INTEGRATING DEFENSE INTO PUBLIC EXPENDITURE WORK

Prepared by:
Nicole Ball and Malcolm Holmes, Consultants

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A NOTE ON PROCESS

This report has been circulated to selected Bank and IMF staff in order to obtain feedback on the issues discussed and the proposals set forward. It was also discussed in November 2001 at a meeting convened by the Bank’s Public Expenditure Thematic Group. The paper has been revised to take into account the comments received.

Since this paper is envisioned as the start of a process to more fully integrate the defense sector into the World Bank’s public expenditure work, additional consultation may be warranted.

For example, the Bank is encouraged to circulate the report further, both within the Bank and among bilateral donors and other multilateral donors to obtain feedback and share experiences. Additionally, small meetings might be convened within the Bank on a regional basis in order to identify regional-specific issues and examples.

This guidance will subsequently be revised, drawing on the experience of staff from the World Bank and other development assistance organizations.
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EXECUTIVE SUMMARY

1. The timing and focus of this paper reflect the growing awareness in the donor community of the importance of both security and a well functioning public sector to development. Governance and public sector management issues gained prominence starting in the early 1990s. More recently, the World Bank and other development assistance agencies have come to understand that poverty-reducing economic and social development is sustainable only if it occurs in an environment characterized by security for the state and its citizens. Since security is a public good, it is both appropriate and necessary for the state to allocate resources to that sector. While donors’ attitudes toward providing assistance to the security sector have gradually changed over the last decade, their involvement has tended to be ad hoc and opportunistic. This paper argues that donors need to accept security and the defense sector as one core component of a well functioning public sector and adjust their policies accordingly.

2. The security sector consists of the full range of organizations mandated to use force to protect the state and its citizens as well as the civil authorities mandated to control and oversee the security organizations. This report focuses on the defense sector. However, the approach to integrating the defense sector into public expenditure work proposed in this paper is equally applicable to other segments of the security sector such as the criminal justice system and civilian intelligence. What is more, in managing the defense sector in a manner consistent with sound public expenditure management (PEM) principles and practices, it is important to manage the links between defense and these other components of the security sector.

3. This paper argues for and provides guidance on integrating defense into the planning, policy-making, and budgeting systems and processes of a country in a manner consistent with democratic, civil control of the defense forces. A central premise is that, from a public policy and process perspective, defense shares many of the characteristics of other sectors and that the citizens of any country will benefit from a defense sector that is subject to the same broad set of rules and procedures of other sectors.

4. The paper argues that in addition to providing assistance to integrate the defense sector into the public expenditure management (PEM) systems and processes of a country, donors should be prepared when asked to offer assistance to countries to help them manage their defense budgeting processes more effectively. Such assistance should, of course, reflect the competencies available to the provider. To the extent that World Bank staff become involved in providing assistance for the effective and efficient management of the defense budgeting process, they would presumably require explicit endorsement of senior management. The paper provides guidance on the types of expertise required to support these objectives. It examines how the various non-lending and lending instruments of the World Bank might be utilized more effectively, and explores the comparative advantages of bilateral donors.

Principles of Public Expenditure Management and the Defense Sector

5. Section II of the paper discusses general PEM principles and techniques and considers how they interact with the defense sector. It looks at both the similarities and the differences between defense and other portions of the public sector. It concludes that most differences are a matter of practice, rather than principle. (See Table 1, pages 8-9.) Work underway in the
Federal Republic of Yugoslavia underscores this point. (See Annex 4, pages 50-52.) The main principle demanding some variant of standard practice relates to a need for greater confidentiality in some aspects of defense. Table 1 provides guidance on approaches to the confidentiality question. While security is legitimately a high priority for any government, it is important not to allow the genuine need for some degree of confidentiality in the defense sector to be used as an excuse for evading the application of PEM principles such as comprehensiveness, transparency, accountability, and contestability. The paper also explains the ways in which systems for allocating and managing resources in the security sector have deviated from PEM principles and suggests remedies. (See Annex 1, pages 37-40 and Annex 2, pages 41-46.)

6. Section II examines the application of key processes, systems, tools, and techniques available to the World Bank and other donors to the defense sector. It is argued that it is essential for defense to be covered by the government-wide treasury system if financial information for defense is to be available on a comparable basis during the phases of the budget cycle. This point is illustrated by the on-going Russian Treasury system project supported by the World Bank and the IMF. Additionally, a concern for efficiency and effectiveness, including any associated anti-corruption program, requires that defense be subject to the basic rules of government procurement. (See Annex 3, pages 47-49.) Section II highlights one possible entry point for integrating defense into overall PEM systems and processes: ensuring that expenditure is appropriately allocated and coded.

7. Section II draws attention to the potential for applying techniques such as deviation analysis and public expenditure tracking surveys, and tools such as the Reports on Observance of Standards and Codes (ROSC) to the defense sector. The Bank’s PEM Core Diagnostic, “Toolkits for Institutional Analysis and Assessment,” stresses that deviations between budgeted and actual expenditure provide a powerful indicator of the quality of the country’s overall PEM system. The defense sector is already included in some of the sample questions. The application of this tool to Uganda in the 1990s demonstrated that deviations between budgeted and actual expenditure – including in the defense sector – were primarily the result of government action or inaction, and not events beyond the government’s control. Public expenditure tracking surveys are increasingly used in the health and education sectors, and it is argued that they could help improve the effectiveness and efficiency of resource use in the defense sector as well. In order to encourage compliance with the IMF Code of Fiscal Transparency, Fund staff have developed a questionnaire probing the degree of which this code is actually applied in individual countries that includes a question on defense. A number of ROSCs on fiscal transparency have been produced and the experience to date suggests that World Bank staff could usefully encourage governments to participate in this activity as a first step toward greater transparency and accountability in the defense sector.

Risk Management Strategies

8. The paper recognizes that there are risks for all actors in extending PEM to the defense sector. To a large extent, these risks also potentially apply to any other sector in which the Bank becomes involved, with at least two important caveats. The first is that since the Bank does not lend for defense, it has no expertise in defense (as opposed to integrating defense into government-wide public expenditure management systems.) Second, conditionality is an
integral part of Bank lending in non-defense sectors but is forbidden in the defense sector.

9. To help manage the risks to the Bank of engaging in the defense sector, the paper suggests that there should be a firewall between Bank involvement in encouraging a country to include defense in government-wide system and processes, on the one hand, and the development of systems and processes to enhance the efficiency and effectiveness with which the defense sector uses the resources allocated to it, on the other hand. Countries and bilateral donors should be encouraged to address efficiency and effectiveness issues, but the Bank should only involve itself where it is explicitly requested to do so.

10. Section III focuses in more detail on strategies for managing the risks of engaging and not engaging with the defense sector. The paper concludes that the risks of non-engagement outweigh those of engagement. It has consequently provided a first cut at a risk management strategy for the World Bank and options for Bank engagement in the defense sector (pages 19-20). All of these are largely applicable to other donors as well. Indeed, this report sees many virtues in collaboration between the Bank and the bilateral donors based on comparative advantage.

11. The paper identifies three major risks for the Bank of extending PEM work into the defense sector. The first is that the Bank’s interventions will be inappropriate. Possible strategies for overcoming this problem include consulting with other donors to assess the reform environment and matching PEM strategy in the defense sector with PEM systems and processes in the non-defense sector. The second risk is that governments will perceive the Bank to be interested only in reducing the level of defense budgets, rather than in strengthening PEM systems and processes. To minimize this risk, Bank staff can underscore their interest in process, integrate defense officials into ongoing PEM work as much as possible to highlight similarities between the defense and non-defense sectors, and to work with government officials (including from the defense ministry) to identify the types of diagnostic work that can assist them in evaluating their PEM needs in the defense sector.

12. The third risk discussed in the paper is that the Bank could create disincentives to reform through its interventions. Ways of minimizing this risk include focusing on process and demonstrating how poor process and lack of systems in the defense sector undermine other key government objectives. Bank staff should also seek to gain the confidence of defense officials by, for example, working with them to identify weaknesses in government-wide PEM practices that affect defense’s own performance, and then help to remedy those weaknesses. It is also important to use every opportunity to legitimize government efforts to introduce sound PEM systems and processes into the defense sector and to pay attention to incentives, such as defense ministries being allowed to retain a portion of savings achieved by increasing the efficiency and effectiveness of the defense sector. Finally, it is desirable to exploit technical developments, for example in the field of FMIS, to help tackle more policy-related issues such as coverage of defense spending in the budget or competition between defense and other sectors for resources.

**Improving Budgetary Outcomes**

13. Section IV discusses and provides guidance on options for donor engagement with the defense sector within the framework of the key objectives of a well functioning budget system. This section also suggests how various World Bank instruments might be utilized in support of
improvements in budgetary performance.

14. The four crucial, inter-related components to managing defense expenditure are considered in turn:

- **As in other parts of the public sector, defense budgets should be prepared against a sectoral strategy.** Governments must be able to identify the needs and key objectives of the security sector as a whole and the specific missions that the defense forces will be asked to undertake. (See Annex 6, page 55.) Options for Bank engagement include encouraging national stakeholders to engage in a strategic planning process and incorporating full consideration of regional issues into this process, liaising with bilateral donors and including the ministries of defense and interior in meetings or training sessions pertaining to the importance of strategic planning or specific planning techniques.

- **As with any other sector, defense policies must be affordable.** A sustainable macroeconomic balance is critical to the long-term economic health of a country. It is now recognized that strengthening institutions is necessary in order to achieve this objective. Without due attention to institutional issues, efforts to achieve short-term stabilization could undermine long-term efforts to manage defense expenditure more effectively and possibly feed back into fiscal instability. Fiscal discipline is also critical, because an easily expanded resource envelope allows governments to avoid firm decisions on priorities. Without a solid floor to the expenditure envelope, resources are not predictable and operational performance will suffer.

Options for Bank engagement on aggregate fiscal discipline include assisting governments ensure that all expenditures and revenue are on budget, that the defense sector adheres to government-wide procedures on borrowing, and that transparency of defense-sector policies and expenditures is adequate and appropriate.

- **Once the overall resource envelope is agreed, resources must be allocated according to priorities both within the defense sector and between defense and other sectors.** Sectoral strategies and information on performance are critical components of the allocative process. The key financial and economic managers plus the legislature must have the capacity to be fully involved in this process and the process must include all relevant actors. Defense must compete fully with other sectors for funding.

Options for Bank engagement on resource allocation include mapping out where policy decisions are made and encouraging the development of a political forum within which all sectors compete for priority and funding. Bank staff can also encourage the development of a defense strategy. They can include defense in analyses of deviations between budgeted and actual expenditure and in medium-term expenditure frameworks (MTEFs). They can also work with the government to ascertain whether the budget office and legislature have the capacity to assess defense programs and whether the defense ministry has the capacity to develop budget projections in accordance with formal government-wide procedures. The assistance of bilateral donors can be sought in addressing deficiencies identified.
Finally, resources appropriated must be used efficiently and effectively. This requires careful monitoring and evaluation of operational performance both within the armed forces and by civil servants. Well functioning FMISs are critical in this regard. Additionally, it is extremely important that irregularities identified in the course of monitoring are addressed, lest a climate of non-compliance be created or reinforced. Particular attention should be given to ensuring the transparency of procurement processes.

There are many options for Bank engagement in strengthening the efficiency and effectiveness of resource use in the defense sector. These range from stressing the importance of efficient and effective resource use in interactions with governments to asking questions about the capabilities and independence of civilian administrators in defense ministries to working with governments to ensure that all defense expenditure is incorporated appropriately in the government-wide treasury system and subject to external audit. Additionally, Bank staff can include defense ministry officials in government-wide capacity building exercises and encourage governments to establish internal audit units and an inspector-general function within the defense ministry.

15. Section IV also discusses the instruments employed by the Bank in a number of ongoing activities connected with the defense sector and, more generally with security. In the latter case, the Poverty Reduction Strategy Paper (PRSP) and the Transitional Support Strategy (TSS) have been the most prominent Bank instruments employed, although Country Assistance Strategies (CASs) have also explicitly addressed the issue of security.

16. With regard to the defense sector, a number of CASs and Public Expenditure Review (PERs) have explicitly addressed this issue. The CAS is a useful vehicle for articulating a strategy for tackling the various public expenditure dimensions discussed throughout the paper. As PERs become more process and institutionally focused, it makes sense for them to include institutional assessments of the defense or broader security sector. The PER can be a useful tool for donors to engage governments in dialogue on ways of strengthening financial management in the defense sector. The defense sector should be included in the PERs analysis of a country’s PEM system, starting with the concept note. Country Financial Accountability Assessments and Country Procurement Assessment Reviews should also encompass the defense sector, preferably as part of a PER exercise.

17. PEM specialists, accountants, and procurement specialists could carry out initial assessments. Should the CAS process identify a need for more detailed study of systems and processes, defense management specialists and/or security and development analysts could be engaged to contribute to such work. (See Annex 5, pages 53-54.) The World Bank could contract for such work or a bilateral might contribute such expertise as its contribution to a PER process. When it comes to support for defense planning, policy, budgeting and management, any assistance requested is likely to be primarily in the form of defense expertise. Whoever provides assistance, it is essential that proper attention be given to process issues, as well as to technical issues. Furthermore, where support is focused on integrating defense into government-wide PEM systems and processes, it should be part of broader reform of these systems and processes. Even where more detailed work on the defense sector is required, technical assistance should where feasible be integrated with broader system and process support.
I. INTRODUCTION

1. The timing and focus of this paper reflect the growing awareness in the donor community of the importance of both security and a well functioning public sector to development. Governance and public sector management issues gained prominence starting in the early 1990s. More recently, the World Bank and other development assistance agencies have come to realize that poverty-reducing economic and social development is sustainable only if it occurs in an environment characterized by security for the state and its citizens. For individuals, a lack of security reduces productive opportunities and increases physical and psychological ill-being and economic uncertainty. Evidence from participatory poverty assessments (PPAs) indicates that the poor are especially vulnerable to ill-disciplined and lawless security forces, repression, and violent conflict. At the national level, the absence of a safe and secure environment can undermine the government’s ability to fulfill central responsibilities such as guaranteeing law and order, providing and enforcing a legal framework conducive to development, and investing in and maintaining critical economic and social infrastructure.

2. Since security from violence against the state and its citizens is a public good, it is both appropriate and necessary for the state to allocate resources for the maintenance of security. However it is also critically important that the security sector is subject to democratic, civil control. In the absence of civil – or state – control, the security forces are able to act with impunity in both the economic and political spheres, with negative consequences for poverty-reducing, sustainable development. Civil control by itself, however, is not adequate because history tells us that in the absence of accountability to all citizens, the state can direct its security forces to act in ways that are inimical to poverty-reducing, sustainable development.

3. As the proposition that security is a public good has gained increasing support within the donor community, donors’ attitudes toward providing assistance to the security

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Box 1. The DAC and Security Sector Reform

“Helping developing countries build legitimate and accountable systems of security – in defence, police, judicial and penal systems – has become a high priority, including for external partners, even though there are risks involved. Security system reform should be treated as a normal part of work on good governance. Though this is a vital area for donors, not all development agencies are equally ready or have the mandate to engage in activities directly related to improving security systems. Development agencies are working together to define agreed uses of Official Development Assistance in such activities.”


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sector have gradually changed. Few if any development donors now retain the Cold War era attitude of seeking to avoid contact with the security sector. (See Box 1). Rather, a growing number of donors have progressively incorporated conflict and the security sector into their regular work. This has led them to support post-conflict recovery efforts, demobilization and reintegration of ex-combatants, and activities designed to strengthen the rule of law (including police reform) and the accountability of the security forces to the civil authorities.\(^2\) The fact remains, however, that such donor involvement has primarily been in response to specific conflicts or, as noted below, has tended to be *ad hoc* and opportunistic. It is time to make this involvement broader based and better informed. Security and the defense sector should be accepted for what they are, namely one core component of a well functioning public sector.

4. The security sector consists of the full range of organizations mandated to use force to protect the state and its citizens as well as the civil authorities mandated to control and oversee the security organizations. (See Box 2.) This report focuses on the defense sector. However, the approach to integrating the defense sector into public expenditure work proposed in this paper is equally applicable to other segments of the security sector such as the criminal justice system and civilian intelligence. What is more, in managing the defense sector in a manner consistent with sound public expenditure management (PEM) principles and practices, it is important to manage the links between defense and these other components of the security sector.

5. The purpose of this paper is to argue for, and provide guidance on, integrating defense into the planning, policy-making, and budgeting systems and processes of a country in a manner consistent with democratic, civil control of the defense forces. A central premise is that, from a public policy and process perspective, defense shares many of the characteristics of other sectors and that the citizens of any country will benefit from a defense sector that is subject to the same broad set of rules and procedures as other sectors. These benefits will be in terms of a better understanding of defense policies, greater clarity on the rationale for the level of resources devoted to them, and systems that can increase the efficiency and effectiveness of defense spending. The paper also seeks to highlight where defense might differ from other sectors and to suggest approaches to take account of these differences.

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6. The international donor community’s interest in the defense sector might be summarized as a concern that resources available to a government are best used to promote social and economic development, including the provision of a safe and secure environment that underpins sustainable development. The approaches suggested in this paper do not involve the donors taking a position, including invoking conditionalities, on the appropriateness of the level of any country’s defense spending or the composition of that spending (or, for that matter, on the efficiency and effectiveness of that spending). These are matters to be determined and dealt with by each country. (See Box 3.)

Box 3. World Bank Approach to the Defense Sector

The Bank’s work on the defense sector is currently guided by an Operational Memorandum, “Note on Military Expenditure,” dated December 9, 1991. This note recognizes that Article IV, Section 10 of the Bank’s Articles of Agreement forbids interference “in the political affairs of any member” or basing decisions on “the political character of member governments.” Nonetheless, where defense spending crowds out social and other development outlays, the Bank can address the issue “at a senior level (Country Director and above).” Direct conditionality on the level of military spending is not allowed, but analytical work and policy dialogue are permitted.

In commenting on these guidelines, then-Bank General Counsel Ibrahim Shihata noted:

“Clearly, the determination of the specific question of what is an appropriate level of military expenditures for a member country is a matter which is typically based on security and political considerations and as such falls, in my view, outside the Bank’s legally authorized powers, let alone its competence.

“This does not mean, however, that the Bank can under no circumstances deal with any question related to military expenditures. In its risk management analysis, its research work and its adjustment lending operations and the dialogue preceding them, the Bank has been heavily involved in the issue of public expenditures…. It is in these areas that the question of allocation of public expenditures for non-productive purposes may arise. However, this issue need not be raised specifically as a question of whether military expenditures are appropriate or excessive, a question which, in my judgment, is not for the Bank to decide.”

In 1993, the Board of Executive Directors approved a report on the Bank’s experience in governance-related work. This report noted that by the end of 1993, the Bank had provided support to Argentina and Uganda in response to requests for assistance “to develop options for bringing military expenditures more in balance with other spending priorities.” The report suggested that Argentina’s experience “shows…there is scope for…what might be termed a governance approach to military expenditures.” Such an approach would include transparency of budgets, regular reviews of defense policies and budgets by executive branch officials, legislators and civil society, and “spending proposals [that] are subject to the same scrutiny as civilian programs.”


7. Having said that, the paper argues that in addition to providing assistance in integrating the defense sector into the public expenditure management (PEM) systems and processes of a country, donors should be prepared when asked to offer assistance to countries to help them manage their defense budgeting process more effectively. Such assistance might encompass, for example, improving the country’s capacity for developing defense policy or for managing
its budgeting process more effectively. Any assistance provided would, of course, reflect the competencies available to the provider. Thus for example, the Bank can encourage countries and bilateral donors to address efficiency and effectiveness issues, but the Bank should only involve itself where it is explicitly requested to do so. To the extent that World Bank staff become involved in providing assistance for the effective and efficient management of the defense budgeting process, they would presumably require explicit endorsement of senior management.

8. The paper also provides guidance on competencies, ranging from those required to support integration of the defense sector into the PEM systems and processes of a country to those required to advise on the efficiency and effectiveness of resource use in the defense sector.

9. Within the World Bank, even a brief survey of operational activities across the regions provides examples of where the defense sector has become a factor in the Bank’s dialogue with governments, analytic work, Economic and Sector Work (ESW), and lending. While much of this work is related to conflict and post-conflict situations and associated effects on military expenditure, there is growing evidence of impacts through the Bank’s nascent attention to public expenditure management, for example in Russia and the Federal Republic of Yugoslavia. (See the discussion in paragraphs 21-23 and 28.) In this context, the paper examines how the various non-lending and lending instruments of the World Bank might be utilized more effectively to support this work. The comparative advantages of bilateral donors are also explored.

10. Section II of the paper discusses general PEM principles and techniques and considers how they interact with the defense sector. Section III focuses on strategies for managing the risks of engaging and not engaging with the defense sector. Section IV discusses and provides guidance on options for donor engagement with the defense sector within the framework of the key objectives of a well functioning budget system, namely aggregate fiscal discipline, resources allocated to priorities, and the efficient and effective use of those resources. This section also suggests how various World Bank instruments might be utilized in support of improvements in budgetary performance.
II. PRINCIPLES OF PUBLIC EXPENDITURE MANAGEMENT AND THE DEFENSE SECTOR

11. The World Bank Public Expenditure Management Handbook identifies ten widely accepted principles of sound budgeting and financial management.\(^3\)

- **Comprehensiveness**: The budget must encompass all fiscal operations of government.
- **Discipline**: Decision making must be restrained by resource realities over the medium term; the budget should absorb only those resources necessary to implement government policies; and budget allocations should be adhered to.
- **Legitimacy**: Policy makers who can change policies during implementation must take part in and agree to the original policy.
- **Flexibility**: Decisions should be pushed to the point where all relevant information is available.
- **Predictability**: There must be stability in macro and strategic policy and in funding of existing policy.
- **Contestability**: All sectors must compete on an equal footing for funding during budget planning and formulation.
- **Honesty**: The budget must be derived from unbiased projections of revenue and expenditure.
- **Information**: A medium-term aggregate expenditure baseline against which the budgetary impact of policy changes can be measured and accurate information on costs, outputs and outcomes should be available.
- **Transparency**: Decision makers should have all relevant issues and information before them when they make decisions and these decisions and their basis should be communicated to the public.
- **Accountability**: Decision makers are responsible for the exercise of the authority provided to them.

12. In the past, the World Bank and other donors have tended to focus on the need for restraint in defense expenditure in order to increase resources available for accepted development purposes. Governance issues such as accountability to democratic, civil authorities, strengthening systems for resource management in the defense, or broadening the policy debate on identifying and meeting security needs were overlooked. In consequence, systems for allocating and managing resources in the defense sector have deviated, often in significant respects, from the principles of sound public expenditure management.

13. Deviations from the central principles take many forms. Portions of defense expenditure are kept off-budget and some of the revenue allocated to the defense sector may be

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Information about expenditures in the defense sector is often shrouded in secrecy – both from the public and from public sector organizations such as the ministry of finance, the full cabinet, the legislature, and in some cases even the ministry of defense. The defense sector frequently has a privileged position when state resources are allocated, and monitoring of expenditure is often weak.

14. The need for confidentiality in the area of defense and national security justifies some modifications to standard sound budgeting practices. However, there appears to be a tendency to invoke confidentiality to avoid debates both among the public and within government (intra-executive branch and between the executive and the legislature) on security policies and the resourcing of the defense sector. As Table 1 demonstrates, it is possible to achieve the necessary degree of confidentiality without violating any of the key PEM principles. Annex 2 describes some of the common deviations from PEM principles in the defense sector and suggests possible remedies. Once again, these points apply equally to the non-defense segments of the security sector.

15. The defense sector is not the only sector in which the principles of sound public expenditure management are routinely violated. This paper argues that neither defense nor any other sector should violate these principles. It is a reality that the defense sector frequently absorbs significant amounts of state resources. To the extent that poor resource management in this sector boosts expenditure levels, defense spending will have consequences for economic and social development and poverty reduction. In addition, actions of defense forces that undermine the stability of “development states” are more likely where principles of accountability, transparency, and comprehensiveness are flouted. Related to this, weak application of PEM principles in the defense sector will reduce the capacity of the defense forces to carry out their statutory tasks of protecting the state and its citizens. Resources allocated to the defense forces have been used inefficiently or siphoned off through corruption, leaving “hollow” armies. In many countries, members of the defense forces have become involved in a wide range of business activities, which has undermined their professionalism. Despite significant allocations to the “defense sector,” countries and their citizens often find themselves less secure than before.

16. There are thus important reasons for focusing on the process by which defense budgets are designed, determined, implemented and monitored. Each country will determine whether such a focus will lead to changes in defense sector allocations. In some instances, significant efficiencies may be identified. In other cases, it is entirely possible that budget expenditures will rise

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Box 4. How Improving the Management of Defense-Sector Expenditure Could Increase Spending

- Bring previously off-budget expenditures on-budget
- Consolidate all defense-related expenditures under the appropriate functional heading
- Budget adequate life cycle and operations and maintenance costs
- More appropriate salary and wage pay rates
- Pay costs associated with downsizing
- Equip a smaller force for greater mobility

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in the short term once good management practices are introduced. Certainly, where significant off-budget expenditure or spending by other sectors is properly incorporated in the defense function, recorded defense expenditure is likely to rise. (See Box 4 and the discussion under “Bank Instruments and Defense” in section IV.)

**Processes, Systems, Tools and Techniques**

17. Before turning in section III to a consideration of the risks involved in engaging with the defense sector and the risks associated with not engaging, the stages of the government’s budget cycle; how defense interacts with that cycle; and support that might be given to improve that interaction, are summarized in Table 1 and the discussion immediately below. A more detailed examination follows in section IV.

18. It was argued above that defense should be subject to a country’s budget process. Similarly, there are a range of associated systems, tools and techniques that should incorporate and/or be applied to defense. A key message here is that in addressing these system issues and using particular tools and techniques in the defense context, opportunities, and sometimes the necessity, to confront associated policy issues arise and should be acted upon.

**Systems**

19. Perhaps the two most important supporting systems are the government’s financial management information systems (FMISs) and procurement. For defense to be treated in the same way as other sectors through the budget cycle, it is essential that defense be covered by the government-wide treasury system (a core sub-system of the full range of government FMISs). Without this coverage, financial information for defense will simply not be available on any comparable basis during the phases of the budget cycle. While not discussed further here, defense also needs high quality internal information systems. Similarly, a concern for efficiency and effectiveness, including any associated anti-corruption program, requires that defense be subject to the basic rules of government procurement. The Bank’s Country Financial Accountability Assessment (CFAA) and Country Procurement Assessment Review (CPAR) are vehicles for raising the issue of how defense is treated in government FMISs and the extent to which it is subject to the procurement rules. (See Annex 3.)

20. Development of appropriately integrated FMISs requires that a number of other basic financial management and accounting issues be addressed both on a government-wide basis and for defense. These other issues, such as accounting standards, again fit very comfortably into the CFAA. What the CFAA will not deal with, however, is the more policy-based issues that will usually arise where a sector not encompassed by the existing government treasury system is to be brought into the system. The project to modernize the Russian Treasury System offers a particularly interesting illustration of this point.

21. The Russian Treasury System project is being supported by the World Bank and the International Monetary Fund (IMF) through the Treasury Development Project. A number of sectors/ministries were not included in the initial treasury system, one of them being defense. Initially there was some natural resistance to being linked into the treasury system on the part
### Table 1. Defense and the Budget Cycle

<table>
<thead>
<tr>
<th>BUDGET CYCLE</th>
<th>SOUND PRACTICE</th>
<th>SHOULD DEFENSE BE TREATED ANY DIFFERENTLY?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budget Planning and Formulation</strong></td>
<td>• Sector strategies.</td>
<td>• No</td>
</tr>
<tr>
<td></td>
<td>• Medium Term Expenditure Estimates (linked to strategies),</td>
<td>• No</td>
</tr>
<tr>
<td></td>
<td>• All sectors compete for funding during budget formulation (based on</td>
<td>• The defense budget is in fact often</td>
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<tr>
<td></td>
<td>strategic priority and performance) within a cabinet-endorsed aggregate</td>
<td>dealt with preferentially, particularly</td>
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<td></td>
<td>resource constraint.</td>
<td>in the sense that it does not have to</td>
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<tr>
<td></td>
<td>• All sector/agency budget proposals are subject to the same scrutiny by the</td>
<td>compete. This is usually justified on</td>
</tr>
<tr>
<td></td>
<td>budget office.</td>
<td>national security grounds. Check</td>
</tr>
<tr>
<td></td>
<td>• Funding set aside for contingencies should be in a single, whole-of-</td>
<td>whether constitutionally or</td>
</tr>
<tr>
<td></td>
<td>government contingency fund; be kept to a minimum; be subject to clear</td>
<td>legislatively mandated. A core defense/</td>
</tr>
<tr>
<td></td>
<td>criteria for its use, rigorous assessment of requests, and full reporting</td>
<td>security sub-committee of the cabinet</td>
</tr>
<tr>
<td></td>
<td>to the legislature on is uses.</td>
<td>could assess those expenditures</td>
</tr>
<tr>
<td></td>
<td>• The defense budget is in fact often dealt with preferentially, particularly</td>
<td>associated with national security,</td>
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<td></td>
<td>in the sense that it does not have to compete. This is usually justified on</td>
<td>including intelligence.</td>
</tr>
<tr>
<td></td>
<td>national security grounds. Check whether constitutionally or</td>
<td>• The issue of national security simply</td>
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<td></td>
<td>legislatively mandated. A core defense/security sub-committee of the cabinet</td>
<td>argues for budget office staff with</td>
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<td></td>
<td>could assess those expenditures associated with national security,</td>
<td>defense oversight responsibility to</td>
</tr>
<tr>
<td></td>
<td>including intelligence.</td>
<td>have necessary security clearances.</td>
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<tr>
<td></td>
<td>• There is no reason for a separate defense contingency fund. Any unexpected</td>
<td>• There is no reason for a separate</td>
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<tr>
<td></td>
<td>security threat would be a legitimate call on the whole-of-government</td>
<td>defense contingency fund. Any unexpected</td>
</tr>
<tr>
<td></td>
<td>contingency fund. Large-scale security threats or the outbreak of war will</td>
<td>security threat would be a legitimate</td>
</tr>
<tr>
<td></td>
<td>usually require a fundamental review and reallocation of resources.</td>
<td>call on the whole-of-government</td>
</tr>
<tr>
<td><strong>Parliamentary Consideration and Scrutiny</strong></td>
<td>• All spending should be subject to the same scrutiny by the legislature,</td>
<td>• Issues of national security, such as</td>
</tr>
<tr>
<td></td>
<td>including through its committee system.</td>
<td>intelligence, could be handled in</td>
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<td></td>
<td>• The detail of appropriations and supporting explanatory material,</td>
<td>closed committee hearings.</td>
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<tr>
<td></td>
<td>including non-financial performance information., should be sufficient to</td>
<td>• Defense should have the same format of</td>
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<td></td>
<td>enable the legislature to hold the executive to account (and not be so</td>
<td>appropriations and detail in explanatory</td>
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<td></td>
<td>detailed as to undermine effective management by agencies).</td>
<td>notes as other sectors, modified to</td>
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<td></td>
<td>• Issues of national security, such as intelligence, could be handled in</td>
<td>reflect legitimate national security</td>
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<td>closed committee hearings.</td>
<td>considerations.</td>
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<td>• Defense should have the same format of appropriations and detail in</td>
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<td>explanatory notes as other sectors,</td>
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<tr>
<td>BUDGET CYCLE</td>
<td>SOUND PRACTICE</td>
<td>SHOULD DEFENSE BE TREATED ANY DIFFERENTLY?</td>
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<td>----------------------------------------</td>
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<tr>
<td><strong>Budget Execution</strong></td>
<td>• Release of funds to departments and agencies to be in accordance with budgeted appropriations. Where there is a shortfall in funds there should be clear rules for any funding changes (ranging from equal sharing of the burden to protecting priority expenditure).</td>
<td>• Defense is often given priority. Establish whether this is consistent with expressed priorities and/or reflects unforeseen changes in security situation. Look at past relationship between budget allocations for defense and actual outlays to see whether there are any persistent patterns. (See discussion in paragraphs 29-31 on the value of deviation analysis.)</td>
</tr>
</tbody>
</table>
| **Monitoring and Reporting** | • All expenditure should be reported, along appropriation lines, to the budget office/accounting office and to the legislature on a timely basis (maximum of 1 month to budget/accounting office and 3 months to legislature).  
• End of year financial statements covering all expenditure should be available in a timely manner (within 3 months of the end of the financial year).  
• Annual reports on departmental operations, including operational performance, should be published. | • No  
• No  
• Reporting on defense operations should encompass the same issues as for other sectors, modified to reflect legitimate national security considerations. |
| **External Audit** | • All expenditure should be subject to external audit.  
a) External audit of financial statements should be available to the legislature in a timely manner (six months after the end of the financial year).  
b) The legislature should have the capacity, through its committee system (usually including a form of public accounts committee), to take up and make recommendations on audit reports.  
c) The legislature should have the capacity to follow up on its recommendations and the executive the willingness to respond. | • The only issues here are that auditors auditing sensitive areas in defense need appropriate security clearance and any related legislative hearings could be closed. |
of these “power ministries” which, heretofore, had dealt bilaterally with the government. Once there was agreement on incorporating all excluded sectors, what was seen as a purely technical issue quickly raised a number of policy issues. In the case of defense, this has led to questions about the nature of budgetary institutions. Is defense to be a one budget line transfer of budget funds or should there be a finer disaggregation of financial flows? This even takes one into the issue of businesses run by the military. Should, for example, a pig farm supplying food (or cash) to the military be considered a budgetary institution? Such questions quickly move into the policy arena, and that is precisely what is happening in Russia. The message here is that apparently technical solutions to issues in which the Bank and other donors comfortably engage can be a vehicle for forcing a country to face the larger political issues. In such situations it is important that Bank and other donor staff be able to support country technical staff in understanding when an issue does require a political decision.

22. The Russian example illuminates two other important considerations. The first is the value of working with defense officials, some of whom may be uniformed officers. As the issues involved in bringing all ministries into the treasury system have been addressed, the Russian Treasury has taken the lead in interacting with the Ministry of Defense (MOD). At times, however, both World Bank and IMF staff members have spoken directly to MOD officials. There have been advantages on all sides from these interactions. The Treasury has benefited from having allies in its efforts to tame the “power ministries.” The Bank has been able to legitimize the Treasury’s position on PEM principles such as comprehensiveness and contestability and to help the Treasury make a case against unreasonable demands from the MOD. For example, when the MOD insisted that the Treasury procure an information system with an unnecessarily high level of security, the Bank refused to finance the purchase. By being included in government-wide dialogues, the MOD has learned that other ministries have pressing and compelling needs and that it must justify its budget requests. For its part, the Bank has been able to begin to lay the groundwork for a program that could reduce one of the major threats facing the Russian economy, the special status of the Ministry of Defense and other former power ministries.

23. Second, the Russian example points to another important system of government, namely the expenditure classification system. It is usually when treasury system reform meets the classification system that issues are quickly moved from the technical realm to the political. In the context of defense one quickly comes up against these issues when considering the core analytical classifications – functional and economic type. These are basically to support the budget formulation process, and the form and detail of these classifications for defense should logically be addressed when considering the information needed for defense to compete with other sectors on an equal footing for budget resources. Similar considerations apply at the legislative stage. The form and detail of appropriations is fundamentally a political decision. Bank staff have an important role to play in this latter context in drawing attention to the proper balance between the concerns for legislative control and the flexibilities needed by managers to manage. The key point here is that decisions need to be made on general applicability of classification rules to defense. External advice should ensure that defense is explicitly addressed when treasury systems are being modernized and classification systems reformed.

24. Consideration of these issues provides another important entry point to integrating defense into the overall systems and processes of government, namely ensuring that expenditure is in fact appropriately allocated/coded. Defense expenditures are often spread
across a range of ministries and are not recorded as defense on a functional basis. (In fact, on a functional basis, a significant amount of defense spending may well appear as a residual, i.e. not elsewhere included/not allocated to function.)

In some cases, the defense forces undertake duties of an essentially civilian nature, such as assistance in natural disaster or fisheries protection. If these are functions assigned to the defense forces in the government’s defense policy, then they should be classified under defense. (See Box 5.) Otherwise, where the expenditure involved is sufficiently significant, they should be classified under the appropriate civil function. Assisting governments to clean up attributions/codings is one early and useful step to putting defense on to the same footing as other sectors.

25. Needless to say, this concern quickly brings one up against the issue of off-budget spending (an extreme form of inappropriate classification). This is another obvious entry point that can be addressed directly or through the building of a comprehensive treasury system. In its Manual on Fiscal Transparency, the IMF notes that “In terms of improving transparency…, the main point to be emphasized is that all fiscal activities should be subject to scrutiny as part of the budget process, and that all fiscal outcomes should be open to scrutiny by the legislature and the public. Although some EBFs (extrabudgetary funds) will be independently managed and under standing legislative authority, this does not mean that they should be immune from periodic review” (para 33). Tackling off-budget expenditures also requires due attention to the full-range of state-owned enterprises which can generate income for the defense sector, as can non-transparent management of defense assets such as arms. The issue of off-budget spending is discussed throughout this report, including in Annex I.

26. The discussion in this section highlights another important principle that is often violated by defense, namely that of being transparent about the gross level of expenditure. Another example of this is the area of off-sets discussed in Annex 3. Fiscal transparency is one component of the IMF’s Reports on Observance of Standards and Codes (ROSC) program. Although the IMF Code of Fiscal Transparency is voluntary, member governments are encouraged to comply with it, including by responding to a questionnaire developed by Fund staff (http://www.imf.org/external/np/fad/trans/question/quest.htm). This questionnaire includes an explicit question about defense: “Describe the budget and accounting classification used. Is military expenditure reported in the budget and annual accounts comprehensively and in detail?” (para 3.2.1).

27. ROSC's covering fiscal transparency had been prepared by 28 countries by the end of 2001. (Ten of these were OECD countries.) Of the 28 countries, only four countries
mentioned the defense sector: Latvia, Pakistan, Papua New Guinea, and Uruguay. With the exception of Pakistan, the responses were brief. Pakistan detailed a system of defense budgeting and accounting that is separate from civil budgeting and accounting. (See Box 6.) Information from the ROSCs is shared with the appropriate department in the World Bank. The ROSC experience to date suggests that World Bank staff could usefully encourage governments to produce ROSCs on fiscal transparency as a first step toward greater transparency and accountability in the defense sector.

28. Finally, work underway in the Federal Republic of Yugoslavia underscores the similarity between defense and other sectors across the full range of PEM issues and the relative ease with which a good PEM specialist can make a useful contribution in this area. Within the context of a Public Expenditure and Institutional Review for the Federal Republic of Yugoslavia, World Bank staff felt it important to examine the public expenditure system in all functional areas, and officials in the Federal Government and both Republics supported this approach. Based on experience in former Yugoslav Republics and transition countries, Bank staff recognized that defense and internal security ministries are frequently not well integrated into the public expenditure system, and that this has consequences for fiscal balance, strategic allocation of resources among sectors, and operational efficiency. Therefore, a list of questions was developed by Bank staff to probe the degree of integration and ministerial financial management capacity for all ministries, including defense. These questions ranged from inquiries about sectoral budget formulation processes and each ministry’s financial management structure to questions about procurement, ministry arrears, and cash releases from the Ministry of Finance. (See Annex 4 for the complete list as it applies to the Defense Ministry.)

Tools and Techniques

29. Consistent with the theme of this report that defense is not different and that external assistance from organizations such as the World Bank is best done through its interaction with governments on their generic processes and systems, there are a number of tools and techniques supporting such work in non-defense sectors that could be effectively applied to defense. This is illustrated by reference to deviation analysis and public expenditure tracking surveys.

30. The current PEM Core Diagnostic of the World Bank emphasizes that deviations between budgeted and actual expenditure provide a particularly powerful indicator of the quality of a country’s overall PEM system (“Toolkits for Institutional Analysis and Assessment” at www.worldbank.org/publicsector/toolkits.htm). Deviations at the department/agency and functional levels are particularly important. The diagnostic includes

Box 6. Pakistan ROSC for Fiscal Transparency

“30. Defense expenditures are included in the budget but detailed budgeting and accounting are separate from the civil accounts. As noted, defense expenditures and accounts are departmentalized accounts maintained by the Military Accountant General. Audit is performed by the Director General, Defense Audit. Defense appropriation accounts are provided to the PAC, as noted above, but circulation of these accounts is restricted for security reasons. Defense pension obligations, however, from FY 2000/2001, have been included in the civil budget.”

defense explicitly in the tables for these questions, and Bank staff should be encouraged to pursue this deviation analysis, for all sectors including defense, in its public expenditure work. The significance of such analysis is that unpredictability of policy and of funding have been identified as key factors in poor operational performance.

31. Uganda in the 1990s offers an example of the power of such analysis. The most compelling message from the analysis was that deviations were primarily due to actions or inactions of the government rather than due to factors “beyond their control”. Defense was shown to be persistently receiving more during budget execution than its original budget allocation (while health and education received less). When aggregate spending had to be reduced during the budget year because of a revenue shortfall, defense tended to be protected at the expense of health and education. More often than not, defense was being supplemented during the budget year at the expense of others sectors, with the legislature playing at best a rubber stamping role.

32. The concern here is not with absolute levels of spending but rather with the destabilizing effects of reallocation during budget execution on efficient delivery of services to citizens. The message is that allocations should be settled during budget planning and formulation and not left to the budget-execution phase. Deviation analysis should be seen as standard in the Bank’s public expenditure work. One vehicle for this is the Public Expenditure Review (PER) and any guidance on PERs could usefully make explicit reference to such analysis.

33. Public expenditure tracking surveys are increasingly being utilized, particularly in the health and education sectors. This technique should be extended to the defense sector because it could contribute to improving the flow of budgeted funds to front line operational units, which in the case of defense includes bases where the military forces are located, and, hence help improve the efficiency and effectiveness of resource use. (See Box 7.) Indeed, since more

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**Box 7. Tracking Defense Spending in Zimbabwe**

In Zimbabwe, notwithstanding its involvement in the Democratic Republic of Congo, defense expenditure has often not been used efficiently and effectively, with negative effects on the basic needs of service personnel and readiness of the force as a whole. The Parliamentary committee responsible for security sector oversight has issued reports highlighting specific problems. Some of the shortcomings identified include overcrowded, deteriorated troop living facilities, overcrowded military medical facilities which also had no medicines available, and grossly underfunded rations allowances that forced commanders to send troops on protracted home leave to assure they were fed. Conditions described in the committee’s 1998 report also affected armed forces capability. For example, military units surveyed lacked most or all of the vehicles necessary for effective functioning while the vehicles actually on hand tended to be very old, dilapidated, or unusable for lack of spare parts. Similar deficiencies were noted for aircraft.

The government has shown no interest in addressing the problems identified by these reports. The intervention in the Democratic Republic of the Congo has demonstrated where its priorities lie. An alternative approach, which may be difficult to implement in the current political environment in Zimbabwe, would be to encourage the Zimbabwean Defence Forces themselves to conduct their own tracking surveys as part of a post-conflict reassessment process.

efficient resource use will contribute to the readiness of military forces, this might be employed as an incentive to the armed forces to conduct tracking surveys. What the Bank can bring to this is lessons on the technical aspects of such survey work. For example, when the issue of undertaking a tracking study in defense was raised with officials in the government of Sierra Leone, they indicated that this was already occurring. However, that survey work is of low quality. The Bank should feel comfortable that it can both recommend such a survey for defense and provide technical advice on its development and execution.

34. There are of course risks here. From the perspective of the Bank, perhaps the major one is that this could be seen as a way for the Bank to obtain information about defense to be used, even implicitly, in conditionality. (Similarly, in a country with a traditional line item budgeting system, defense would be rightly suspicious that any budget office interest in its performance was because it wanted savings). To help manage this risk, there should be a firewall between Bank involvement in encouraging a country to encompass defense in its government-wide systems and processes and the efficiency and effectiveness with which the defense sector uses the resources available to it. Countries (and bilaterals) should be encouraged to address these latter issues, and the Bank should only involve itself in such issues where, as suggested in the Introduction, it is explicitly requested to do so. The following section addresses the issue of risk management in more detail.

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III. RISK MANAGEMENT STRATEGIES

35. As with any sector, there are risks associated with engaging with the defense sector and risks associated with not engaging with the defense sector. These risks can potentially affect both the country with weak PEM systems and processes in the defense sector and the World Bank and other donors. Such risks should be acknowledged and strategies identified for minimizing their effects. Similar risks can be anticipated in relation to other portions of the security sector.

36. To a large extent, the risks identified for the defense sector also potentially apply to any other sector in which the Bank becomes involved, with at least two important caveats. The first is that since the Bank does not lend for defense, it has no expertise in defense (as opposed to integrating defense into government-wide public expenditure management systems.) Second, conditionality is an integral part of Bank lending in non-defense sectors but is forbidden in the defense sector.

Risks of Not Engaging

37. If the government chooses to allow the defense sector to retain privileged access to state resources, it runs several serious risks.

38. First, it jeopardizes its ability to fulfill its development and poverty-reduction objectives. By allowing the defense sector to compete on an unequal – often vastly unequal – footing with other ministries for scarce resources, non-defense development priorities may be relatively and unnecessarily underfunded.

39. Second, it undervalues security as a fundamental co-condition for poverty reduction and social and economic development. Defense forces that are financially unaccountable often are professionally weak and are unable to provide the state and its citizens with adequate security. Without mechanisms to prioritize objectives and needs in the defense sector, critical security needs may be underfunded. (Such privileged access is unlikely to have anything to do with the role of security in social and economic development.)

40. Third, it increases the chances that the determination of the defense budget during the budget planning and formulation process will not be taken seriously. This may well lead to resources being reallocated to the defense sector during the course of the fiscal year. Such unpredictability not only undermines the ability of government to deliver basic services to its people. It also undermines multi-year expenditure frameworks and may threaten a country’s macroeconomic stability. To the extent that the defense forces use state resources (financial, material, human) for commercial activities, the state’s control over its own resources is further diminished.

41. Fourth, the existence of a “special relationship” between the government and the ministry of defense undercuts the ability of the ministry of finance to strengthen resource management in other sectors. Rules that are applied with significant exceptions do not have a high degree of legitimacy. Fifth, where the defense forces are financially unaccountable, the
chances that resources allocated to the defense sector will be used inefficiently or diverted for personal use increases.

42. Sixth, financially unaccountable defense forces are often politically unaccountable as well. This can lead to human rights abuses, threats to the constitutional order, and military adventurism. Seventh, society will not get “value for money” (achieving greater military effectiveness for a given level of resources) in a sector that often absorbs a large share of state resources. By not prioritizing “value for money” in the defense sector, the government may be ignoring a major entry point for engaging the defense forces themselves in reform processes.

43. Finally, by failing to subject the defense sector to the same principles of public expenditure management and good practice in developing and implementing the budget, governments are missing a major opportunity to reduce corruption. Large procurement projects combined with unaccountable defense forces are only likely to stoke rent-seeking. At the same time, the obverse of “privileged access” is also an issue. Defense forces that are consciously underfunded and required to “live off the land” almost invariably engage in corrupt or illegal activities.

44. When the World Bank and other donors fail to incorporate the defense sector into governance work, including public expenditure work, they run the risk of jeopardizing their ability to carry out their main missions of poverty-reduction and economic and social development.

45. First, as with national governments, they allow security to be undervalued as a national priority and a fundamental co-condition for poverty reduction and social and economic development. Second, by avoiding process problems and focusing on levels of expenditure and trade-offs with social sectors as the donors have tended to do in the past, they are unable to deal with problems of budget execution and the adverse consequences for basic service delivery. All too often, budget outcomes, which tend to reflect a country’s true priorities, deviate significantly from budget appropriations, which often reflect donor conditionalities, with the negative outcomes identified earlier in this report. Third, comprehensive coverage is critical for the reliability of the assessments of a country’s economic and social prospects made by the Bank and other donors and hence to the advice proffered by the external funders. Even from a narrow fiduciary perspective, poor advice will lead to poor outcomes.

**Risks of Engaging**

46. In deciding to engage in strengthening defense-sector governance, and particularly integrating the defense sector into public expenditure work, governments run several risks.

47. First of all, they risk alienating the defense forces. In particular, by seeking to apply the principles of sound public expenditure management in the defense sector, they can be seen to be directly attacking both personal prerogatives of the officer corps (generally the most senior officers) and the corporate prerogative of the defense forces themselves. Additionally, governments can undermine incentives for reform in the management of defense budgeting process by requiring that all resources saved through efficiency gains or profits received from
the sale of defense assets be returned to the treasury.

48. For their part, the World Bank and other donors also run risks in deciding to engage in strengthening defense-sector governance, and particularly integrating the defense sector into public expenditure work.

49. First, if they are not careful about assessing the environment in a country, they might attempt to extend work into the defense sector too rapidly and thereby jeopardize their ability to engage with the government on public expenditure management issues in general. Second, as with governments, by pressing for or otherwise giving the impression they prioritize reductions in defense expenditure or by suggesting that all resources saved through efficiency gains or profits received from the sale of defense assets to be returned to the treasury, donors can reduce the incentives for reform. Indeed, by not giving adequate thought to appropriate incentives for the government or the defense forces to engage in resource management reform, donors will complicate efforts to extend sound public expenditure management practices into the defense sector.

50. Third, they risk alienating the defense forces. In particular, by seeking to apply the principles of sound public expenditure management in the defense sector, they can be seen to be directly attacking both personal prerogatives of the officer corps (generally the most senior officers) and the corporate prerogative of the defense forces themselves.

51. Fourth, by assuming that special expertise is required to take any steps toward incorporating the defense sector into their normal public expenditure work, donors will significantly reduce the positive impact they could have in this area. It may be useful to have a security and development analyst as part of a PEM team and specialized defense resource expertise is important when reforming the defense ministry itself or strengthening the capacity of the defense forces to manage their resources effectively and efficiently. (See Annex 5.) Nonetheless, a good PEM specialist will be able to address many of the issues raised in dealing with the defense sector in the normal course of his/her work.

52. Finally, there is a danger that the donors will start the process of integrating the defense sector into their normal work but when difficulties arise decide to abandon the subject for the more familiar terrain surrounding poverty alleviation and the “priority areas” of the social sectors, agriculture, and transport.

Risk Management

53. The concept of a firewall was introduced at the end of Section II essentially as part of a risk management strategy. Outside the firewall are the government-wide PEM systems and processes. Inside are the level, composition and efficiency and effectiveness of defense spending. Clearly inside defense but straddling the firewall are the systems and processes internal to defense. (See the defense policy, planning and budgeting flowchart on page 22.) In a well-functioning, integrated government, these internal systems and processes will be quite tightly linked with the external systems and processes. The idea is that the Bank would go beyond the firewall only at the very specific request of a government and that bilateral governments would normally take the lead in providing assistance. In all other areas, either the
Bank or a bilateral could take the lead, depending on country circumstances.

54. From the perspective of risk management, it may be helpful to think in the following “outside/inside” terms:

- **Outside**: Work on government-wide systems and processes should include defense as a matter of course.

- **Outside/Inside**: Work on government-wide systems and processes could be linked up with internal systems and processes of the defense sector. The emphasis here would be on helping defense make its internal systems and processes more compatible with, and therefore better able to draw on, external systems and processes.

- **Inside (1)**: This involves work on internal systems and processes of defense as part of government-wide work on sector systems and processes. Such work is likely to be more attractive to defense where it is presented as an opportunity not only to strengthen its own systems and processes but also to identify potential improvements from a defense perspective in external systems and processes. (Greater predictability of funding, including, for example, payment of allowances and the adoption of medium-term expenditure frameworks, is a case in point.) As such, it could be thought of as an example of “Inside/Out.”

- **Inside (2)**: Stand-alone work on level, composition and efficiency and effectiveness of defense spending would be undertaken only on request from the government. The points made on Inside (1) are relevant here as well.

55. In all contexts, key messages for the Bank and other donors are to fully engage the defense sector in discussing these issues and be transparent about the reasons for engagement. Emphasize that engagement by the defense sector has the potential to increase its legitimacy and its ability to drive more performance out of a given level of resources. Perhaps most challenging would be an acknowledgement that any consequent increase in spending levels from improved processes would not result in sanctions from the donors. The defense sector should also be encouraged to see the potential benefits of reform through being able to influence the wider systems and processes to be more supportive of defense. There is no doubt that being able to build on existing reform efforts, or even movement, is a very powerful risk management strategy.6

56. Finally, there is a catch-22 that needs to be acknowledged. The argument in this report is that defense should basically be treated the same as other sectors. However, the report also points out that this involves raising the profile of defense. It will be only too easy to argue that this represents unequal treatment. Such an argument is, however, specious. Ignoring defense is in fact what constitutes unequal treatment. Having said that, every effort must be made to avoid dealing with the defense sector in a way that could be interpreted as singling it out. The principle here is that defense should be brought along in tandem with other sectors. Where defense practice is lagging, it should be raised to a level consistent with current PEM standards and practices. The final section provides guidance on approaches to this issue.

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Risk Management Strategy for the World Bank

I. In order to reduce the risk of inappropriate interventions, Bank staff should:

1. Consult with other donors to assess first the general reform environment and second the reform environment in the defense sector on a country-by-country basis. In particular, they should:
   - Identify the players and processes involved in developing, implementing and monitoring defense policies and performance. This involves identifying gaps between actual and desired functioning as well as informal institutional arrangements that may jeopardize democratic civil control and oversight of the military.
   - Pay special attention to the issue of confidentiality and understand the ways of overcoming resistance to greater disclosure. (See particularly Table 1 in this regard).
   - Only then provide advice: 1) Drawing on general PEM principles wherever possible; 2) In support of the key principle of democratic civil control of the defense forces; and, 3) On issues of level, composition and efficiency and effectiveness at the specific request of the government.

2. Match PEM strategy in the defense sector with PEM systems and processes in the non-defense sectors.
   - Where there is a low-level of adherence to PEM principles and slow or minimal progress in improving PEM in non-defense sectors, consider the feasibility of identifying areas of concern in the defense sector in bilateral dialogue, in the CAS, in public expenditure work, at Consultative Group (CG) meetings.
   - Where there is government commitment to strengthening PEM, and particularly where a government requests assistance to improve defense-sector PEM, work with the government to identify priority reform areas and employ the full range of Bank lending and non-lending instruments to support the strengthening of PEM in the defense sector.

3. Conduct in-house discussions between staff who have previously addressed defense in the context of PEM work and those in countries where the issue is on the agenda or ought to be on the agenda.
   - Exchange experiences in an informal lessons learned exercise.
   - Develop consultant roster.
Risk Management Strategy for the World Bank (cont’d.)

II. In order to avoid the perception that the Bank is only interested in reducing the level of defense budgets, Bank staff should:

1. Underscore that the Bank’s interest lies in strengthening the process of managing defense resources, with any consequent changes to the level or composition of defense spending or the effectiveness and efficiency with which resources are used in the defense sector being driven by an improved process.

2. Work with government officials and bilateral donors to assess the extent to which the defense sector is part of the PEM system and process.

3. To the extent possible, integrate defense officials into ongoing PEM work in order to highlight the similarities between defense and non-defense sectors and to undermine the argument that defense merits special treatment.

4. Encourage the government to undertake sector planning – leading to the preparation of a defense policy paper and a defense review – and discuss with bilateral donors the possibility of supporting such an exercise.

5. Work with government officials, including from the defense ministry, to identify the types of diagnostic work – CFMA, CPAR, deviation analysis, tracking surveys, expenditure coding, for example – that can assist them in evaluating their needs in the defense sector.

III. In order to avoid creating disincentives to reform, Bank staff should:

1. Focus on process; avoid simplistic references to levels of expenditure, size of armed forces, specific defense purchases. Demonstrate how poor process and lack of systems in the defense sector undermines other key government objectives.

2. Gain the confidence of defense officials, for example by
   - Working with them to identify weaknesses in government-wide public expenditure management practices that affect the sector defense and help to remedy these weaknesses.
   - Working with them to strengthen internal defense PEM practices and/or encourage bilateral donors to support such work.

3. Use every opportunity to legitimize government efforts to introduce sound PEM into the defense sector, for example by:
   - Encouraging the inclusion of defense officials in reform working groups and task forces.
   - Encouraging ministry of defense officials to attend CG meetings; devote some portion of the meeting to PEM process issues.
   - Encouraging the inclusion of defense officials in country PER teams.

4. Structure Bank activities to build confidence between defense officials and civilians and consider assisting the civil authorities to increase their knowledge of defense issues.

5. Encourage the government to allow the ministry of defense to retain some share of savings achieved by increasing the efficiency and effectiveness of defense expenditure.

6. Exploit technical developments, such as in the field of FMIS, to help tackle more policy-related issues, such as coverage of defense spending in the budget and competition between defense and other sectors for resources.
IV. IMPROVING BUDGETARY OUTCOMES

57. There are four crucial, inter-related components to managing defense expenditure:

- Identifying the needs and key objectives of the security sector as a whole and the specific missions that the defense forces will be asked to undertake.
- Determining what is affordable.
- Allocating scarce resources according to priorities both within the defense sector and between defense and other sectors.
- Ensuring the efficient and effective use of resources.

58. Sound public expenditure management requires a feedback loop between policy, planning and budgeting. (See the flowchart on linking defense policy, planning and budgeting on the following page and the flowchart outlining the process of conducting strategic defense reviews and developing defense policy frameworks found in Annex 6.) Information on performance will be increasingly important and defense is no exception. While defining and measuring performance in the defense sector is more difficult than for many other sectors, a focus on readiness/capability has been shown to be helpful to any discussion of the role, structure, performance, and resource needs of defense. The sequence in which any necessary reforms are introduced and the pace at which they proceed will vary from country to country, as will the policies, structures and practices developed to implement the basic PEM principles. Anyone embarking on a reform of the public expenditure management process should, however, be aware of the very long-term nature of such an undertaking.

Policy and Organizational Reviews: Defining Sectoral Needs and Objectives

59. As in other parts of the public sector, defense budgets should be prepared against a sectoral strategy. For the defense sector, key elements are: 1) an evaluation of a country’s security environment, 2) broad policy guidelines based on the principles underpinning the country’s approach to security on which the key stakeholders have reached consensus, and 3) a detailed elaboration of the mission, doctrine, force design, and human resource needs of the defense forces. The strategic environment and the policy guidelines are generally set out in a policy paper. The organizational evaluation is intended to help operationalize the policy guidelines. These documents would clarify which activities undertaken by the defense forces should be classified under the “defense” function and which should be classified under the appropriate civil function.

60. The regional dimensions of the security environment in many parts of the world are becoming increasingly evident as the Cold War recedes further into the past. In Africa, the wars in Sierra Leone and the Congo have clear regional roots and will not be resolved without regional approaches. The land crisis in Zimbabwe has potentially explosive implications for other countries in Southern Africa, particularly Malawi and South Africa, and efforts to address the land question on a regional basis through the Southern Africa Development Community
began in 2001. Cross-border criminal activities – such as illegal immigration and smuggling vehicles, narcotics, and firearms – have grown in magnitude throughout sub-Saharan Africa. It is therefore essential that the regional dimension of security be fully reflected in the strategic planning process.

61. Policy papers and organizational reviews involve not only the defense forces and defense and foreign affairs ministries, but also other relevant ministries with a mandate for national security, bodies such as the office of the President/Prime Minister, the office of the national security adviser, the legislature and relevant legislative committees, and the finance ministry or budget office. Central to understanding the strategic review process is understanding the relationship between and roles of the defense forces and the civil administration such as the ministry of defense. The policy and organizational review processes should ideally be as transparent and inclusive as possible. In so far as they are based on a broad consultation among the relevant stakeholders, and if the final product is made public, for example through the publication of a policy paper, their legitimacy will be strengthened.

62. The following box on options for Bank engagement in strategic planning, together with the subsequent options boxes, should be read in conjunction with Table 1 (pages 8-9), the box on a risk management strategy for the Bank (pages 19-20), Annex 2 (pages 41-46), and Annex 6 (page 55).

### Options for Bank Engagement on Strategic Planning

- Encourage national stakeholders to engage in a strategic planning process.
- Consult with Bank staff, other donors, and security specialists to ensure that regional issues are fully incorporated into strategic planning in the defense sector in all countries in a region.
- Draw attention to the importance of identifying and costing non-defense activities in the context of developing the defense strategy (and other sector strategies), particularly where these activities are no Include the ministries of defense and interior in meetings or training sessions pertaining to the importance of strategic planning for budget formulation and execution or generic techniques for undertaking strategic planning exercises.

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Aggregate Fiscal Discipline: Determining What is Affordable

As in all other areas of the public sector, defense policies must be affordable. (See Box 8.) The resources available to the public sector as a whole are a function of many factors, including political choice about the role of government and taxation levels. Economic growth and the quality of fiscal management clearly influence the size of the pie. A safe and secure environment is particularly important for economic growth.

The balance between short-term stabilization and long-term stability is important, especially in countries in transition from war to peace. This balance is difficult to achieve. It is now recognized that strengthening institutions is necessary in order to achieve sustainable macroeconomic balance. Neglecting institutional strengthening while pursuing macroeconomic balance may have destabilizing effects that could potentially undermine long-term efforts to manage defense expenditure more effectively, subsequently feeding back into fiscal instability. This is particularly likely to occur where political stability may justify government policies that run counter to the goal of limiting public expenditure.

Box 8. Defense Budgeting in Botswana

“The processing of the BDF [Botswana Defence Force] budget is done in the same way as that of other government departments. The budget and the actual procurement are debated and authorized by parliament. In order to achieve accountability, the checks and balances for other ministries are applied to the BDF. For example, the Special Tender Board comprises only civilians and is chaired by the Permanent Secretary to the President to ensure the presence of the highest civil servant and highest office authority....

“As part of the checks and balances of the government accounting systems, the BDF is subject to audit by the Auditor General and is accountable to parliament through the Public Accounts Committee. This parliamentary committee can call upon the Commander to account for the spending of funds allocated to him. The Internal Audit of the Ministry of Finance is another measure of ensuring accountability and transparency. In all of the above finance controlling mechanisms, the BDF just like any government department has an obligation of fulfilling the requirements of the Finance and Audit Act. Perhaps, future improvement in accountability and transparency lies in government’s moving away from incremental based budgeting to programming budgeting.”

65. Once the aggregate level of government expenditure is chosen, it is vital that this figure be accepted both as an upper and, as far as possible, a lower limit. An easily expanded resource envelope makes it possible to avoid firm decisions on the prioritization of policy objectives. In the absence of a firm floor to the expenditure envelope, resources are not predictable, with adverse consequences for operational performance. Methods of evading fiscal ceilings such as guarantees, off-budget expenditure and arrears, which can subsequently undermine fiscal stability, should therefore be discouraged. There is evidence that the lack of mechanisms to review the potential impact of assuming defense-related debt before approving defense purchases has had destabilizing effects on fiscal policy down the track, and the Bank has on occasion expressed concern about specific defense-related purchases. (See Box 9).

66. There should also be clear rules for any reallocation during budget execution, including in response to a shortfall in revenue. One method of reducing opportunities to soften fiscal discipline found in other key sectors like health and education is to adopt a medium-term forward planning process linked to medium-term revenue projections. In fact, defense officials are frequently favorably disposed to medium-term frameworks because procurement of military equipment and construction of military facilities involve multi-year expenditures.

**Box 9. Proposed Tanzanian Air Traffic Control System Purchase**

The UK export license for the purchase of a $40 million BAE military air traffic control system by Tanzania specified that the World Bank must be satisfied that the system can be used both for military and for civil aviation purposes before the deal can be finalized. Although the Bank will only make a decision when it discusses Tanzanian debt relief in early 2002, it expressed concern about the sale in December 2001.

A technical evaluation conducted in 2001 concluded that additional expensive equipment would be required to make the BAE system functional for civil purposes. The World Bank stated on December 20, 2001 that it opposed the sale because “a civilian system more suited to a country with only eight military aircraft would cost a quarter of the price” of the proposed BAE contract. The Bank has been particularly concerned about the debt implications of the purchase.

Both the World Bank and the IMF have refused to extend credits to enable the Tanzanian government to finance the purchase. This has led Tanzania to seek commercial funding from Barclay’s Bank. While Barclay’s proposes to lend the money at well below market rates, Tanzania would still be paying more for the loan than if the Bank or the Fund had provided credits. According to press reports, the deal was negotiated without parliamentary consultation.

Options for Bank Engagement on Aggregate Fiscal Discipline

- Assist government in ensuring that all expenditures and revenues are on-budget. Pay special attention to defense procurement (including off-sets), raw material exports, revenue of state-owned enterprises and military-owned businesses, funds, and foreign military assistance.
- Assist government in identifying whether and how practices in the defense sector diverge from formal arrangements and provide assistance to bring practice into line where deviations occur.
- Assist government in ensuring that the defense sector adheres to government-wide procedures for reviewing, restraining, approving and budgeting for borrowing.
- Assist government in ensuring that the defense sector lives within its approved budget.
- Assist the government in ensuring that transparency of defense-sector policies and expenditures is adequate and appropriate.

Allocating Resources According to Priorities

67. Only after the overall resource envelope is determined, which may in itself represent a major undertaking for some countries, can decisions be taken about how to allocate these resources among the government’s priority areas, both within the defense sector and between defense and other sectors. This allocative process involves political bargaining among a wide range of actors. It is essential that this process be informed by a set of sectoral strategies and, wherever possible, information on performance. Once the budget envelope for defense is set by the authorities responsible for central budget management, the defense ministry should take the lead in developing initial budget projections in collaboration with the difference services: army, navy, air force, intelligence and, where relevant, paramilitary forces.

68. From an efficiency perspective, it is particularly important to get the allocation right between recurrent and capital budgets. Within recurrent expenditure, it is also important to strike an appropriate balance between wages and salaries, and between operations and maintenance. Unless this balance is achieved, there may be capital investments that are not properly maintained. Practices such as keeping “ghost” soldiers on the payroll and channeling defense-related personnel costs through other ministries complicate this calculation. Moreover, recurrent funds may be spread too thinly. For equipment procurement, it is critical to evaluate up-front the full life-cycle costs of defense materiel.

69. The central budget office should assess the appropriateness of the defense ministry’s budget request. In this respect, it is important that finance ministries have the capacity to analyze security programs, just as they should have the capacity to analyze other sectoral programs. Even where the budget office is confined to ensuring only that the defense budget conforms to the guidelines laid down and that costings are reasonable, this should be underpinned by a knowledge of the policy issues. Given the weaknesses in the disciplining
framework in many developing countries and the failure to demand performance (in terms of outputs and outcomes) from ministries, it is important that budget offices build the capacity to engage in the policy debate.

70. The challenge role of the budget office not only ensures that decision makers confront the full range of issues; it also will contribute to raising the quality of proposals from ministries over time. Moves to more output- and outcome-oriented systems will only place more demands on budget offices to understand the policy issues. Given the limited policy capacity in many countries, it is of course essential that this policy capacity be effectively allocated across central agencies and between central agencies and line ministries. The central budget office should ideally consider spending proposals within a medium-term resource envelope and should seek to ensure tight links between policy-making, planning, and budgeting. This enhances the likelihood that that budget ceilings and floors will be respected and defense outcomes, however implicit, will be achieved.

71. Again, it is important to recognize that, particularly in poor countries, resource allocation decisions will involve very difficult trade-offs between the defense and non-defense sectors. This suggests that the executive should deliver the final appropriation request to the legislature by a date that affords legislators adequate time to evaluate and debate the spending proposal before the beginning of the new fiscal year and before a vote on the budget is required. Procedures are likely to differ from one political system to another. Additionally, methods of consulting with the public on the proposed trade-offs can strengthen the entire process by contributing to a national consensus on priorities.

72. If a country is placed on a war footing and is forced to transform the economy to respond more effectively to unforeseen security needs, the budget system too must be able to respond – allocations and the pattern of appropriations will need to change to reflect the change in government priorities. The executive should always be able to react swiftly to major security threats and many constitutions empower the executive to take exceptional action should the need arise. A key issue with respect to the management of defense expenditure in such instances is the ability of government to avoid emergency regulations that undermine the ability to revert to good practice once the war is over.

<table>
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<tr>
<th>Options for Bank Engagement on Resource Allocation</th>
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<tbody>
<tr>
<td>• Identify where policy decisions are made and encourage the development of a political forum within which sectors, including defense, compete for priority and funding.</td>
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<tr>
<td>• Encourage and facilitate the development of a defense sector strategy, with the involvement of all relevant stakeholders.</td>
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<tr>
<td>• Include the defense sector in analyses of whether the government is able to ensure a high degree of consistency between the original budget and actual expenditures using the Bank’s institutional analysis and assessment tools.</td>
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<tr>
<td>• Include the defense sector in medium-term expenditure frameworks. Determine whether the armed forces may be a useful ally in encouraging government-wide adoption of MTEFs.</td>
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Options for Bank Engagement on Resource Allocation (cont’d.)

- Ascertain whether the budget office and legislature have the capacity to assess defense programs and interact with the ministry of defense. Work with bilateral donors to provide necessary capacity building.
- Ascertain whether the ministry of defense had the capacity to develop budget projections in accordance with formal government-wide procedures.
- Work with the government to ensure that legislators receive the appropriate amount of information to enable them to carry out mandated oversight responsibilities. Support efforts to enhance the capacity of legislators to request the appropriate information.
- Encourage government to develop and implement transparent rules for any necessary reallocation of resources between sectors during budget execution.
- Identify opportunities for drawing defense into the government policy process through technical interventions, notably in the areas of the treasury system and budget classification and coverage.

Promoting Efficient and Effective Resource Use

73. Once a budget has been approved by the legislature and monies appropriated, the goal is then to ensure that resources are used efficiently and effectively in the implementation of the strategic sectoral priorities. This requires careful monitoring and evaluation of operational performance, both within the armed forces themselves and by civil servants. As a general rule, funds appropriated should be spent for the purposes and in the amounts intended. This is necessary for sound fiscal planning and management as well as for the operational effectiveness of the defense forces. Stability in policy and funding, particularly during the budget year, is important for operational performance. It is difficult to assess stability in policy if there is no strategy for defense and no predictability of funding. At the same time, without transparent and comprehensive defense budgets, it is difficult to achieve predictability of funding.

74. As noted above, well-functioning financial management information systems are critical if decision makers and public-sector managers are to obtain the financial data they require for controlling aggregate expenditure, prioritizing expenditure among and within sectors, and generally operating in a cost-effective manner. It is also extremely important that irregularities identified in the course of monitoring performance be addressed. Failure to do so may create or reinforce a climate within which non-compliance can flourish.

75. Transparent procurement practices are a critical element in achieving value for money and cost-effectiveness. Procurement should be open to public scrutiny with expenditure fully accounted for. Purchases should also reflect actual, rather than perceived, threats and equipment should be relevant to agreed tasking. (See Annex 3, pages 47-49, for a discussion of
distinctive features of defense procurement.)

76. The defense sector should meet the same standards of accounting as non-defense bodies. Defense ministries should maintain an internal audit unit and consideration might be given to supporting the establishment of an inspector-general function. The auditor-general should audit defense ministry accounts regularly, along with those of the armed forces. The results of these audits should be reported in a timely fashion to the legislature and irregularities addressed rapidly. Additionally, cash flow and expenditures should be monitored closely. Methods of verifying the number of personnel in the armed forces and employed by the defense ministry and of linking salary and wage payments to actual employees facilitate these tasks. Tracking studies, carried out by or for the defense ministry, can be an important tool for determining whether resources are reaching their intended targets. Finally, as in any sector, feedback from monitoring and evaluation into strategic planning is critical.

77. While it may not be appropriate to push for a greater performance orientation in the defense sector where the public sector as a whole remains deficient in this regard, information on defense performance should be an objective. This would be particularly important with regard to defense preparedness, which is akin to outputs. Clear objectives, specification of preparedness, measures of performance supported by monitoring and evaluation should all be encouraged. Value for money audits by the external auditor also help focus attention on efficiency and effectiveness issues, and the defense sector should not be excluded from the mandates of the external auditor and other oversight bodies. (See Box 10.) Where a more performance-oriented budgeting system is being implemented, defense should be considered for inclusion in any pilot phase.

Box 10. Monitoring Defense Spending and Arms Procurement in Chile

“The Office of the Comptroller General is responsible for monitoring all accounting aspects of the implementation of the state budget. It can audit the accounts for arms procurement but is not authorized to examine the choice of arms to be procured or whether value for money has been obtained. Nor is the Congress empowered to conduct this type of monitoring.”


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9 The Inspector-General function has been implemented by an increasing number of developed countries, particularly in support of strategies to limit fraud and abuse. Inspectors-General tend to be given responsibility for investigations of allegations of security breaches, fraud, waste, abuse and commercial impropriety. They may also be expected to undertake independent reviews of internal systems and processes through evaluations, audits, and fraud risk assessments. As such the position has many of the features of internal audit but would be expected to subsume that function. As a normal rule, the IG would be part of the internal management.
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<th>Options for Bank Engagement on Efficiency and Effectiveness</th>
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<tr>
<td>• In dialogue with governments, stress the importance of efficiency and effectiveness in all sectors.</td>
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<tr>
<td>• Identify systemic weaknesses as well as any weaknesses specific to defense that undermine the stability of policy and funding for the defense sector.</td>
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<tr>
<td>• In order to promote stability in policy and funding, encourage governments to develop defense strategies and to place a high value on predictability of funding, transparency, and accountability. The defense sector should be expected to live with its approved budget, and any necessary reallocation of resources during budget execution should be subject to clear rules.</td>
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<tr>
<td>• Ask questions about the capabilities and independence of mind of civilian administrators in the ministry of defense.</td>
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<tr>
<td>• Include the defense sector in Country Procurement Assessment Reviews and Country Financial Accountability Assessments. Work with bilateral donors to provide necessary technical assistance to strengthen the procurement process.</td>
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<td>• Work with governments to ensure that all expenditure by the defense sector is reflected in the treasury system.</td>
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<tr>
<td>• Provide assistance with relevant tools and techniques such as expenditure tracking surveys to identify issues relating to the efficiency and effectiveness of resource use in the defense sector.</td>
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<tr>
<td>• Encourage governments to establish internal audit units and an inspector-general function within the defense ministry.</td>
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<td>• Ask questions about the ministry of defense’s capacity to link strategic planning, policy, programming, budgets and implementation.</td>
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<tr>
<td>• Where countries are adopting more performance-oriented budgeting systems, engage defense ministries in the early stages of such reforms.</td>
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<tr>
<td>• Include ministry of defense officials in government-wide capacity-building exercises.</td>
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<tr>
<td>• Ascertain whether the external auditors have the capacity to audit defense budgets, whether appropriate systems of confidentiality are in place within the external audit department, and whether information is provided to parliament on a timely basis. Work with bilateral donors to provide necessary technical assistance.</td>
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<tr>
<td>• Encourage governments to include the defense sector in “value for money” audits.</td>
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<tr>
<td>• Ascertain whether legislators have the capacity to monitor defense expenditure and whether appropriate systems of confidentiality are in place. Work with bilateral donors to provide necessary technical assistance.</td>
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**Bank Instruments and Defense**

78. As noted elsewhere, the Bank is currently engaged in a variety of activities connected with defense and, more generally, security. In this latter case, the Poverty Reduction Strategy Paper (PRSP) and Transitional Support Strategy (TSS) are the most prominent Bank instruments employed. There are, however, instances where defense issues have been raised in CASs. A number of recent PERs have also addressed defense issues explicitly (Ethiopia, Cambodia, Croatia).

79. It appears that the Bank is most comfortable addressing defense issues directly where there is either rising or high levels of defense spending that are seen as having the reality or prospect of squeezing out priority development expenditure. The PRSP has the potential to legitimize more attention to defense expenditure in the context of the crowding out argument. There is some evidence that Bank staff have been able to take advantage of tension between rising defense expenditures and stagnant or falling social sector expenditure within a hard aggregate budget constraint to discuss with the IMF the scope for some increase in the overall deficit (including grants) and even bank borrowing. In this context there does seem to be some distance still to go on both accepting and understanding the implications of fungibility. This is not an easy area, as the importance of stable fiscal policy to sustainable poverty reduction is difficult to overstate.

80. Having said that, Bank staff should be prepared to engage in a discussion with countries and the Fund on the trade-offs involved between higher deficits and fiscal restraint. It is for this reason that PRSPs should be developed within the budgetary framework of the country. It is highly preferable to discipline the process by what is affordable over the medium term and to force the trade-offs to be confronted at this stage rather than later in the process. (The argument is no different to the one for incorporating the defense sector into these processes.) This process might well lead to an acknowledgment that defense sector spending in a particular country may need to rise because of the inadequacy of resources relative to the safe and secure environment required for sustainable development. In this context, there is likely to be an opportunity to encourage the defense sector to seek greater efficiencies in order to demonstrate that allocating additional resources to the sector is warranted.

81. The PRSP is also an appropriate vehicle for addressing the impact of a country’s security environment on the poor. This can lead to a discussion among national stakeholders of the role of the defense sector in providing the necessary security for poverty-reduction. Situations may arise where national security is considered the highest priority of government. (See Box 11.) In such a situation, the Bank and other donors should be prepared to engage fully, drawing on all the options outlined above. At the same time, situations will inevitably

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**Box 11. Security in the Sierra Leone IPRSP**

“In order to provide the enabling environment to facilitate poverty reduction, the highest priority will be given to the creation of a security environment that allows the free movement of persons and goods. A key component for the re-establishment of security countrywide is the implementation of the Disarmament, Demobilisation and Reintegration (DDR) programme. In tandem with the implementation of the DDR programme, the Government is currently restructuring, retraining and equipping the army and police within the context of its comprehensive security policy.”

arise where governments consider national security their highest priority, but the Bank and other donors will not concur. In the event that the Bank or other donors do not agree with a country’s assessment, they can either focus on the work described in this paper in order to achieve the maximum transparency and accountability in the system or they presumably can reduce their activities in the country.

82. CASs would also be expected to draw attention to situations where defense spending, or any other so-called non-development spending, is seen to be crowding out development spending. The CAS is an obvious vehicle for drawing attention to these issues. However, it is perhaps even more a vehicle for articulating a strategy for tackling the various public expenditure dimensions (particularly systems and process issues) discussed throughout this paper. Improving the coverage of defense spending and encouraging its integration into the systems and processes of government will have long-term pay-offs in relation to comprehensiveness, transparency and accountability, and ultimately more appropriate allocations to and improved performance of the defense sector.

83. PERs, CFAAs and CPARs all have a role to play in this latter work (see below). There is also a need to recognize that other avenues of public expenditure work, including one-off analytical pieces, may well be more effective where specific assistance is sought by a country, including under the umbrella of a PRSP. Where there are TSSs, they often pick up on quite a comprehensive set of interventions, including issues of transparency in the budget process. The latter is also receiving attention in Poverty Reduction Support Credits (for example, Vietnam). It is important that PEM issues do in fact receive appropriate attention and do not fall off the back end as they have so often in the past. The key point here is that the CAS should be seen as the vehicle for identifying where work encompassing the defense sector might usefully be undertaken, particularly as part of an overall strategy for public expenditure work in a country.

84. Military spending has been explored in detail in very few PERs. The Argentine PER of 1992 and recent PERs for Ethiopia are the most extensive treatments of this subject. In neither country has military expenditure been approached from an institutional perspective, although the work in Ethiopia could be interpreted as moving in that direction. However, the 1999 Cambodia PER demonstrates that a full analysis of the defense sector is not necessary in order to identify significant problems related to defense-sector governance. (See Box 12.)

85. As PERs become more process and institutionally focused, it makes sense for them to

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**Box 12. The Defense and Security Sector in the 1999 Cambodia PER**

According to the 1999 Cambodia PER, revenue shortfalls and “an overrun in defense and security expenditures” were a cause of “the squeeze on development expenditures” experienced by Cambodia. This report argued that the relationship between defense and security spending and development expenditures “highlights three critical weaknesses in budget management: (i) unreliability of the macro framework (revenue shortfall); (ii) the lack of legitimacy of the budget (reallocation during budget implementation), and (iii) the residual nature of expenditures on social and economic services.” The 1999 PER also points out that the Ministry of Economy and Finance has no authority over the budgets of the Ministries of Defense and Interior. Furthermore, the latter two ministries have been exempt from audit, unless authorized by the Prime Minister.

encompass institutional assessments, even if this begins by simply covering defense in data presentation and in any deviation analysis. The Bank and other donors could use the PER process to engage in dialogue with governments on ways of strengthening the financial management of the defense sector. Where appropriate, the Bank and other donors could provide technical assistance aimed at building capacity in defense-sector budget development, implementation, and oversight.

86. As a matter of course, PERs should explicitly include the coverage of the defense sector in the analysis of a country’s PEM system. This is not because the defense sector is different, but precisely because it is so similar to other sectors. The obvious starting point is for these issues to be included in the concept note. CFAAs and CPARs, preferably as part of a PER exercise, should similarly encompass the defense sector. The skills required for such work are primarily those of the PEM specialist, accountant and procurement specialist, supplemented by guidance such as is in this report. It may be deemed useful in some cases to include a security and development analyst in a PER process. In the event that the defense sector is identified through the CAS process as requiring more detailed study from the systems and process perspective, whether or not as part of a PER, there is a strong case for engaging a defense management specialist and/or security and development analyst to contribute to this work. There does not appear to be any reason why the World Bank should not contract for such work, although a bilateral might provide such expertise as its contribution to a PER.

87. At the next level of detail – ranging from approaches within defense to planning, policy, budgeting and management to the level, composition, and/or efficiency and effectiveness of resource use – any assistance in response to a request from a country will primarily be in the form of defense expertise. It is essential that proper attention be given to process issues as well as the technical issues. As already noted, the technique of engaging defense sector officials (military and non-military) in discussion of government-wide systems and process issues is relatively simple but can be very effective. A related issue is that of engaging the defense sector with the legislature and civil society. It is important, of course, that defense officials understand why they are being included in government-wide systems and process activities and that the benefits of participation are made evident to them. Defense officials are more likely than officials in most other sectors to successfully invoke confidentiality, irrespective of the reason for doing so.

88. The work suggested will not be costless. In the context of constrained budgets, any decision to include defense in public expenditure work will mean, for a given budget, less attention to some other area. However, since the main focus of this report is the application of the same PEM principles to defense as to other sectors, the additional costs will be marginal. The fact that Bank staff are already focusing on defense-related issues, sometimes in PERs but more often through other interventions, suggests that judgments have been made that the benefits of so engaging outweigh the cost. Given the relative size of defense budgets in most countries, the potential benefits in terms of greater stability at the macro level, improved allocations, and greater efficiency and effectiveness would seem to more than justify some reallocation within public expenditure work and wider budgets. Even for this basic PEM work support could be sought from bilateral donors. Any broader or deeper involvement in the sector would presumably see an even greater recourse to the bilateral donors for support.

89. Technical assistance has had a checkered history and this paper does not intend solving
the problems besetting this form of assistance. We do, however, commend the sentiment in Schumacher’s favorite slogan, “Find out what the people are doing and help them do it better.” It is important to stress that the problems of technical assistance are essentially the same in the defense sector as in all other sectors of government. One significant criticism of technical assistance is that insufficient attention is paid to process. Ironically, because of its sensitivity, process is likely to be even more important in the defense sector. In broad terms, the approach to technical assistance should parallel the approach to analytic work discussed throughout this paper. Where the support is focused on integrating defense into the PEM systems and processes of the country, it should be as part of broader reform of those systems and processes wherever possible. This is not an area where stand-alone technical assistance is likely to be successful. Even where more detailed work on the defense sector is required from the system and process perspective, technical assistance should, wherever feasible, be integrated with broader system and process reform support. It is only at the most detailed level of support to defense systems or performance that stand-alone technical assistance is likely to be appropriate.

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10 Cited in Ellerman, “Helping People Help Themselves.”
V. CONCLUSIONS

90. This paper has argued for and provided guidance on integrating defense into the planning, policy-making and budgeting systems and processes of a country in a manner consistent with democratic, civil control of the defense forces. One central premise is that from a public policy and process perspective, defense shares many of the characteristics of other sectors. A second central premise is that the citizens of any country will benefit from a defense sector that is accountable to democratic, civil authority and subject to the same broad set of rules and procedures as other sectors. There are three main benefits to applying PEM processes to the defense sector: 1) better understanding of defense policies; 2) greater clarity on the rationale for the level of resources devoted to them; and 3) increased efficiency and effectiveness of defense spending. These would apply equally to other portions of the security sector.

91. While the paper has focused on the similarities between defense and other portions of the public sector, it has also identified differences between defense and other sectors and suggested approaches to take account of these differences. Most of these differences are matters of practice, rather than principle. The main area in which principle needs to be adjusted is in terms of providing for greater confidentiality in some aspects of defense. Even there, however, the adjustments should not jeopardize the ten fundamental principles of sound public expenditure management.

92. Throughout the discussion, three issues have arisen time and again. The first is the need for a defense strategy. In common with all other sectors, planning and resource allocation in the defense sector must be tied to a sectoral plan. Development of a defense strategy involves 1) an evaluation of a country’s security environment; 2) broad policy guidelines based on the principles underpinning the country’s approach to security on which the key stakeholders have reached consensus; and 3) a detailed elaboration of the mission, doctrine, force design and human resource needs of the defense forces.

93. The second core issue that has emerged is the need for performance information. As in other sectors, it is not sufficient to “get budget allocations right.” Performance information is a critical component of the policy development and planning process, as well as for evaluating the effectiveness and efficiency with which resources are used. Additionally, reallocation of expenditures during the budget year can severely complicate the ability of governments to deliver services to their citizens. Public expenditure review processes should incorporate the defense sector. Tracking surveys and deviation analyses are useful tools to identify performance problems.

94. Third, there is a need for defense to be on budget and subject to competition with other sectors for funding. The defense sector is frequently allowed to avoid hard fiscal restraint through supplementary budgets, off-budget expenditures and revenues, or the inappropriate classification of resources. The defense sector also frequently receives preferential treatment – in its relations with the government, in the allocation of resources, and in the release of funds in resource-constrained environments. While security is legitimately a high priority for any government, it is important that the simple allocation of resources to the defense and other security forces not be mistaken for the provision of security. Similarly, it is important not to allow the genuine need for some degree of confidentiality in the defense sector to be used as an
excuse for evading PEM principles such as comprehensiveness, transparency, accountability, and contestability.

95. This report has argued that while donors are increasingly incorporating the security sector into their regular work, their support has been largely *ad hoc*, responding to particular situations. Donors need to accept the fact that security and the defense sector are one core component of a well functioning public sector and fashion their approaches on this basis. In particular, they need to support work in the areas discussed in this report and work with national stakeholders in reforming countries to identify other areas worthy of further work or discussion.

96. The paper has identified a number of risks to governments and to the donors of choosing to engage or to not engage in the defense sector. It concludes that the risks of non-engagement outweigh those of engagement. It has consequently provided a first cut at a risk management strategy for the World Bank and options for Bank engagement in the defense sector. These are, for the most part, not specific to the Bank and are thus largely applicable to all donors. Indeed, this report sees many virtues in collaboration between the World Bank and the bilateral donors based on comparative advantage.
ANNEX 1

MECHANISMS FOR OFF-BUDGET MILITARY EXPENDITURE AND REVENUE

The following examples of off-budget military spending and revenue were derived from the countries examined in this study. In certain countries, there has been progress on one level or another in addressing the off-budget problem. But where this progress is based excessively on increased donor scrutiny and pressure rather than improvements in security-sector governance, then the concern is that this progress will both be partial and short-lived. As the following list suggests, there is a wide variety of mechanisms that governments or military organizations can use to keep military spending and revenue off-budget.

A. Budgetary mechanisms for disguising military spending

1. Contingency funds
   - Reserve budget-lines for emergencies used to pay military ‘debts’; fund establishment of ‘urgent’ military commissions to resolve border disputes, pay defecting soldiers from anti-government forces, care for refugees in conflict zones, repair military hardware (substantiation of spending rarely provided by the military).

2. Supplementary budgets
   - Government can top up this budget line during the year by passing a new sub-decree; money taken from other budget lines that have not disbursed funds due to lack of ‘absorptive capacity; Government justifies spending to Parliament at year’s end in vague terms.

3. Spending under non-defense budget lines
   - Military units commissioned to build roads which either are not built or serve primarily military commercial interests (logging); disbursements under Public Works/Rural Development budget lines
   - Defense spending (for the Home Guards, a form of territorial army) placed under police budget line
   - Army pay increases kept off-budget because too sensitive
   - Military involvement in administering social ‘safety net’ during times of crisis, including provision of disaster relief, running hospitals, etc.
   - Personnel costs (military wages) run through non-security ministries
   - Rice supplements for military monetized and counted as ‘civilian wages’
   - Spending for military vehicles recorded in social budgets, for instance as ‘ambulances’ or for use in ‘peace operations’.
4. **Non-transparent or highly aggregated budget categories (budget lines for debt repayment, public investment/capital, Presidential Offices, etc.)**
   - Repair of military equipment paid for by non-concessional loans and funds recorded under public investments
   - Government bailed out highly-indebted banking sector covering many military businesses which had received massive preferential loans that they could not repay
   - Accumulation of wages arrears, including military salaries, covered under a non-defence budget line

5. **Diversion of resources from social budget lines after budget approved**
   - Due to lack of absorptive capacity in social sectors, unused funds diverted to military spending
   - When donor funding for a particular development program requiring counter-part funding does not materialize, counter-part funding is freed up for other (military) uses
   - Salaries of military personnel working on development projects have been paid through the investment (development) budget

6. **Procurement of military materiel**
   - Procurement of military equipment funded through non-defense budget lines or not accounted for in the budget
   - Procurement of military equipment through supplier credit terms without prior scrutiny by appropriate authorities to ensure funds are available

7. **Under-valuation of economic resources**
   - When forced labor is used to construct military infrastructure, this does not adequately reflect the true opportunity cost to society or the level of resources consumed by the military.

**B. Extra-budgetary sources of military revenue**

1. **Parastatals** Non-military (including companies owned by ruling parties) which are used to fund security services.
   - State-owned enterprises are decapitalized to release funds for the military, and then recapitalized the following year; another method is simply for governments to bail out enterprises that have become heavily indebted due to the diversion of resources for military purposes.

2. **Military-owned businesses/involvement in non-military activity**
   - ‘Charitable’ status tax-exempt foundations serve as holding groups for commercial enterprises/co-operatives that are used to fund the military; leakage from military-owned business is very high.
   - Military interests run private security companies and serve as suppliers of various materiel to the military and other government departments for which they receive state subsidies.
• Police units have a financial interest in private security firms; both military and police personnel work in private security firms to supplement salaries

3. **Creation of funds**
   • Petroleum fund - entirely off-budget, reportedly 20-50% of income allocated to the armed forces
   • Cocoa Board - funds used to finance President’s special forces
   • Reforestation fund (fed by logging fees) and under military control, ostensibly served to replant trees/build roads, though funds were allegedly diverted
   • Fund ostensibly created to assist the unemployed was used to divert resources to the Ministry for War Veterans, undermining IMF austerity targets

4. **Barter trade**
   • Agricultural commodities bartered for military equipment

5. **Direct financing of military in field through extraction of natural resources**
   • Often involves the use of state/military organizational structures, though levels of leakage are typically very high. Includes exploitation of diamonds, precious stones, timber, fisheries, oil etc.
   • Both the government and the rebel forces have granted concessions and access to mineral and other natural resources to their allies
   • During the war against an insurgency movement, the government officially signed over control of all timber revenue to the military
   • Use of revenue from sales of natural resources used as collateral to finance short-term borrowing in order to procure military equipment

6. **Avoidance of taxes**
   • Military-run casinos and unused land purchased for purposes of speculation by the military are regularly exempt from taxation; a region settled by former rebel soldiers officially exonerated from paying tax on all business activities and imports from neighboring countries in order to ‘avoid destabilizing the peace process’ (Government army also heavily involved in this trade)

7. **Mortgaging of national resources**
   • The government has granted long-term concessions to foreign oil companies in exchange for substantial advance payments in annual fees which have been used to fund the war effort.

8. **War levies**
   • 10% (revenue of firms, tax on citizens) used to fund the government’s war effort; process is largely ad hoc, not recorded in the budget.
   • ‘Voluntary’ security levy raised from citizens and recorded in the budget under non-tax revenue and defense spending

9. **Foreign military assistance**
• Military equipment received as a foreign grant not recorded in capital budget
• Budget reports less income from all donors than they record as having granted – suggested that resources may potentially be diverted to the military

10. **Donor assistance for demobilization**
• Donor assistance provided to support military demobilization and reintegration programs not recorded in the defense budget.

11. **Assistance from multi-national companies**
• Oil company provided assistance to the government to procure arms and pay salaries of state security personnel protecting its operations
• Oil company provided financial support to the Government to cover the costs of security personnel protecting its operations

12. **Informal/criminal activities**
• Numerous activities including fuel smuggling; casinos; trafficking in drugs, humans, arms, timber, precious stones; kidnapping; protection rackets; prostitution; printing of money; piracy

ANNEX 2
COMMON DEVIATIONS FROM PEM PRINCIPLES IN THE DEFENSE SECTOR

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<th>PEM Principle</th>
<th>Defense Deviation</th>
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<td>Comprehensiveness</td>
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| The budget must encompass all fiscal operations of government. | 1) Portions of defense spending are off budget.  
2) Portions of revenue allocated to the defense sector are held in extrabudgetary accounts.  
3) Defense is not subject to government-wide controls on borrowing. | 1) In this and all other aspects of applying PEM principles to the defense sector, it is crucial that ministries of defense are staff by able civilian administrators with a track record of effective financial management and independence of mind. If these officials show signs of capture, they should be rotated to other sectors.  
2) In this and all other aspects of applying PEM principles to the defense sector, it is important to ensure that the legislature and civil society also have the capacity to monitor defense/security budgets and policies.  
3) In this and all other aspects of applying PEM principles to the defense sector, it is critical to foster an environment that supports and demands performance in relation to aggregate fiscal discipline, prioritization, and technical efficiency.  
- Accept and apply principle that all expenditure and revenue must be incorporated into the budget. Show all defense expenditure in the budget on a gross basis, including materials provided in-kind and off-set arrangements.  
- Accept and apply the principle that defense should be subject to all government-side rules relating to, e.g. contingent liabilities, borrowings. | 4) In this and all other aspects of applying PEM principles to the defense sector, it is important to engage the head of government and state and other senior officials in a dialogue on the adverse consequences for other priority sectors and often for defense itself when process is undermined. |

1 This list of common deviations and potential remedies is illustrative and not intended to be comprehensive.
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<th><strong>PEM Principle</strong></th>
<th><strong>Defense Deviation</strong></th>
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<td><strong>Discipline</strong></td>
<td>1) There is no strategic plan against which to budget.</td>
<td>1) Develop a strategic plan for defense sector with involvement of the legislature and all relevant portions of the executive branch; review and update this plan periodically.</td>
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<td>2) The defense sector is allowed to avoid hard fiscal restraint through supplementary budgets, expenditures without reference to an existing strategic plan.</td>
<td>2) Develop defense budgets based on resource availability rather than perceived needs, especially within a medium term framework.</td>
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<td>3) The defense sector receives preferential treatment in releases of financing.</td>
<td>3) Develop mechanisms within the executive branch to promote adherence to hard budget restraints, with transparent rules for any reallocation during the budget year.</td>
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<td>4) The procurement of defense materiel is carried out in a non-transparent, unaccountable manner, leading to losses due to corruption, over-pricing, procurement of in appropriate materiel.</td>
<td>4) Subject defense procurement to the same tender board approval processes as apply to other ministries.</td>
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<td>5) The defense sector maintains “ghost soldiers” on their books in order to increase personnel allocations.</td>
<td>5) Strengthen the capacity of the external auditors to audit defense expenditure and enforce sanctions for inappropriate behavior.</td>
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<td>6) Strengthen the ability of the external auditors to conduct “value for money” audits, especially for defense procurement.</td>
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<td>7) Require the defense sector to undertake actions to improve the efficiency and effectiveness of resource use – internal audit, tracking studies, evaluation, establish inspector general role.</td>
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<td>8) Ensure that the armed forces have adequate capacity to control expenditure; apply the same standards of accounting and audit to the armed forces as to other government bodies.</td>
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<td>Legitimacy</td>
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| Policy makers who can change policies during implementation must take part in and agree to the original policy. | 1) There is no strategic plan for defense against which to budget.  
2) The defense budget is determined separately from budgets in other sectors.  
3) The defense budget is subjected to limited scrutiny during budget formulation because of the expectation that it will be favorably treated during budget execution. | 1) Ensure that defense policies and funding to be debated within cabinet alongside all other demands on the budget.  
2) Develop a strategic plan.  
3) Develop and make public as appropriate (in terms of national security) information on the costs and performance of the defense sector. |
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| **Flexibility** | Decisions are pushed to the point where all relevant information is available. | 1) Within the military, operational decision making is held at too high a level (usually reflecting hierarchical nature of military).  
2) Defense minister/ministry has much greater latitude vis-à-vis other ministries over the use of resources, with limited requirement to disclose how resources are used to the ministry of finance, the legislature or the public.  
3) Defense minister/ministry is by-passed by the president or military brass on decisions regarding defense sector.  
4) Bureaucrats in the defense ministry have inadequate authority over expenditure decisions. | 1) Review decision-making authority and place it more in line with this principle, in support of strengthening military capability.  
2) Make available information on costs and performance of the defense sector.  
3) Strengthen internal audit and create inspector general role to assure proper use of flexibilities.  
4) Strengthen the process of external audit and enforce penalties on misuse of funds. |
| **Predictability** | There is stability in macro and strategic policy and funding of existing policy | 1) There is no strategic plan for defense to discipline budget allocation.  
2) The defense sector receives preferential releases in resource-constrained environments.  
3) The defense sector has access to off-budget funds.  
4) The full cost of procuring defense materiel is consistently understated.  
5) At the other extreme, the defense sector faces unpredictability in its resourcing because it is seen to be low priority. | 1) Develop a strategic plan.  
2) Establish priorities, and allocate resources accordingly, during budget formulation.  
3) Develop and implement a process for determining how resources will be allocated when there are financing shortfalls during the budget year.  
4) Bring all expenditure and revenue on-budget.  
5) Take into account life-cycle costs of defense materiel when procurement decisions are made. Existence of some form of MTEF is necessary for this to be effective. |
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<td><strong>Contestability</strong></td>
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<td>All sectors compete on an equal footing for funding, with the same principle applying within sectors.</td>
<td>1) Defense does not have to compete on an equal footing with other sectors during budget formulation. 2) The defense sector is able to make bilateral deals with the finance minister. 3) The defense sector has a direct line to the cabinet/president. 4) Portions of defense spending are concealed in other portions of the budget 5) The defense sector has access to off-budget revenue 6) Extensive commercial-type activities are not subject to any competition or assessment as to their efficiency.</td>
<td>1) Ensure that defense competes with other sectors for priority and funding during the budget formulation process. 2) Enforce principle of comprehensiveness. 3) Create a unit within the finance ministry to analyze defense programs. 4) Show all defense expenditure in the budget, including materials provided in-kind and off-sets. 5) Test defense activities to see whether they might be more efficiently delivered by the not-for-profit or private sector.</td>
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<td><strong>Honesty</strong></td>
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<td>The budget is derived from unbiased projections of revenue and expenditure.</td>
<td>1) Defense expenditure and revenue are off-budget 2) Ghost soldiers inflate defense spending. 3) Concealing personnel costs in non-defense ministries minimizes level of defense spending. 4) Life-cycle costs of defense materiel are not included in budget estimates.</td>
<td>1) Increase comprehensiveness of defense budget expenditures and revenue. 2) Accurately classify expenditure to its sector. 3) Take into account life-cycle costs of defense materiel when procurement decisions are made. 4) Strengthen the process of external audit and enforce penalties on misuse of funds. 5) Create an Inspector General role in the defense sector.</td>
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### PEM Principle | Defense Deviation | Remedy
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**Information**<br>A medium-term aggregate baseline exists against which the budgetary impact of policy changes can be measured.<br>Accurate information on costs, outputs and outcomes is available.<br>1) Off-budget defense spending undermines accuracy of baseline.<br>2) Non-defense activities undertaken by defense forces are not clearly identified or costed.<br>3) An assessment of the actual or expected effectiveness of defense programs is not available or undertaken. (This can be confidentiality-driven.)<br>4) Assessments of operational efficiency are not available or undertaken. (This can be confidentiality-driven.)<br>1) Include all defense spending in budget figures.<br>2) Develop a strategic plan.<br>3) Identify and cost non-defense activities.<br>4) Evaluate programs.<br>5) Undertake tracking studies.<br>6) Undertake value-for-money audits.

**Transparency**<br>Decision makers have all relevant issues and information before them when they make decisions.<br>1) Defense expenditure and revenue are off-budget.<br>2) There is no strategic plan for defense.<br>3) Non-defense activities are not identified and costed.<br>4) Limited or no information is available on costs, outputs, outcomes of the defense sector.<br>5) Procurement systems are opaque; off-sets obscure the true cost of military equipment.<br>6) Finance ministry and legislature do not receive detailed information on the defense budget.<br>1) Bring defense expenditure and revenue on-budget.<br>2) Develop a strategic plan.<br>3) Identify and cost non-defense activities.<br>4) Develop information on costs, outputs and outcomes.<br>5) Publish budget appropriations and final accounts.<br>6) Encourage the ministries of defense and finance and relevant legislative committees to undertake defense expenditure tracking surveys.<br>7) Publish audited defense accounts.
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<th>PEM Principle</th>
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<td>Accountability</td>
<td>Decision makers are held responsible for the exercise of the authority provided to them.</td>
<td>1) Require that the defense budget be subject to the same process of preparation, implementation and audit as other sectoral budgets. Thus, for example, if non-defense sectors are subject to value-for-money audits, the defense sector should be as well.</td>
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<td>1) The finance ministry and legislature are uninformed about some or all of the details of the defense budget and are unable to scrutinize or monitor the defense sector.</td>
<td>2) Require that the legislature receive detailed defense budgets in a timely fashion so that they are able to debate their contents prior to the beginning of the fiscal year.</td>
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<td>2) The external auditors are prevented from auditing the defense sector.</td>
<td>3) Ensure that the armed forces have adequate capacity to control expenditure; apply the same standards of accounting and audit to the armed forces as to other government bodies.</td>
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<td>3) Financial management within the armed forces is inadequate, making it impossible for the defense ministry to oversee defense expenditure.</td>
<td>4) Encourage the ministries of defense and finance and the relevant legislative committees to undertake defense expenditure-tracking surveys.</td>
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<td>4) The head of state or government routinely bypasses established process in the defense sector.</td>
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1. Defense budgeting specialists consulted in the course of writing this report have consistently observed that there should be little difference between public expenditure management in general and public expenditure management in the defense sector. In line with this view, they have taken the position that defense procurement should adhere to the same principles that guide public sector procurement in non-defense areas: fairness, impartiality, transparency, cost-effectiveness/efficiency, openness to competition. Additionally, it is essential that there be high-level consultation and evaluation of all major procurement projects for all forms of public sector procurement.

2. At the same time, defense budgeting specialists have noted that – with the exception of procurement of works and commodities (such as construction, clothing, food, fuel, office equipment, general vehicles and consultancy services) – defense procurement does exhibit some distinctive characteristics. These relate to: 1) the relative importance of cost in determining which bid is accepted; 2) confidentiality related to national security considerations; 3) time frame for major weapons procurement; 4) complexity of defense procurement; and 5) the existence of international arms control treaty regimes and national legislation governing arms procurement. These distinctive characteristics are deviations in scale rather than principle. As explained in paragraph 14 of this report, adequate levels of confidentiality can be maintained without violating basic public expenditure management principles. There certainly should be skepticism about any claims that procurement of relatively standard works, services, and commodities for defense should be subject to different rules.

- **Cost considerations in bidding.** While standard procurement practice in non-defense sectors is giving increasing emphasis to value-for-money considerations, defense analysts argue that cost considerations are more frequently not the major factor in accepting a bid for weapons procurement projects than for projects in non-defense sectors. They point out, however, that national legislation can play an important role in regulating the role that cost plays in procurement processes in the defense sector. In South Africa, for example, the Defence Review ([www.mil.za/Articles&Papers/Frame/Frame.htm](http://www.mil.za/Articles&Papers/Frame/Frame.htm), click on “Defence Review ‘98”) and the White Paper on Defence Related Industries ([education.pwv.gov.za/Legislation/White_Papers/Defence.htm](http://education.pwv.gov.za/Legislation/White_Papers/Defence.htm)) spell out which technologies are considered...
“strategically essential capabilities” and thus exempt from lowest-cost considerations. The South African Parliament has approved both policy documents.

- **Confidentiality.** Transparency in defense procurement must be limited by national security interests. Confidentiality clauses will be required in the defense procurement process. This too can be regulated by national legislation. The South African Defence Review lists a number of reasons for confidentiality in defense procurement. These include: the protection of third party commercial information, the national security of South Africa, harm to South Africa’s ability to conduct international relations, and the protection of South Africa’s economic interests and commercial activities of government bodies.

- **Time frame for major weapons procurement.** From inception to final acceptance of product, procurement of major weapon systems may take as much as 15 years. Some flexibility needs to be built into the procurement process to take account of contingencies such as fluctuations in currency exchange rates. This long time frame also makes quality control throughout the procurement process essential, rather than when the product is ready for delivery. Defense procurement projects should also take into account full life-cycle support to and cost of the acquired systems. The long time frame also makes it essential to attempt to forecast spending farther into the future than in non-defense sectors. The UK, for example, has a 10-year “Long Term Costing” system for defense.

- **Complexity of defense procurement.** Due to the complexity of defense procurement, sound management of the defense procurement process requires interdisciplinary project teams. Such teams should contain expertise on engineering, resource management, contracting, quality assurance and design assurance. Additionally, because of the complexity of the procurement process for major weapon systems, which involves a substantial number of subcontractors, opportunities for corruption are particularly great. These projects therefore require the highest level of management and scrutiny by governmental accountability mechanisms. South Africa has three levels of approval for major arms acquisition projects within the South African Department of Defense. For major projects, parliamentary approval may also be required.

- **Existence of international arms control treaty regimes and national legislation governing arms procurement.** General government procurement is not subject to this sort of international and national legislation. Some defense budgeting specialists suggest that such national and international regulation increases transparency due to associated oversight mechanisms.

3. Finally, one issue requiring particular attention in the defense sector is that of off-sets. As the box below demonstrates, the term “off-sets” covers a variety of arrangements. As a 1986 US General Accounting Office study\(^2\) noted, military offsets have a number of objectives.

   Military sales between U.S. corporations and foreign countries continue to be negotiated not only on the basis of cost and military effectiveness, but also on the acceptance of corollary agreements designed to offset the purchase price.

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Foreign countries have increasingly required "offsets" when buying U.S. military equipment to enhance their own employment, technical knowledge, and production capacity.

Even where the primary objective is to gain technical knowledge or enhance production capacity rather than to reduce the purchase price, the gross cost of any acquisition or procurement must be specified.

**Box A3-2. Definition of Offset Elements**

“Although the terms of the offset on individual contracts may vary substantially and a contract may call for more than one kind of offset, offsets can generally be grouped into the following types:

**COPRODUCTION**

"Overseas production based upon government-to-government agreement that permits a foreign government or producer to acquire the technical information and know-how to manufacture all or part of an item of U.S. equipment. It includes government-to-government licensed production. It excludes licensed production based upon direct commercial arrangements by U.S. manufacturers.

**LICENSED PRODUCTION**

"Overseas production of all or part of an item of U.S. equipment based upon transfer of technical information and know-how under direct commercial arrangements between a U.S. manufacturer and a foreign government or producer.

**SUBCONTRACTOR PRODUCTION**

"Overseas production of a part or an item of U.S. equipment. The subcontract does not involve license of technical information or know-how and is usually a direct commercial arrangement between the U.S. manufacturer and a foreign producer.

**OVERSEAS INVESTMENT**

"Investment arising from the offset agreement, taking the form of capital invested to establish or expand a subsidiary or joint venture in the foreign country.

**TECHNOLOGY TRANSFER**

"Transfer of technology occurring as a result of an offset agreement that may take the form of: 1. Research and development conducted abroad. 2. Technical assistance provided to the subsidiary or joint venture of overseas investment (see below). 3. Other activities under direct commercial arrangement between the U.S. manufacturer and a foreign entity.

**COUNTERTRADE**

Purchase of goods and services from the buyer country as a condition of the offset agreement, excluding purchases under coproduction or licensed or subcontractor production. These purchases may be made by the U.S. government, the U.S. contractor, the contractor's suppliers, or by third parties with whom the contractor acts as a middleman. The purchase may involve products for defense or civil use.

ANNEX 4

QUESTIONS FOR THE MINISTRY OF DEFENSE
FEDERAL REPUBLIC OF YUGOSLAVIA

1) Please describe the current Ministry budget formulation process, including.
   a. How costs are estimated (process and methodology), including personnel, material, capital, etc.
   b. How new programs or policies are costed and included in the budget?
   c. A chronology (timeline) of the process, including the key roles of organizations at each stage of the process.

2) Please describe the financial management structure in the Ministry.
   a. Is there a budget office in the Ministry of Defense? How many staff does it have?
   b. How many subordinate spending units are there (second and third-line users)?
   c. What type of guidance or instructions are issued to subordinate budget users for budget development? Are methodologies prescribed?
   d. When the Ministry receives the budget requests from users, what type of analysis is done of the requests? What types of explanations or justifications are provided? Does the Ministry change the request before sending to the Ministry of Finance?
   e. Are the multi-year implications of spending decisions taken into account in formulating the request?

3) What types of analysis or justifications is provided to the Ministry of Finance in support of the Ministry of Defense budget request? Are objective measures of output or performance included in the materials?
   a. Are discussions between the Government and Ministry of Finance and the Ministry of Defense regarding the Ministry of Defense budget request based on policy and output issues as well as total Government finance constraints, or only total finance constraints?

4) Does the Ministry of Defense budget request to the Ministry of Finance include Ministry own-revenues (revenues generated from fees or charges, ownership of productive enterprises, land ownership, asset sales or rentals, surplus equipment sales)?
   a. What is are the volume of own revenues for 2000, and estimate for 2001 and 2002?
   b. How many productive enterprises are owned by the Ministry or its subordinate budget users (hotels, construction, manufacturing, etc.)?
   c. If own revenue are not in the budget, how does the Ministry control and use such funds?
   d. How are these funds accounted for? Are they deposited in Ministry accounts, or budget users accounts? What types of reports does the Ministry receive on budget user own revenues and how frequently does it receive them? How does the Ministry assure budget users do not spend more than is available from own revenues?
e. Please provide a table of own revenue application by object of expenditure (salaries, materials, contracts, etc.).

5) Please describe the budget execution process in the Ministry.
   a. How are budget resources made available to subordinate budget users?
   b. How does the Ministry make sure subordinate users spend only budgeted amounts and for the appropriate purpose? What reporting and control arrangements are in place within the Ministry?
   c. How does the Ministry assure invoices are accurate, and appropriate number and quality of goods and services have been received, prior to payment?
   d. How is cash in the Ministry 637 accounts managed?
   e. If a subordinate budget user spends more funds than was budgeted, what internal Ministry disciplinary procedures are exist? Have these been applied within the last 2 years?
   f. Does the Ministry have its own budget inspectors?
   g. After the budget is passed by Parliament, how does the Ministry prepare its financial plan for the quarter?

6) We understand the Ministry of Defense and its subordinate budget users have arrears (expenditures, where goods or services have been received, in excess of available cash). What is the source of the arrears? How large are the arrears (200, estimates for 2001)? What steps is the Ministry taking to reduce or eliminate the arrears?

7) Does the Ministry of Defense provide regular in-year reports on spending to the Ministry of Finance? How frequently?
   a. How frequently does the Ministry receive reports on spending from subordinate budget users?

8) If the Ministry of Defense realizes adjustments to its budget may be necessary, what is the process for preparing requests for changes to the Ministry of Finance? If these are not approved, how does the Ministry of Defense adjust its own spending to meet its budget target?

9) How frequently does the Ministry of Finance transfer cash to the 637 account of the Ministry? Are monthly transfers made, or only transfers as requested by the Ministry?
   a. If less cash is transferred than requested or expected, how does the Ministry handle the shortage? Does the Ministry have established priorities for payment (e.g. pensions first, then salaries, then contracts to suppliers)?

10) Does the Ministry have a separate procurement or contract management office?
   a. What percentage of contracts are competitively bid?
   b. Does the Ministry use a tender board to evaluate bids?
   c. What percentage of contracts are cost-plus and what percentage fixed-price?
   d. Does the Ministry use formal contracts for all its purchases (including utilities)? What percentage of purchases (dinars) are made without formal written contracts?
11) Please describe the inventory and asset management function of the Ministry and its subordinate users.
   a. What are the safeguards against non-operational loss or theft of inventory or assets?
   b. Is there a formal mechanism for asset or surplus inventory sales? How are the proceeds of such sales accounted for?

12) Does the Ministry or its subordinate users issue guarantees to enterprises? Does the Ministry regularly maintain a register of such guarantees? What is the estimated dinar value of guarantees for 2001?

13) Does the Ministry maintain its own foreign exchange accounts? What is the estimated amount of such accounts for 2001?

14) Does the Ministry maintain a register of financial assets and liabilities? Does the Ministry own shares of domestic or foreign enterprises? What is the value of such shares? How frequently are reports on financial assets provided to the Ministry of Finance?

ANNEX 5

CHECKLIST TO ASSIST IN IDENTIFYING SECURITY AND DEVELOPMENT AND DEFENSE RESOURCE SPECIALISTS

Background

Work on the defense sector will be based on the proposition that the process of managing the defense budgeting process should be guided by the same principles of public expenditure management as the non-defense portions of the public sector. There are two broad areas that may require strengthening in order to achieve this objective. The first are the government-wide public expenditure management systems and processes. The second are the systems and processes internal to defense which affect the efficiency and effectiveness with which defense-sector resources are used and the level and composition of defense budgets. In a well-functioning, integrated government, the internal systems and processes are quite tightly linked with the government-wide systems and processes. Donors have different competencies and mandates and these affect the ability of any individual donor to provide the full range of assistance to strengthen a government’s capacity to manage its defense sector according to PEM principles and practices.

When deciding to engage in the defense sector, a donor can develop collaborative relationships with other donors with different competencies and/or decide to supplement its public expenditure management capacity with security and development or defense resource specialists. The value of such specialists may go beyond the need to supplement expertise or limitations imposed by the organization’s mandate. Having one or both of them as part of a donor team (depending on country circumstances) may also make key national stakeholders, particularly the defense forces, more confident that their interests will be acknowledged and addressed and therefore more likely to collaborate fully in donor-sponsored activities.

Potential Tasks

There are at least five broad areas where security and development and defense resource specialists could provide value-added:

1. Assessing the extent to which the defense sector is part of the government-wide PEM system and process for budget preparation, execution, and monitoring (including contracting and procurement).
2. Advising on gaps between the government-wide process and system and the defense sector and on how to close those gaps.
3. Assessing budget preparation, execution, and monitoring systems and processes internal to the defense sector.
4. Advising on policies and programs to achieve objectives to strengthen internal systems and processes.

In addressing these questions, it will be helpful to have as background analyses of: 1) the defense sector’s role in the political and economic systems of the country; 2) domestic civil-
military relations (including the legislature and civil society); 3) capacity of civil authorities to carry out their mandated control and oversight roles; 4) regional security dynamics; and 5) the strengths and weaknesses of any past efforts to strengthen the management of the defense budgeting process.

Requirements

Depending on the specific task at hand, the security and development or defense resource specialist should have a critical mass of the following characteristics:

1. The capacity to analyze defense/administrative issues both in general and in specific areas such as procurement, human resource management, and strategic assessment.

2. The capacity to analyze the armed forces (official policies, involvement in economic and political systems, civil-military relations, adherence to rule of law) from a broad development perspective.

3. The ability to identify similarities and differences between the defense sector and the rest of government and to be able to articulate the reasons for these.

4. An appreciation of the broad geopolitical/strategic aspects of defense.

5. A sound understanding of the roles, organization and rationale of armed forces.

6. An understanding of and sympathy for military/defense culture.

7. An appreciation of the different methods of implementing sound PEM principles in the defense sector.

8. Sensitivity to cultural differences.

9. Professional training in defense/security management/development at university level and/or defense staff college.

10. Professional experience in the armed forces or as a civilian employee in a defense (or related) department.

11. Professional experience facilitating interactions among members of the armed forces, key executive branch officials (such as national security advisers, ministry of defense and finance, auditors general), legislators and civil society representatives.

12. An appreciation of modern defense equipment and its capabilities.

13. Good interpersonal skills; the ability to deal at all levels (President to junior officer) in the military and in the civil service; flexibility; patience.
ANNEX 6

PROCESS FOR CONDUCTING STRATEGIC DEFENSE REVIEWS AND DEVELOPING DEFENSE POLICY FRAMEWORKS

Consultation/Information
Depending on the issue under consideration, input may be sought from:
- Ministry of finance
- Other ministries not directly involved in the review process
- Legislators
- External expert review panels
- Armed forces
- Informal groups of experts from academia, industry, policy community, interest groups
- Relevant civil society organizations
- Members of the public

Non-defense Security Policy Process
Including civilian intelligence, criminal justice system, customs and so on

Decision and Scrutiny by Relevant Executive/Legislative Bodies

Assessment of Options

Force Structure Options within Context of Financial Parameters
Including force structure, materiel/procurement, end strength, infrastructure, readiness

Military Tasks and Force Development

Defense Policy Framework
Fundamental values
National interests (vital interests, strategic interests)
Legal basis of defense policy (domestic and international)
Foreign policy objectives

Security Environment/Strategic Assessment
Domestic, regional, international environment
National commitments
Potential risks/challenges

Publications
Policy Paper/White Paper
Strategic Review
Background Papers

Economic Policy Framework
Including national development objectives, defense budgeting process (see flowchart on page 22)

Guidance on Review Process
Overall policy direction
Issues to be addressed
Fiscal framework
Required consultations
Due date