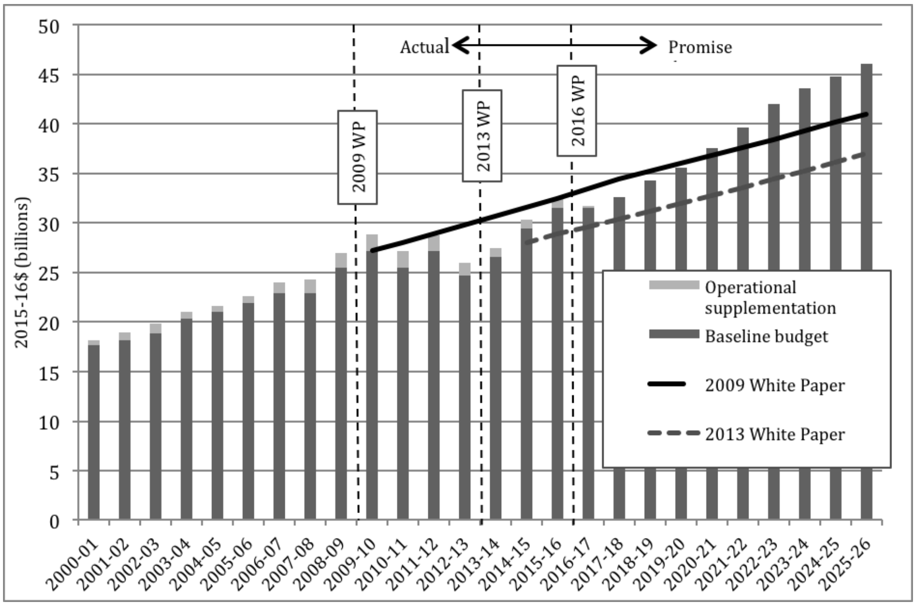
Figure 1: Defence funding and progressive projections of GDP



Source: ASPI analysis of 2016 DWP and Treasury Budget Papers 2012 to 2015.

Over the next decade, annual funding is planned to grow by 81 per cent in nominal terms and 45 per cent in real terms, assuming 2.5 per cent inflation. In annual terms, the rate of growth is equivalent to a nominal increase of 6.8 per cent a year compounding, or a real increase of 4.2 per cent compounding. To put this in context, over the past ten years defence spending has amounted to $276 billion; over the next ten years, aggregate defence spending is planned to be $388 billion, representing a 40 per cent increase (both figures are expressed in real 2015-16 dollars).

Figure 2: White paper funding promises past and present



Source: ASPI analysis of 2009, 2013 and 2016 DWP, 2015-16 Defence Portfolio Budget Statements and Defence Annual Reports 2000-01 to 2014-5.

Figure 2 compares the planned funding with that contained in the 2009 and 2013 White Papers. While the latest funding commitment comfortably exceeds that made in 2013, it takes until 2020-21 for planned funding to exceed the unfulfilled promise of 2009.

From a funding perspective, there are two ways that today's plans for the ADF could run off the rails; the government could fail to deliver the promised funding, or actual costs could exceed promised funding. Each is considered in turn below.

AFFORDABILITY—WILL THE MONEY BE THERE?

In the past, promises to increase defence funding have been more honoured in the breach than in the observance. Setting aside the short-lived 2013 White Paper, it is a matter of record that governments failed to deliver the funding promised in the 1976, 1986 and 1994 White Papers. Only the Howard Government kept the promise it made in the 2000 White Paper. But the 2000 White Paper was rolled out during a period of strategic turmoil and unexpectedly strong government revenues. While the former may be in prospect today, the latter is not.

For the decade-long funding program to be realised, the priority for stronger defence will have to prevail over competing economic and political imperatives. The tussle will be between the four possible ways that the government can allocate resources: defence spending, paying down debt, reducing taxes, and providing services to the community such as health, education and transfer payments. The first two categories are largely about managing risk. Defence spending prepares the country to meet strategic risks, while debt reduction prepares the country to face economic risks.

The case for stronger defence is implicit in much of the analysis presented in this issue of *Security Challenges* and so need not be repeated here. The case for paying down debt to bolster our economic position is less well appreciated, but Treasury Secretary John Fraser set out the case in a recent speech.[12] More generally, economic uncertainty is high at present, with the major economies of the world seemingly at an inflection point—only the US economy is showing encouraging signs. Quite apart from better preparing us in case of an economic downturn, lower debt reduces both interest payments and intergenerational cost shifting.

The Abbott Government's alliterative chant of 'debt and deficit disaster' is but a distant memory, the adverse public and media reaction to the 2014 Federal Budget having pushed deficit reduction off the agenda. And, whatever the fairness or otherwise of the 2014 Budget, it would have only modestly redressed the fiscal situation even if all its measures had made it through the Senate. As for the 2015 Budget, it saw the projected deficit[13] increase by $56 billion over four years, followed by another $26 billion in the mid-year update.

In addition to falling government revenues, the deteriorating fiscal situation reflects the political reality that people do not want to pay higher taxes or see government services cut. At the best of times that would be unsurprising, but with wages stagnant in real terms[14] and after-tax income eroding under bracket creep, people are especially sensitive to anything that reduces their standard of living.

It remains to be seen if the current and future governments will be able to stave off public expectations of tax cuts and undiminished levels of government services. Even if they do, tensions will remain between fiscal and strategic imperatives. As our strategic and economic circumstances evolve, public sentiment may shift in favour of one at the expense of the other. But for the time being, private financial concerns appear to be

[12] John Fraser, 'The Australian Budget—Some Context', Speech to the Sydney Institute, 28 January 2016.
[13] Measured as 'underlying cash balance'; May 2015—2014-15 to 2017-18, December 2015—2015-16 to 2018-19.
[14] Australian Bureau of Statistics, '2015 Ends with Lowest Wage Growth on Record', Media Release, Canberra, 24 February 2016.

foremost in peoples' minds, and the fractiousness of the electorate guarantees that politicians will be attentive to those concerns. For that reason, future governments will face far greater difficulties in ramping up defence spending than the Howard Government did in the halcyon days of the 2000s.

AFFORDABILITY—HAS ENOUGH MONEY BEEN SET ASIDE?

In the past, Defence has done a very poor job of assessing the cost of delivering and maintaining capability. For example, and as already mentioned, the funding for the 2000 White Paper soon proved to be inadequate for the task. There are two ways in which funding can be inadequate; either the costs are underestimated initially, or 'scope creep' causes costs to rise above initial estimates. Throughout the 2000s, efforts were made to correct the former malady in successive Defence Capability Plans, and there is evidence that progress was made.

DWP2016 took the search for reliable costs a further step forward by seeking "external validation" of its costs by "private sector experts".[15] To this end, at least $14.6 million was spent on cost assurance by consulting and accountancy firms.[16] Even though firms were prohibited from canvassing prices from prospective suppliers, it is likely that the costs underpinning DWP2016 are more reliable than any of its predecessors. In fact, if anything, the costs disclosed in the accompanying Integrated Investment Program (IIP)[17] seem overly cautious. For example, it is difficult to see how to spend $4-5 billion upgrading the combat system of the three yet-to-be-delivered Hobart class destroyers given that the three vessels are only costing a little over $9 billion to build and fit out.

Nothing in the development of DWP2016 will prevent the military from escalating its aspirations for the capabilities outlined in the IIP. Indeed, in many areas the document shows the willingness of Defence planners to pursue enhancements of ever more marginal worth. For example, the long-range rockets ($750-1,000 million) and land-based anti-shipping missiles ($4-5 billion) for the Army duplicate operational effects that can be delivered by existing ADF assets. That is the sort of profligate planning you get from a funding model (2 per cent of GDP) that privileges financial inputs over cost-effective capability outputs. Only time will tell whether Defence can constrain its ambitions sufficient to remain within budget.

The scale and complexity of the Defence enterprise makes it impossible to assess the adequacy of planned capital and sustainment guidance[18] on the

[15] Department of Defence, *2016 Defence White Paper*, p. 25.
[16] Mark Thomson, *The Cost of Defence 2015-16* (Canberra: Australian Strategic Policy Institute, 2015), p. 139.
[17] Department of Defence, *2016 Integrated Investment Program* (Canberra: Commonwealth of Australia, 2016).
[18] Department of Defence, *2016 Defence White Paper*, p. 182.

basis of publicly available information. Employee funding, on the other hand, is amenable to analysis because we know the planned size of the workforce and can therefore extract the anticipated rate of growth in per-capital costs. Curiously, doing so reveals that Defence plans to reduce its per-capita employee spending by 0.26 per cent a year in real terms across the next ten years.[19] While structural changes to the Defence workforce may help constrain per capita cost growth, it is difficult to see how planned employee expenditure guidance will be adequate unless we have a decade of stagnant real wages across the Australian economy.

Can Defence and Industry Deliver?

Assuming that funding is available and adequate to the task, there is still no guarantee that the goals of DWP2016 will be delivered on schedule. To some extent, it will be difficult to tell, because the new IIP is much less forthcoming about schedule milestones than previous public disclosures.[20] Nonetheless, delays will arise unless the capacity of both Defence and Defence industry (henceforth Industry) are adequate.

Unlike previous White Papers, the 2016 version has not been preceded by a freeze on approvals. On the contrary, a series of major projects were approved throughout 2015, including additional C-17 transport aircraft in April, additional KC-30 aircraft in July, frigates and Offshore Patrol Vessels (OPV) in August and Hawkei armoured vehicles in October. Consequently, a smaller than usual backlog of projects has accumulated over the twenty-two-month development of DWP2016.

In addition to the early approval of many projects, the challenge to local industry is further alleviated by the large number of off-the-shelf foreign purchases from established production lines, including the F-35 Joint Strike Fighter, the additional C-17 transport aircraft and the new P-8 maritime patrol aircraft. Yet the task should not be underestimated. According to DWP2016, no less than $195 billion will be spent across the next decade to fund investment in the future force although, curiously, only $162 billion of guidance has been set aside for capital investment.[21] In any case, plans will see investment in new equipment and facilities rise, in real terms, by the equivalent of 7.7 per cent a year, from $6.6 billion in 2016-17 to $18.6 billion in 2025-26. And there are some large local projects to be launched, especially in ship and submarine building. Looking back to the 2000s when somewhat less ambitious growth (in the vicinity of 5 per cent a year) was unsuccessfully attempted, there is no guarantee that the investment program can be delivered.

[19] Mark Thomson, 'The New Normal: A Decade of Stagnant Real Wages for Defence Personnel?', *The Strategist*, Australian Strategic Policy Institute, 8 March 2016.
[20] Mark Thomson, 'The (Kinda Sort Of) Integrated Investment Program', *The Strategist*, Australian Strategic Policy Institute, 9 March 2016.
[21] Department of Defence, *2016 Defence White Paper*, p. 9.

Two factors complicate the delivery of the program. First, there appears to be a shift in defence industry policy away from foreign purchases towards local production. On past experience,[22] that will increase the risks and delays to the delivery of capability. Not unexpectedly, it takes longer and costs more to mobilise local production rather than purchase from an established production line with larger economies of scale.

Second, in the medium term, the program is dominated by three large naval construction projects. Moreover, the nine-vessel Future Frigate (>$30 billion in cost) and twelve-vessel Offshore Patrol Vessel (OPV) ($3–4 billion in cost) projects have each been brought forward by several years[23] to preserve jobs in the politically sensitive shipbuilding sector, notwithstanding that work on existing naval projects will have largely wound down by the time the new projects commence. And although the demise of the car industry and decline of the resource investment boom will free up labour for the task, the overlap of the frigates and OPV with the twelve-vessel Future Submarine (>$50 billion in cost) project will create competition for scarce talent. Given the debacle of the three-vessel Air Warfare Destroyer (AWD) project—at least a billion dollars over budget and thirty-three months delayed—the risk presented by domestic naval shipbuilding cannot be discounted, especially given the largely bespoke specifications for the frigates and submarines.

Quite apart from question of Industry capacity, the successful implementation of DWP2016 will depend upon Defence's ability to prepare, seek approval for, and manage the 166 unapproved projects in the IIP. Despite the less-than-usual bow-wave of new projects accompanying the new White Paper, there are eighteen projects scheduled for approval prior to 1 July 2016, and another fifty-one scheduled to commence their 'program timeframe' in 2016. To make matters worse, the intervention of an election in 2016 will necessarily disrupt the consideration and approval of projects. One way to expedite the progress of projects would be to raise the threshold for ministerial approval.

In the normal course of events, the scale and complexity of work would be a forbidding enough prospect. But the fact that Defence is mid-way through a major internal reform program following the April 2015 First Principles Review (FPR),[24] adds further uncertainty to any assessment of its capacity. Although many of the seventy-six recommendations of the FPR are unrelated to the capability life cycle, the most substantial reforms underway are in that area. Indeed, the former quasi-independent Defence Materiel Organisation (DMO) has been disbanded and a new Capability Acquisition and Sustainment Group (CASG) formed. In addition, the old Capability

[22] Ibid., p. 182.
[23] Tony Abbott and Kevin Andrews, 'The Government's Plan for a Strong and Sustainable Naval Shipbuilding Industry', Media Release, Adelaide, 4 August 2015.
[24] Department of Defence, *First Principles Review: Creating One Defence* (Canberra: Commonwealth of Australia, 2015).

Development Group has been disbanded and its functions divided between the three Services, the new CASG and a new Strategic Policy and Intelligence Group (SPIG). As of early 2016, the new processes and capability life cycle management regime were yet to be finalised, despite being close to half way along the planned twenty-four-month implementation period.

In addition to the new organisational arrangements, Defence has been following the FPR recommendation to *inter alia* 'reduce organisational layers'. This has been most apparent in the new CASG, where most senior executive positions are now one pay level below where they were previously. The resulting reduction in human capital can only make it harder to deliver the capability set out in the new White Paper cost effectively. As partial mitigation of the reduced capacity within CASG, it appears as though greater reliance will be placed on (1) Industry managing projects above the line, and (2) partnering with Industry below the line in lieu of traditional competition. While the former may present opportunities when capabilities can be sufficiently well specified at an early stage, the latter will require Defence to develop new ways to assure value for money in its multi-billion dollar acquisition and sustainment programs. Whatever the merits and disadvantages of competitive tendering, and as the troubled AWD alliance program demonstrates, competition is easier to implement than partnerships built on nebulous catch phrases such as 'win-win outcome' and 'best for project decision'. If anything, Defence should be upgrading rather than downgrading its acquisition workforce to implement this new approach.

Conclusion

The goals of the 2016 Defence White Paper can only be achieved if future governments make good on the funding commitment made by the Turnbull Government in February 2016. Even then, success will not be assured. Ramping up investment levels quickly enough to meet the plan's demanding schedule will be a major challenge, especially with a major internal reorganisation underway.

It is clear that today's plans for the ADF are as ambitious as anything that has emerged since at least Robert Menzies' defence build-up in the 1960s. It is too early to declare the plans overly ambitious, but the challenges to continued funding and successful implementation are many and serious.

In all likelihood, priorities and plans will change in the years ahead—as they should when circumstances change and new information comes to light. There will surely be one or more new White Papers over the ten-year funding horizon of the one just released. Good government comes more from agility than slavish adherence to the plan of predecessors. In three or four year's time, thinking will have moved on and we will look back at

DWP2016 for what it is; a starting point for further evolution rather than an end point in itself.

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