**Speech – The Cost of Defence 2017-18 – Dr Mark Thomson**

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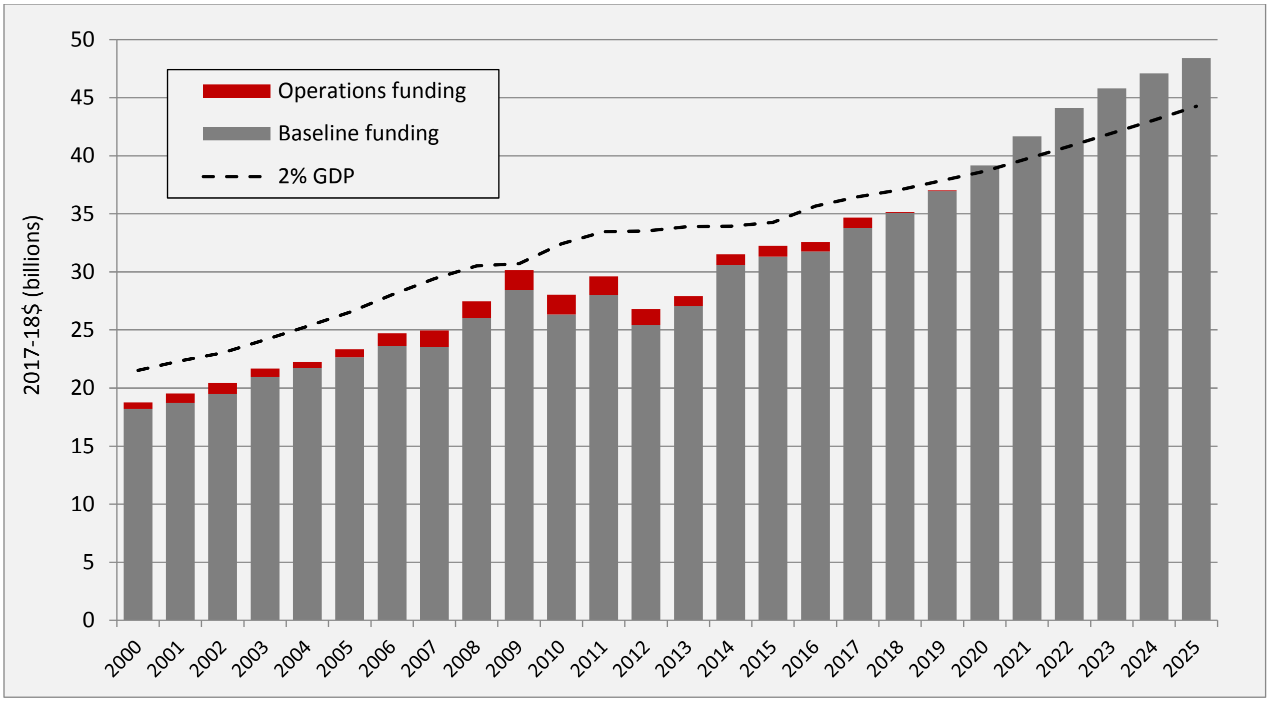
Your excellencies, ladies and gentlemen.

I want to start by giving credit that's where its due. This year's Budget Brief relied heavily on the contributions—and patience—of a great many people at ASPI. My sincere thanks go to them all.

My talk this evening will be divided into three parts. I'll begin by giving you the key facts and figures from this year's Defence Budget. Of the 292 charts, tables and graphics in this year's Budget Brief, I've selected a single graph to tell the story. Then I want to examine several issues that will be critical to the delivery of the future ADF envisaged by the 2016 Defence White Paper. Finally, I want to draw your attention to the most basic question in any nation's defence planning: how much is enough?

Let's start by following the money. Here's a chart showing past and planned defence spending. The vertical grey bars are baseline defence expenditure, and the red caps represent the net additional cost of overseas deployments. The black dashed line is the historical and projected 2% of GDP threshold.




As a result of this year's Budget, Defence spending in 2017-18 will be $34.7 billion, representing 1.9% of GDP—a 6.5% real increase on last year.

The largest measure in the budget was an additional $936 million over three years to cover the next additional cost of ADF deployments to Afghanistan, Iraq and elsewhere. Next year, the cost of operations will amount to $903 million, including $454 million for fighting so-called Islamic State and $222 million for operational support in the Middle East. At present, there are around 2,300 women and men of the ADF deployed on various operations.

Defence has also been subject to efficiency dividends, amounting to about half a billion dollars over four years. While that might seem to a case of the government stepping away from its White Paper funding commitment, the efficiencies relate to areas where there's been precipitous growth in expenditure over the past couple of years, including consultants, contractors, and business travel. Taken in context, the measures are neither onerous nor unreasonable.

This year's measures and dividends are but small shifts to the $30 billion wedge of additional funding granted by the 2016 White Paper. Largely because of that wedge, the hallowed benchmark of 2% of GDP is projected to be met in 2020-21, as forecast in last year's White Paper, and three years earlier than promised in 2013. Don't get too excited by that, the early projected attainment was largely driven by falling GDP forecasts since 2013.

The next few years will see spending increase by an average of 4.7% per annum in real terms, with investment in new equipment the main beneficiary. In, 2015-16, the year preceding the White Paper, defence capital investment amounted to $9.2 billion. By 2020-21 it will reach $16 billion, and by 2025-26 it will exceed $23 billion.

In that same year, nine years hence, the total defence budget will be close to $59 billion in nominal terms, or about $48.4 billion in today's dollars. To put that in context, it means that Australian defence spending will have doubled in real terms in the 20 years from 2005 to 2025.

On course, spending money is a means not an end. The goal behind the planned substantial diversion of national wealth is set out it the 2016 Defence White Paper; a moderately larger but much-better equipped defence force.

Key elements of the future force include; 72 F-35 Joint Strike Fighters (to replace our ageing F-18 Hornets), 9 anti-submarine warfare optimised frigates (to replace our existing smaller 8 Anzac frigates), and 12 'regionally superior' conventional submarines (to replace our 6 Collins-class boats). That's just the headline items—almost every aspect of ADF capability is slated for enhancement or expansion over the next 20 years.

So where are we at?

In the 14 months since the release of the 2016 Defence White Paper, the government continues to fulfil its funding promise. Defence continues to initiate new acquisition projects, and industry have gotten on with delivering the equipment and support needed to build a stronger ADF. It's early days yet, but, for the moment at least, things are largely on track.

There are two risks to defence funding. On the supply side, current and future governments are likely to find it hard to placate a fractious electorate that shows little interest in national security. With an election in 2019 and a planned return to surplus the year after, the test will come soon enough. As we saw between 2009 and 2013, it is entirely within the scope of Australian politics for a government to abandon plans for a stronger ADF in favour of trying to engineer an early return to surplus.

On the demand side, the risk is that the planned growth in capital investment will outstrip the capacity of Defence and industry to deliver. As the current raft of large off-the-shelf foreign purchases gives way to even larger domestic naval construction programs, the risk of underspending will grow. Back in the 2000s, anything more than a 5% per annum increase in equipment purchases proved unsustainable. Then, as now, the harsh rule is this: use it or lose it. Nothing encourages a government to withdraw funding more than handing back money.

I want to turn now to look at three areas that are critical to the delivery of the future ADF described in last year's White Paper: personnel, defence industry, and procurement.

**People**

Let's start with personnel. Adequate numbers of properly training personnel—both civilian and military—are an essential underpinning of ADF capability. So, it's good news that, after struggling to maintain its numbers a few years back, the ADF workforce looks to be in better shape. For the most recent year reported, the ADF met 90% of its recruiting target, compared with a historical average of 86%, and the separation rate was 8.3%, compared with a historical average of 10.8%. Even so, the ADF currently has 333 people fewer than budgeted for, from a workforce of around 59,000. But that's a much better result than the shortfalls of between 1,000 to 2,000 experienced from 2012 to 2015.

If only things were looking that good for Defence's civilian workforce. This year, civilian numbers fell 600 positions below the budgeted figure (from a workforce less than a third of the size of the ADF). And recent internal surveys have revealed disappointingly low civilian morale. In a survey from March 2016, 41% of civilians rated their workplace morale as 'low' or 'very low', while only 17% of ADF personnel were similarly disaffected. Having not had a pay rise since 2013, and being offered an increase below that awarded to ADF members (breaking a quarter-century practice), low morale is understandable. With the government predicting economy-wide wage growth of 2.5% to 3.0% in its Budget, now is the time to stop treating civilians as second-class members of the Defence workforce and to restore parity with military wage increases.

**Industry**

Let's turn to defence industry, which the government elevated to a 'fundamental input to capability' in its 2016 Defence Industry Policy Statement.

With no risk of exaggeration, I can say that it's been an exciting 12 months for Australian defence industry. While many previous defence industry policies have gathered dust, the 2016 policy statement led to a flurry of action.

We now have a dedicated Minister for Defence Industry, and the three key components of the government's decade-long $1.6 billion defence industry program are up and running, including the Centre for Defence Industry Capability, the Defence Innovation Hub and the Next Generations Technologies Fund.

More importantly, and in a departure from its 2016 defence industry statement, the government has adopted an avowed 'buy Australian' policy. To quote the Prime Minister 'I am determined that every dollar we spend on defence procurement as far as possible should be spent in Australia…'.

We haven't seen such an overt commitment to local content since the old Australia Industry Involvement program of the 1990s. But while the old approach set Australian content targets, the latest approach is built on the philosophy of the more Australian content the better.

Whether it's the lucrative $195 billion of projects up for grabs, or the 'buy Australian' policy, international defence firms have spent the past 12 months redoubling their investments in Australia. New offices and research centres have been popping up in South Australia and elsewhere, new global supply chain agreements have been signed and existing agreements renewed.

The government could not have asked for a more encouraging response from industry. Yet, the current surge in industry activity probably reflects the hard reality that, over the next several years, the government will be picking its major suppliers for the next couple of decades. There will be winners, and there will be losers, and industry knows that now is the time to stake their claim.

**Shipbuilding**

Progress continues on the centrepiece of the government's vision for Australian defence industry; continuous naval construction split between SA and WA. Although construction won't start until 2018 for the Offshore Patrol Vessels, 2020 for the frigates, and 2022 or 2023 for the submarines, initial work is well underway.

Requests for tender have been released for both the Future Frigates and the Offshore Patrol Vessels, and a design and mobilisation contract has been signed with our submarine design partner DCNS. By mid-2018, more than $446 million will have been spent on submarines and $297 million on frigates.

The government's long-awaited Naval Shipbuilding Plan was released in mid-May. And while there are still many unknowns, which will only be resolved by future decisions, the Plan provides useful information. For one, we now know that the government will own the naval shipbuilding infrastructure in SA and WA, and plans to invest substantially in both locations over the next several years.

There was also further information about schedules, though some of the numbers did not make sense, and there seemed to be a hint that the Future Frigate project will be delayed. That might not be a terrible thing. Though the fiendish politics of shipbuilding would portend against a delay, the potential cost of hastening too quickly with a $35 billion project could be much worse. On the critical question of contractual arrangements, we remain in the dark. Finding a way to drive value-for-money in the monopoly shipyards that are being created is a key challenge that government is yet to address.

## Jobs and growth

Coming back to the government's emphasis on local defence purchasing, there's been surprisingly little economic analysis to back up the idea that Australian defence industry will be the backbone of the government's broader 'jobs and growth' push.

I've only found two studies released by Defence addressing the question; a 2016 study projecting the impact of JSF-related exports, and a 2015 study looking at a hypothetical six-boat submarine program.

I don't pretend to understand the economic models used, but the results are clear enough. The F-35 model forecasts an average of 3,939 net additional jobs over 33 years, based on average annual exports of $161 million. The submarine model forecasts an average of 733 net additional jobs over 16 years, based on average annual expenditure of $938 million.

To be clear, the submarine study says that of the 2,900 assumed to be working on the project, 2,200 of those people would have found work in other industries that were 'crowded out' by the decision to build locally. With a net employment forecast far below the government's figures for the future submarine project, it's easy to see why it was only released under FOI.

Taken together, the two studies imply that every dollar of defence exports generates 32 times more jobs than a dollar spent building defence equipment in-country.

Even though both studies use the same sort of economic model, there's a significant difference between the two situations. While the submarine project requires additional taxation to fund the build, JSF-related exports don't. Because the models used take account of taxation, that may help explain the very different results. Indeed, all other things equal, additional taxation will subtract from economic activity. Other factors that might be relevant are the differing geographic locations of the two programs—SA versus mainly VIC and NSW—and differences in the calibration and implementation of the two economic models.

Taken at face value, a renewed emphasis on defence export facilitation and global supply chain agreements is called for. In some circumstances, the maximum economic benefit might be gained by foregoing domestic production in favour of securing access for local firms into global supply chains. Remember, the F-35 exports only came about because we're purchasing the aircraft from US factories.

Of course, two isolated studies are a fragile basis on which to build a policy. Without further work, we can't be sure how much of the difference between the two studies comes from the export nature of the F-35 program, as opposed to other differences in what was modelled, and how the modelling was conducted. Indeed, without independent replication, we can't be sure that either study is correct.

If the government is serious about jobs and growth, rather than just flouro-vest photo ops, it should commission economic modelling to properly and systematically determine how Australian defence spending can best be harnessed to create jobs and grow the economy. If we're going to use defence spending to grow the economy, let's get the most out of it.

**Force development and procurement**

Another factor critical to the delivery of a strengthened ADF is the development and approval of acquisition projects. Because there have been significant reforms to capability development arrangements due to the First Principles Review (FPR), I'll use that as the context for what I want to say.

The good news is that reform is going well across the vast Defence enterprise.

Two years on from the Review, 63 of 69 recommendations have been completed, and the vast bulk of recommendations are expected to be signed off by mid-year. Indications are that the implementation of the FPR has been a case study in careful and systematic change management; structural rearrangements are complete, new committees are well-established, and new processes are being refined.

Nowhere have the changes been more transformative than in the capability life cycle, particularly the capability development process. A key metric for the new arrangements is the approval of new projects in line with the demands of the 2016 Integrated Investment Plan. However, after years of uninterrupted transparency, the government has ceased disclosing what projects it approves.

While that could be taken as a sign that things are not going well, I don't think that's the case. As best as can be estimated, although approvals look to be running somewhat behind schedule, it's not by much. If anything, the recent pace of project approvals has matched or exceeded historical rates. I had anticipated that the disruption wrought by the new arrangements would result in severe delays. I was wrong.

What I failed to appreciate, but now understand, is that the reforms to capability development were really just a dismantling of the Kinnaird reforms of 2004. Acquisition and sustainment are now back within Defence, internal contestability has been re-established, Finance has got its old seat back at Defence's capability committee, and the detailed paperwork introduced under the Kinnaird reforms has been pared back substantially. Everything old is new again. We've even gone back to the 1990s 'buy Australian' policy.

For all the talk of 'smart buyer', the tools of the trade have not changed. Acquisition strategies have always been tailored to the problem at hand, and sole-source acquisitions have been commonplace for as long as Defence has been buying kit.

What's happened, is that we've reverted to the old balance between expediency and risk, with the emphasis now on the former. The Kinnaird process sacrificed time to retire risk; the new approach shifts the balance back. So, while some unnecessary work has probably been eliminated by recent changes, so too have many of the checks and balances introduced by Kinnaird.

Consider, for a moment, the Air Warfare Destroyer project. The design phase began with a bespoke 'baby-Bourke' as the preferred design. Everybody knew that the Navantia F-100 was a stalking horse that had only been included because the Kinnaird reforms mandated an off-the-shelf option.

But once the analysis was complete, it became clear that a properly informed analysis of cost, risk and capability favoured the Spanish design. Given the troubles experienced with the less-ambitious F-100, imagine where we would be now if we'd truncated the process and sole-sourced the US design. The lesson is simple: you don't know what you don't know.

There is no magic formula that allows essentially the same group of people to somehow make better decisions in less time and with less information.

Just because you call yourself a 'smart buyer' does not make it so.

I don't make those observations as criticisms; our current strategic situation justifies an elevated tolerance of procurement risk. But if that's what we are going to do, we need recognise it and adjust accordingly. Most importantly, we need to marshal sufficient resources to manage the risks we are shouldering.

Given the massive scale and manifest risk of the planned program, we could devote substantial additional resources to its management and be confident of a positive return on investment. The danger is that the recent reforms to Defence have stripped away program management capacity just when the opposite should be happening.

**How much is enough?**

Even if everything goes to plan—that is, the government continues to meet its promises, and defence and industry deliver capability on time and within budget—a crucial question remains. Are we doing enough?

The scale and timing of today's plans for the ADF are the consequence of an ad hoc decision to spend 2% of GDP on defence by an arbitrary date. To pretend otherwise is to mistake numerology for strategy.

What's more, the capabilities sought in the 2016 White Paper are little more than a re-hash of the Rudd government's abandoned 2009 plan. Not only did today's plans have their genesis in far less challenging times, but we are starting seven years late.

In case you've missed it, the world is going to hell. Or as Henry Kissinger put it more eloquently last year 'the world is in chaos'.

In January this year, a report from the normally staid US National Intelligence Council pointed to 'deep shifts in the global landscape that portend a dark and difficult near future'. It went on to say:

> The next five years will see rising tensions within and between countries. Global growth will slow, just as increasingly complex global challenges impend. An ever-widening range of states, organizations, and empowered individuals will shape geopolitics. For better and worse, the emerging global landscape is drawing to a close an era of American dominance following the Cold War. So, too, perhaps is the rules-based international order that emerged after WWII.

Yet we continue as if it's business as usual, squabbling about whether defence industry jobs will be created in one electorate or another. We've taken our eye of the ball at what might be a critical time.

Current plans will only strengthen Australia's defences slowly. For example, the first of our aptly named 'future submarines' won't enter service until the early 2030s, and we won't have twelve boats until the early 2050s.

The glacial pace of strengthening the ADF is consistent with 2016 Defence White Paper's assessment that 'the United States will remain the pre-eminent global military power over the next two decades'—a critical judgment that the latest US National Intelligence Council assessment calls into serious question.

That's giving the DWP more credit that it deserves. We know that neither the scale nor pace of plans for the ADF has anything to do with balancing strategic risks and costs, let alone soothsaying about where the US will be in 20 years. As I've explained, today's plans are driven by the decision to spend arbitrary share of GDP by an arbitrary date.

We need to do more, and we need to do it now.

**Just add people and support**

The quickest and most cost-effective way to strengthen our defence would be to enhance the readiness and sustainability of existing capabilities. Stockpiles of munitions and spare parts should be made sufficient for prolonged independent operations, and additional personnel should be signed-up to increase the availability of existing platforms for deployment. We should analyse where and how we can get the most worthwhile boosts to capability for each extra dollar spent.

Next, we should examine the feasibility of keeping selected existing platforms in service beyond their planned retirement date—even if only as reserve capabilities. Our 71 classic Hornet fighters would be a perfect candidate, but we've probably passed the point of no return. If only we'd had the foresight to complete the centre-barrel replacement program.

What about new capability? Naval platforms might seem an obvious solution, but they take too long to build, at least the way we do it. At the beginning of WWII, Australia planned to build eight 2,500 ton Tribal-class destroyers—only three were delivered prior to war's end. And, although the Army can expand quickly, I think we have adequate land forces for the moment. So it's to the RAAF we must turn.

Aircraft are supremely useful in our part of the world, and mature designs are available from existing production lines. We should investigate expanded purchases of current and planned ADF combat aircraft. No decision need yet be made. Think of it as an insurance policy—a contingency plan—with any final decision contingent on a further deterioration in the strategic outlook.

Even with the cautious approach outlined above, strengthening the ADF would cost money, and that would pressure the government's finances. But a triple-A credit rating will be of little solace if we enter a major conflict unprepared.

Australia's security depends on more than its military defence. So, here are three further areas for priority action:

First, we need to revitalise our diplomatic capacity. After years of cuts and growing demands for consular services, the Department of Foreign Affairs and Trade is stretched to the limit. Australia's diplomats are the government's eyes, ears and voice in foreign capitals. Now, more than ever, the government needs the unique insights and influence that only well-staffed and properly resourced embassies can deliver.

Second, Australia's resilience to geopolitical disruption should be bolstered. Sophistry around Australia's non-compliance with the requirement to hold 90 days of fuel has gone on too long. If it's good enough for China, Japan, South Korea, the EU and the US to maintain strategic fuel reserves, what makes Australia think that it can rely on foreign markets in a crisis? A strategic reserve of oil and other critical commodities should be created without delay.

Third, the government needs to practice its decision-making and crisis management skills. The National Security Committee should commence a program of structured simulations (wargames) to hone the government's response in a strategic crisis. No ADF unit would ever deploy without having competed an extensive exercise program to confirm its readiness, and no lesser expectation should prevail for the government's higher decision-making processes.

Alongside a strengthened defence force, those three measures would better position Australia to deal with the challenges of an increasingly unstable and uncertain world.

The proposal set out here might seem overwrought. I'm sure there are many strategic Goldilocks who would argue that today's plans and defence posture are 'just right'—despite the clear recent deterioration in the strategic landscape.

But we currently plan to spend close to $450 billion on defence over the next decade. If that is the scale of spending needed to keep us safe in the 21st century, surely we can afford to spend a little more in response to the ‘dark and difficult near future’ we confront today.

And there’s one more thing: we need a strategy.

For what it’s worth, I’d double down on the US alliance. It’s true that the relative strength of the US in North Asia is declining, but the US will continue look to Australia as an anchor on the western side of the Pacific, even if it is pushed from North Asia.

Nothing would please me more than a squadron of US Virginia-class nuclear submarines operating from an Australian port, except perhaps the boats being dual-crewed by RAN sailors. I know that a great many people would disagree with me; barely a day goes by without a call for Australia to take a ‘more independent’ position—which is code for moving away from the United States.

We should be talking now about the choices we might have to make. It’s possible, and even likely, that in the ‘dark and difficult near future’ an Australian government will have to makes rapid decisions with profound consequences for generations to come.