

Financial Management in Defence: Macro Issues

Amit Cowshish

Financial management is all about raising the requisite resources and applying them in the most judicious manner to achieve the pre-determined objectives of an organisation in accordance with a carefully crafted business plan. The objectives are set out collectively by the top management after intense deliberations and there is continuous review of performance to ensure that the organisation remains on course. These fundamental principles of financial management are applicable as much to the governmental organisations as to the private business enterprises, though the manner in which they are applied may be different. On all these counts, financial management poses a challenge in defence.

The starting point of any enterprise or organisation is its *raison d'être*. This, when expressed in terms of goals, becomes the focus of long-term planning and short-term strategies to achieve those goals. What is important at all stages of planning and strategising is an accurate assessment of the financial resources required for achieving the objectives, and where those resources will come from. This regimen is almost absent in defence planning in India. This, arguably, is the biggest – though not the only—challenge in financial management in defence.

To begin with, there is no overarching structure in the Ministry

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of Defence (MoD) which could prepare a plan covering all the Services and departments under the administrative control of the ministry. Therefore, the plans, such as they are, are fragmented. The Services have their 15-year Long-Term Integrated Perspective Plans (LTIPPs), 5-year Defence Plans and Annual Plans covering a few selected activities, such as capital acquisition and works. The Coast Guard has a separate plan. The Ordnance Factory Board (OFB) has its own plans and so does the Department of Defence Research and Development (DDR&D). Other organisations and establishments, such as the Military Farms or the Directorate General of Quality Assurance (DGQA), either do not have a plan or their plans are subsumed in the aforesaid plans. It is not an efficient way of planning because the financial advantages that could accrue from synergy and jointness among all the constituents of the defence establishment are lost in this fragmented approach to planning.

At a more fundamental level, the problem with defence planning is related to the objectives of the plans, the assumptions on which the plans are prepared and the methodology adopted for planning. In the absence of the national security objectives and strategy, the Defence Minister's Operational Directives serve as the immediate guide for planning. In the run-up to the 12th Defence Plan (2012-17), the Services were asked whether these directives were a good enough basis for planning. They all said that they were. While it may be true, not only in relation to the 5-year Defence Plans but also the 15-year LTIPP, it is extremely doubtful if these directives can serve as the loadstar for planning by all other constituents of the MoD, including the OFB and the DDR&D. This leaves everyone free to decide the objectives, which may or may not be congruent with the ultimate goal of maintaining the highest level of defence preparedness.

This uncoordinated approach to planning is compounded by the unrealistic assumption regarding the availability of funds. Let us take

the plans related to the armed forces. Broadly speaking, there are three sets of assessments on which the plans are based: the threat perception, the capabilities required to meet the security challenges and the financial resources required for acquitting those capabilities. Assuming that the existing system of making these assessments is perfect, the resultant plans would also be perfect. But all these perfect plans run into difficulty on account of the actual availability of funds.

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It is generally believed that the LTIPP 2012-27 is based on the assumption that the defence allocations would equal 3 per cent of the Gross Domestic Product (GDP) throughout the 15-year period. That has never happened in the past two decades or even more. It is one thing to include in the plan all that is required to meet the perceived threats regardless of what it might cost, but if the requirement is to be curtailed on financial considerations, such curtailment has to be in accordance with a realistic assessment of the funds likely to be available during the plan period.

This problem manifests itself in a more pronounced manner when the 5-Year Plans are carved out of the 15-Year Plans. In fact, the mismatch between the projections – assuming that the costing of all the programmes and activities is fairly accurate – and the availability of funds has been the bane of practically all the 5-Year Plans. The 9th 5-Year Defence Plan (1997-2002) was approved by the Cabinet Committee on Security (CCS) in December 1997 after the initial projections made by the MoD were cut down by about 23 per cent. The 10th Plan (2002-07) remained under discussion between the MoD and the Ministry of Finance (MoF) till the third year of the plan period when an agreement was reached between the two ministries on an overall figure. Needless to say, it was much lower

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than the initial projection. The disagreement between the two ministries on the size of the 11th Plan (2007-12) could never be resolved. The efforts were abandoned in the third or the fourth year of the plan. The projection for the 12th Plan (2012-17) is also believed to be much higher than the funds likely to be available.

The whole issue boils down to the wisdom of planning without taking into account the funds likely to be available during the plan period. The notion that there is no indication of the funds likely to be available during the plan period is not quite correct. For the 10th and 11th Plans, the MoF did indicate the growth rates that could be assumed for the purpose of planning. For the 12th Plan, the MoD itself laid down the limit. However, none of these plans adhered to the indicated limits. The choice is between preparing defence plans which do not take due cognisance of the likely availability of funds, on the one hand, and preparing them on the basis of what is perceived as the inescapable requirement, irrespective of the financial implication, on the other. If the plans are to be prepared based on what is perceived as the inescapable requirement irrespective of its financial implication, ways and means will have to be found to bridge the gap between projections and requirements.

The needlessly excessive secrecy about defence planning prevents any informed discussion on various aspects of planning, starting with the threat perception itself. It is doubtful if during the process of planning, different alternatives are evaluated from the financial point of view before deciding what capabilities are required or what other activities need to be undertaken during a particular plan period. The techniques adopted for costing of programmes and activities are quite rudimentary, resulting in

the estimates being completely off-the-mark in a number of cases. The secrecy shrouding the planning process also prevents any outside professional help. All this is in contrast to how the national plans are prepared by the Planning Commission. Perhaps the time has come to consider seriously the need for setting up a Defence Planning Board on somewhat similar lines.

Financial Management in Defence

The second macro issue related to financial management in defence is an offshoot of the larger issue of defence planning. The effect of the 15-Year and 5-Year Plans being formulated without taking into account the funds likely to be available for executing the plans is felt at the time of formulating the annual budget. At least in theory, the annual requirement of funds is worked out on the basis of what is envisaged in the relevant 5-Year Plan. Therefore, this too reflects a disconnect between the projected requirement and the likely availability of funds. This has been a perennial problem for the past several years.

This problem is dealt with in a routine manner every year. The requirement is assessed by the Services and the other departments in whichever way they choose to do. The MoD issues no guidelines to them to ensure that there is a commonality of approach, the same techniques are employed for assessing the requirements, and the projections conform to the likely availability of funds. The requirements projected by the Services and other departments are aggregated in the MoD and conveyed to the MoF. Everyone is in a perennial race against time because the defence budget has to be incorporated in the union budget and the presentation

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of the union budget cannot be postponed. There is hardly any scrutiny in the MoD, not just because of the paucity of time, but mainly because there is no annual plan document against which the projected requirements could be benchmarked. The only possible exception is the requirement on account of capital acquisitions.

There are no common databases which could be accessed for making the estimates as accurate as they should be. The total requirement projected to the MoF is almost always higher than what can reasonably be expected to be allocated. The budgetary ceilings fixed by the MoF are always vehemently contested till the matter cannot be delayed any further, keeping in view the timetable for presentation of the union budget to the Parliament, of which the defence budget is a part. The allocation made by the MoF is then distributed by the MoD to the Services and other departments with the direction to prioritise their requirements and decide how much should be allocated under different budget heads. The Services and other departments protest but have no option but to fall in line. A promise is made that efforts will be made to get more funds at the revised estimate stage. After the presentation of the budget, there is a hue and cry about the inadequacy of the defence budget. The Parliamentary Standing Committee on Defence raps the MoD for the inadequate allotment to the Services. And then it is business as usual.

All this is anathema to efficient financial management. As it is, there is lack of clarity about the annual targets, against which the achievements could be measured at the end of the year. On top of it, the MoD does not get involved in allocation of funds under different budget heads by the Services and departments. It is difficult to unravel the mystery of how the priorities

are reset or, to use a cliché, how do the Services and departments actually ‘reprioritise’ to be able to cope with the allocation that is far lower than the projected requirement? No questions are asked and no explanations are given about the impact of this reprioritisation because the consequences that follow could be a matter of concern. Inevitably, the focus shifts to utilisation of the budget rather than achieving any pre-determined targets.

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It is necessary to digress from the main theme to highlight the possible consequences of this bugbear of financial management in defence. The defence budget is divided into the revenue and capital segments. Under the revenue segment, more than two-third of the budget is spent on pay and allowances. This expenditure is absolutely inescapable. The remaining one-third of the budget is spent on rations, clothing, fuel, transportation, ammunition, spares, other ordnance stores, maintenance of buildings and miscellaneous activities. Much of this expenditure related to rations, clothing, fuel and transportation is also inescapable. Therefore, the effect of scarcity of funds inevitably gets passed on to procurement of ammunition, spares, other ordnance stores and maintenance of buildings. Most of this expenditure has a direct bearing on operational preparedness, which takes a beating because of inadequate allocation of funds, though this is not the only factor that affects operational preparedness.

The capital budget has not faced a similar problem so far. Approximately three-fourth of the capital budget is spent on capital acquisitions. Let us, therefore, focus on the capital acquisition portion of the capital budget. With the capital acquisitions picking up in the recent years, the committed liabilities are increasing. Consequently, it is possible that in future, the allocations would be barely sufficient to meet the committed liabilities with no, or totally inadequate, funds left for undertaking any new acquisition programmes. Thus, the inadequacy of allocation under

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the capital segment too could also have adverse implications for defence preparedness in the future.

This scary scenario is the subscript of a process of planning that does not take due cognisance of the finances likely to be available for executing the plan. However, there is a vital difference between the larger issue of long-term planning and the management of the annual budget. While the former has no immediate effect, the latter could result in sub-optimum utilisation of the scarce budgetary allocations in the absence of a well thought-out fallback plan. Since it is known beforehand that the annual allocations would invariably be less than the projected requirement, there is no reason why a fallback plan should not be in place to cope with the situation and make best use of the financial resources. The choice really is between ensuring that the budget is utilised in any manner possible and making best use of it to achieve pre-determined targets within the resources made available, however inadequate these might be.

Application of Funds

The third macro issue relates to efficiency in application of funds or, to put it plainly, in spending the money. There are many questions related to it. Is the money being spent for a legitimate purpose and relatable to expected outcomes? Is the procedural propriety being observed? Are there any leakages and wastages in the system? While all these issues are related to micro management of expenditure, the answer to these, and many other similar questions, depends on the soundness of the systems and procedures that govern expenditure and the robustness of the audit and oversight mechanisms.

Most of the expenditure is incurred as per authorisations, scales, standing orders and instructions. Where these do not exist, special sanctions are accorded. The authorities competent to approve the expenditure proposals are specified and so are the authorities competent to sanction the actual expenditure. [These two authorities are not always the same. For example, the authority to approve a capital procurement proposal beyond Rs 100 crore is the Defence Acquisition Council's but the authorities to accord sanction for signing the contract are the Defence Minister (up to Rs 500 crore),

the Finance Minister (up to Rs 1,000 crore) and the Cabinet Committee on Security (beyond Rs 1,000 crore).] The financial powers related to revenue procurements are exercised with the concurrence of the Integrated Financial Advisers (IFAs), though, in some cases, expenditure can be incurred without financial concurrence up to the specified limits. The procedure to be followed for procuring goods and services and execution of civil works is laid down. The payment is made in some cases by the Services and other departments and by the Defence Accounts Department (DAD) in the rest. All expenditure, regardless of who makes the payment, is compiled by the DAD into monthly and yearly accounts.

There is nothing seriously wrong with this basic architecture but there are certain issues which need to be addressed for bringing about greater efficiency in expenditure management. The most important of all these aspects is related to the procedures to be followed while incurring the expenditure. Approximately 85 to 90 per cent of the defence budget is spent in accordance with the procedure laid down in the Defence Procurement Procedure (DPP), Defence Procurement Manual (DPM)

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and Defence Works Procedure (DWP), which govern capital acquisitions, procurement of goods and services from the revenue budget and execution of civil works respectively. It is an open secret that there are time and cost overruns in practically all acquisitions, procurements and civil works projects, for which the blame is promptly passed on to the complexities of the existing rules and procedures.

The MoD has been making efforts to keep the procedures abreast of the changing requirements. The DPP was first brought out in 2002 and has since then been amended several times. The latest 2011 version is again being reviewed. The DPM has also been amended several times and the latest 2009 version (to which a supplement was brought out in 2010) has also been under review for some time. The DWP has, however, not undergone such frequent changes as the DPP and the DPM; it was last revised in 2007. The perception about these being complex, or even archaic, is so widespread that it overshadows the efforts being made by the MoD to keep them in tune with the changing requirements. Ironically, those who take such a dim view of the MoD's efforts have not really come up with concrete suggestions that would help in refining the procedures with a view to preventing time and cost overruns.

The problem perhaps lies not in the procedures being complex or outdated but in the fact that there is no permanent mechanism in the MoD for receiving continuous feedback from those who are affected by these procedures, especially those who are outside the government, and acting promptly on such feedback. The DPP and DPM have been under review for more than a year. The problems have to be addressed as soon as they arise. It would do a lot of good if the MoD opens its website to continuous feedback and suggestions from the general public and takes prompt action on this input either by creating a permanent cell in the ministry or through consultants.

There is some apprehension that the Public Procurement Bill, 2012, might override these procedures once it is enacted. There was a view

within the MoD that the ministry should be exempted from the purview of the Bill. These apprehensions are misplaced. There is a need for greater discipline in spending the money and it will do no harm if the MoD also follows that discipline. In so far as the question of continued validity of these procedures is concerned, there is no doubt that these will survive the enactment of the Bill. Clause 60 of the Bill provides that “all rules, regulations, orders, notifications, etc., relating to procurement of goods, services or works provided for in the proposed legislation, which are in force on the date of commencement of the

proposed legislation, shall continue to be in force to the extent they are consistent with the provisions of the proposed legislation, until they are repealed or superseded by any rule, guideline, notification or order made or issued under the proposed legislations”. The MoD, therefore, needs to remain focussed on improving the systems and procedures, get inputs from those outside the system and hasten the process of ongoing reviews.

The second aspect that has a bearing on expenditure management is the scheme of delegation of financial powers. The purpose of delegation of power is that a functionary responsible for a particular activity should also have full authority to spend the budget to achieve the specified targets. But that is not the basis on which the financial powers are delegated. The officer managing a workshop, depot or dockyard, for example, does not have full financial powers to discharge the responsibility assigned to him. This is not an efficient way of managing the finances. Full financial powers should be delegated to a functionary so that he may discharge the responsibility entrusted to him without having to seek sanction from

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higher authorities to carry out a part of the work entrusted to him if the cost of that work is beyond his financial powers. Apart from being cost-effective, delegation of full powers commensurate with the responsibility would bring in greater accountability, provided such delegation is accompanied by an effective oversight mechanism and outcome appraisal. More on this will follow.

There is an important issue related to the exercise of delegated financial powers which merits attention. Except for exercise of financial powers for very low value transactions, the Competent Financial Authorities (CFAs) exercise the financial powers delegated to them

with the concurrence of the Integrated Financial Advisers (IFAs) who are officers of the Defence Accounts Department. At the higher levels, fairly senior officers of the Indian Defence Accounts Service function as the IFAs. These IFAs are often blamed for causing delay in processing of expenditure proposals. Keeping in view the fact that the CFAs have the authority to overrule the advice of the IFAs, this is inexplicable. Be that as it may, the IFA system requires to be reviewed to remove any misgivings that the CFAs or the IFAs might have about each other, as such misgivings are detrimental to the smooth functioning of a system that was introduced, as a part of the system of checks and balances, to bring in greater efficiency in expenditure management.

The third aspect concerning expenditure management is the sub-optimal use of Information and Communication Technology (ICT) for various finance and accounts related activities, including creation

of appropriate databases and generation of Management Information System (MIS) reports. While efforts have been, and are being, made in this regard by all concerned, these have largely been disjointed. For example, the Indian Navy launched a Financial Management System in the later part of 2012 but it did not have linkages with the DAD. Such initiatives should come from the DAD, which is the official book-keeper of the MoD.

There is no information or data about financial transactions related to defence, irrespective of where the finances come from, which does not flow into the DAD at some stage or the other. The department is, therefore, ideally placed to create a wide variety of databases not just for better financial management but also to facilitate more informed executive decision-making. It is also necessary that the expenditure is compiled on a real-time basis and the programmes are so designed as to provide access to decision-makers in the ministry, Services and other departments for generating MIS reports required by them, as and when they require these. This will eliminate the duplication of efforts and create authentic databases. This is eminently doable. The DAD had indeed undertaken an ambitious ICT project under the rubric of Mission Excel Information Technology (MEIT) about a decade ago but it was aborted midway. Since then, a number of stand-alone projects have been successfully implemented, such as the monthly payment of pay and allowances to the *jawans*, but this is no substitute for an all-encompassing payment, accounting and reporting system that could serve as the basic mechanism for efficient financial management in defence.

A comprehensive financial management system covering all the Services and departments, including organisations like the Coast Guard and the Border Roads Organisation which are not funded from the defence budget, will have numerous other advantages, apart from real-time accounting. It can be ensured through such a system that all recoveries and payments, whether related to serving personnel or third parties, are

made correctly and in time. It will also help in tracking the outstanding receipts and claims. The scope is, indeed, unlimited and there is no doubt that it will have a very positive impact on financial management.

Review, Oversight and Audit Mechanisms

The fourth macro issue concerns review, oversight and audit mechanisms. The policies that have financial implications must be reviewed periodically to see whether they need to be continued, discontinued or altered. The policy on stocking, turnover and disposal of ordnance stores is an example. The policy on procurement of vehicles from a state-run factory when the private industry can shoulder this responsibility very well is another example. The policy of deputing personnel for training and then not making use of the expertise they have acquired makes no sense. The practice of high-powered delegations going abroad for 'vendor identification' is inexplicable in this age of Information Technology (IT). There is no data on this but the teeth-to-tail ratio appears to be skewed with the tail wagging the master. This is inexplicable given the scarcity of officers and men to perform combat duties. The examples could be multiplied. While these examples may sound trivial when viewed in isolation, the totality of the expenditure that gets incurred in pursuance of these policies without commensurate advantages, is possibly quite substantial. There has to be a system of identifying the policies that impact the finances, and reviewing them periodically.

Identification of policies for review could be a difficult task but a different orientation in internal audit could automatically reveal areas warranting a close look. The DAD is responsible for carrying out internal audit of defence expenditure. However, the present system of internal audit, despite many changes that have been made in the past, is not geared to perform this task.

There are many problems with the existing system of audit. One, it is not concurrent. Two, it is focussed almost entirely on checking the

correctness of various types of accounts (cash, stores, rations, clothing, mechanical transport, etc.). Three, there is little room for what could be called performance audit or review. Four, it is not a high priority area in the DAD and there is little involvement of the higher level officers in the audit stream. Five, the quality of internal audit leaves much to be desired. It has not thrown up any substantive systemic issues or revealed serious transgressions. The results achieved are not commensurate with the deployment of manpower on this job. Lastly, little importance is accorded to the internal audit findings. What attracts public attention is not the internal audit report(s) of the DAD but the statutory audit reports of the Comptroller and Auditor General of India.

It does not really have to be that way. A three-pronged strategy could change the situation. One, a rapid transition to ICT-based audit would reduce the requirement of manpower presently deployed for carrying out the propriety audit manually, which could then be redeployed to carry out more important tasks. Two, a system of performance review or audit by middle and higher level officers could throw up substantive systemic issues for consideration by the MoD and the Services. Three, DAD must be asked to immediately commence the task of audit of sanctions, which it is mandated to perform anyway. The sanctions issued by the MoD should also be within the purview of such audit. Needless to say, the audit of sanctions will have to be concurrent and it would need to be carried out by, or under the supervision of, middle and higher level officers of the DAD. This may well turn out to be the most effective oversight mechanism.

One could argue that the MoD should resort to outcome budgeting to bring in greater transparency and accountability. Though it is formally exempted from preparing outcome budgets, the Standing Committee on Defence has been insisting that the MoD should prepare them. There are numerous problems in preparing an outcome budget for defence. The enormity of the budget and the manner in which it is distributed

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and utilised make it difficult to prepare a single outcome budget for the MoD. The problem is compounded because of the need to maintain confidentiality of information, the difficulty in fixing the targets in tangible terms and the difficulty in measuring all the outcomes. It would be almost impossible to prepare a single outcome budget for the MoD along with the expenditure budget because of the difficulty in

coordination with a large number of organisations which will have to provide inputs.

It might be possible to prepare a single outcome budget if all these issues are resolved but this would take a while. As an alternative to this, the MoD could identify certain organisations, such as the National Cadet Corps and the Military Farms, and certain programmes, projects and activities, such as the Married Accommodation Project, and ask the organisations concerned to prepare analytical annual performance appraisals related to their area of responsibility. This approach to performance appraisal could cover a large part of the defence establishment and the appraisal reports prepared by them could be a prelude to outcome budgeting in the long run. In the short run, however, these will serve as a useful tool for more efficient management of a substantial proportion of the defence budget.

Defence Expenditure and the Indian Economy

The fifth macro issue concerns the unrealised potential of the defence expenditure as a stimulus for the Indian economy. The defence budget is mainly an expenditure budget. Therefore, the conventional approach has been to secure adequate allocations from the MoF and contain the expenditure within the allocated funds. All the issues discussed above relate to this. However, there is another dimension of financial management which needs to be recognised. The allocation of funds for defence depends

on the state of the economy in a given year. The defence expenditure can contribute significantly to the economic activity by boosting the manufacturing and services sectors. The defence organisation would be doing itself a great service by providing this stimulus to the economy. There are three broad areas of unrealised potential: manufacturing, services, and Research and Development (R&D).

Each of these three areas needs a different treatment. Take manufacturing, for example. Despite all the policy pronouncements and procedural innovations, India continues to be dependent on import of the defence equipment and weapon systems. Its emergence as the largest importer has coincided with the rise of China as an exporter. Between 2002-06 and 2007-11, the volume of Chinese arms exports increased by 95 per cent. Though much of this rise is on account of increase in Pakistan's import from China, the fact remains that China now ranks as the sixth largest exporter of arms, closely trailing the United Kingdom.

While India may not be able to become a large exporter of arms in the near future, it can certainly reduce dependence on imports and encourage export of dual use equipment and small arms to the friendly foreign countries. This will provide a tremendous boost to the Indian economy, which could pave the way for higher allocations for defence. But for this to happen, it is necessary to create a congenial eco-system by addressing sector-specific issues relating to industrial licensing, taxation, foreign direct investment and exports. The other two areas, *viz.*, services and R&D require similar sector-specific treatment.

Conclusion

The perceptions about the defence budget being inadequate notwithstanding, it accounts for a substantial amount in absolute terms. The budget for 2013-14 might be 1.79 per cent of the GDP but it accounts for approximately 12.23 per cent of the total central government expenditure. Going by the average rate of growth during the past ten

years, the defence budget could cross US\$ 100 billion in the next ten years or so. The management of a budget of this size requires a better approach to financial management than has been the case so far. Planning, of course, takes primacy among all the macro issues. But that is not the only issue. Some other macro issues have been discussed in this paper; there may be many more. The MoD will do well to involve the think-tanks in identifying the issues that merit immediate attention and for recommending a strategy for putting in place an appropriate mechanism for financial management before it is too late.

