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Off-Budget Military Expenditure and Revenue: Issues and Policy Perspectives for Donors

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EXECUTIVE SUMMARY

1. This study is part of follow-up work to the February 2000 Security-Sector Reform and Military Expenditure Symposium organised by DFID. The central message of the symposium for donors was that a focus on how military budgets are arrived at is more important than levels of expenditure.
2. Off-budget military spending includes outlays that do not appear within the state budget or are disguised in non-defence budget lines and do not appear in a functional breakdown for defence.
3. Off-budget military spending is of concern to development agencies because it can threaten macroeconomic stability, undermine efforts to eradicate poverty and prevent conflict, and obstruct the development of democratic political systems operating under the rule of law.
4. This report addresses four central issues:
5. First, it identifies the most commonly mentioned mechanisms for funding the military off-budget (Boxes 3 and 4); explores the reasons for the prevalence of this problem; and identifies some of the challenges facing governments seeking to address the problem. The report argues that underlying problems of political governance exacerbated by an environment of insecurity and instability are critical both in understanding the nature of the off-budget problem and in responding to it.
6. Second, the report examines how off-budget military spending affects efforts to promote security and development. Off-budget military spending reduces the credibility of the overall budgeting process. It has potentially negative effects on macroeconomic stability and indebtedness because it makes sound economic management, including the targeting of inflation, more difficult. It also is one symptom of a political environment in which the armed forces are insufficiently accountable to civil authorities.
7. While it has not been possible to specify the scope of the problem in detail, this report concludes that it is more widespread than generally recognised. Off-budget spending will likely be a problem of some magnitude where:
 - There is a large, autonomous military sector;
 - The military are directly represented in political institutions;
 - There is a strong executive decision-making culture;
 - The government and/or the armed forces have access to income generated by natural resources;
 - There are significant security problems, including armed conflict;
 - A period of protracted war is coming to an end.
8. These conclusions are supported by a more detailed examination of four countries – Cambodia, Indonesia, Sierra Leone and Uganda – which drew upon information available either in the public domain or from non-UK government sources.
9. Third, this report considers the challenges facing the donors in addressing the problem of off-budget military spending and revenue. These include:
 - The risks associated with a ‘business-as-usual’ approach to public expenditure management.
 - The need to clarify the relationship between sensitivity of security-related information and the need for confidentiality.
 - The importance of avoiding unintended consequences of donor interventions.
 - The desirability of incorporating

supply-side approaches into efforts to reduce off-budget military spending.

10. The report concludes that the central issue is not about improving data collection so as to better hold governments to account for off-budget spending problems. While data collection and dissemination can be an empowering force for change, the priority for donors should be to help countries address the underlying governance problems that reduce transparency within the defence sector. This is a long-term challenge that will involve creating incentives for both militaries and governments to keep military spending on budget, strengthen fiscal policy and the management of the defence sector, and develop alternatives to military spending.
11. Finally, the report recommends a number of specific steps that the bilateral donors and the Bretton Woods institutions can take to address the off-budget military

spending problem within the broader governance framework for managing military spending introduced during the February 2000 meeting.

12. Specifically with regard to openings for bilateral development agencies and their governments, the report proposes that:
 - The Bank should be encouraged to incorporate the defence sector into public expenditure reviews, PRSPs, Medium-Term Expenditure Frameworks, and public-sector reform programmes.
 - Bilateral donors should provide information about problems in the defence sector to the World Bank and the IMF; encourage host governments to strengthen the management of the defence sector; and consider how effective assistance can be provided in this domain.

I. CONTEXT FOR STUDY

1. This study is part of follow-up work to the Security-Sector Reform and Military Expenditure Symposium hosted by DFID in February 2000. The central message of the symposium was that in seeking to help countries manage military expenditure more effectively, a focus on how military budgets are arrived is more important than levels of spending. From a governance perspective, what matters is that the same principles of accountability, transparency, comprehensiveness and discipline which apply to other portions of the public sector should also apply to the security sector, in particular the military¹.
2. One category of public spending that does not conform with any of these criteria is off-budget military expenditure. This issue is one aspect of broader problems of security-sector governance, but it merits special attention because of its potential negative implications for security and development.

Definition of 'off-budget' military spending

3. In this report, 'off-budget' covers two categories of military spending that do not conform to core governance principles: 1) military spending that is disguised within the budget under non-defence budget lines and is not included in a functional breakdown under "defence"; and 2) outlays that do not appear in the budget and are financed by revenue accruing to the armed

forces from both formal and criminal economic activities.

4. In many countries, a sizeable portion of revenue accruing to the armed forces from both budgetary and non-budgetary sources is diverted to military groups or personnel, often working closely with civilian and political elites, for private consumption. These corrupt activities must be distinguished from the problem of off-budget military spending so that incentives appropriate to addressing these two separate problems can be developed.

Why should this issue be of concern?

5. From a security and a poverty reduction perspective, off-budget military spending and revenue is of concern for three key reasons:
 - First, if there is a sizable level of off-budget military spending and revenue, this undermines the budgetary process and makes it more difficult to ensure an optimal allocation of public resources, to limit budget deficits, and to ensure macro-economic stability;
 - Second, without knowing how many resources the armed forces absorb and the mechanisms by which they are financed, it is difficult to get a realistic sense of how much it costs to protect a country or to determine whether security reforms are needed, and of what kind.
 - Third, significant levels of off-budget spending and revenue suggest that there are problems of accountability in the armed forces. Where effective civil oversight of their activities is lacking, this makes it more difficult to ensure that they can fulfil their legitimate protective functions in an efficient and effective manner, and within the rule of law.

¹ The background paper for the symposium lays out the case for a 'governance' approach to addressing military expenditure problems. The paper can be found in the official proceedings: 'Security-Sector Reform and the Management of Military Expenditure: High Risks for Donors, High Returns for Development', available on the internet at www.dfid.gov.uk by searching under "ssrmilex".

Objectives of the study

6. Off-budget military spending and revenue are difficult to examine in detail because by definition they are not subject to a process of fiscal reporting. Combined with the fact that these issues are particularly sensitive for both governments and donors, there has been a tendency to see them as essentially a resource allocation question rather than as a broader problem of political governance in the security sector. As a consequence, the impact of the problem on both security and development has been down-played.
7. This study had four objectives which are the focus of the following sections:
 - *Section two* examines the various forms which off-budget military spending and revenue can take; the causes of this problem; and the dilemmas governments face in addressing it.
 - *Section three* examines how off-budget military spending and revenue affect the overall budgetary process; macro-economic stability; and the accountability and effectiveness of the security forces.
 - *Section four* considers the challenges that bilateral donors, the World Bank and the IMF, face in addressing this problem, including the perverse consequences that may arise if it is overlooked.
 - *Section five* makes a number of specific policy recommendations to address the off-budget problem in a manner that is consistent with a broader governance approach to security-sector reform.
8. In order to ground the analysis in some concrete cases, special attention was paid to four countries where there was some evidence that off-budget military spending and revenue is an issue for concern: Cambodia, Indonesia, Sierra Leone and Uganda (see Annex). However, no attempt was made to assess levels of off-budget spending or revenue in these countries. A brief overview of each country is provided in country 'boxes' spread throughout the paper.

II. UNDERSTANDING THE PROBLEM AND ITS CAUSES

9. The reported level of military expenditure in the national budgets of most countries does not reflect the true level of economic and financial resources devoted to the military. This is in part a consequence of the difficulties countries face in classifying military expenditure accurately. Misclassification can occur because of weak financial management systems or because some expenditures can be legitimately classified in non-defence categories (for instance, where the military is involved in disaster relief activities). It is also in many cases a consequence of deliberate attempts by governments or militaries to disguise the true level of resources they consume and the sources of these funds. These problems also occur in some OECD countries.
 - the prevalence of security problems, including internal and external threats, which provide a strong rationale for elevated levels of military spending;
 - institutional fragility – particularly in countries emerging from war – characterised by low levels of human resources and weak institutional capacity to manage public resources and regulate economic activity;
 - the availability of lucrative natural resources and the direct involvement of the military in either protecting or extracting and selling these resources.
11. Problems of off-budget military spending and revenue arise either because governments lack the political will to address them, or because the legal and financial management mechanisms needed to do so are weak. The problems are put under a spotlight when countries seek to increase the comprehensiveness and transparency of the budgetary process. In so far as these efforts are often in part driven by donors, the nature of their interventions – including the use of conditionalities – must also be considered a factor in understanding the problem. Where pressure is applied to either reduce military spending or bring it on budget, this may create an incentive for military spending to be hidden through ‘creative accounting’ techniques. It may also increase the pressure to resort to off-budget sources of funding for military activities.

The causes of the problem

10. What sets many developing countries apart from the OECD countries is not only the magnitude of off-budget military spending, but also the distinct nature of the underlying problems of governance. Five significant issues are:
 - the prevalence of strong executive decision-making cultures which can limit transparency and open debate on how public resources are used;
 - the integral role played by the military establishments in the social and economic fabric of many countries, often as a key component of elite-dominated political systems;

Box 1 – Cambodia

Until the war with the Khmer Rouge ended in 1998, there was a strong political rationale for high military spending in Cambodia. This was used to justify political interventions in the budgetary process to divert resources to the military. Since 1998, the government has faced increasing pressure from donors to down-size the army and reduce military spending. This was a key condition for the IMF's 1999 ESAF loan to Cambodia and the World Bank's Structural Adjustment Credit. However, donor support for the World Bank-led demobilisation programme

has been weak and it has been plagued by management problems. There has been little external interest in supporting the institutional development required to build an accountable and cost-effective army. Closely allied with the ruling party, the army continues to benefit from public resources diverted from non-defence budget lines. Unlike other portions of the public sector, military spending is not subject to scrutiny by finance ministry inspectors. With crucial national elections approaching in 2003, the government cannot afford to lose the military's support.

12. The problem can be understood as having two distinct components for the purposes of illustration – a budgetary and a extra-budgetary dimension – though the two components are in practice closely related.

The budgetary dimension

13. The existence of a budget law outlining clear procedures for formulating a budget does not guarantee that its provisions will be observed in practice. There are several areas of budget law that are commonly abused as illustrated in Box 3. These include the use of *supplementary budgets*, *contingency funds* and the *accumulation of arrears*. The conditions for the use of these categories is often not clearly specified in budget laws. The use of *non-transparent or highly aggregated budget categories* and the creation of *special funds* are devices used to remove a portion of public spending from normal scrutiny. A final category of abuse arises because of the *inappropriate classification* of funds, for instance, when funds destined for the military are incorrectly recorded under non-defence budget lines.
14. Normal budgetary procedures should allow for some flexibility to respond to contingencies that may arise, but budgetary processes can be severely disrupted by political interventions. Underlying these problems is the ease with which government officials, military officers and rulers

intervene in the resource allocation process with flagrant disregard for established procedures and pre-determined spending priorities. This may include military officers walking into the treasury and presenting invoices for expenses incurred outside the budget framework and defence ministers telling finance ministers that they cannot have the details of defence spending.

The extra-budgetary dimension

15. Broadly speaking, there are four key sources of military revenue, highlighted in Box 4, which are often not accounted for in national budgets. This includes 1) *military business activities*, including military-run business ventures in the formal economic sector, and *military involvement in the extraction of natural resources*; 2) *special funds* alimented by the diversion of resources from non-military parastatals or by *war levies*; 3) *foreign military assistance* provided by other countries or by multinational companies which either equip and/or pay the salaries of state security personnel in order to protect their business interests; and 4) *criminal activities* which run the gamut from trafficking in drugs, humans and arms to running protection rackets and kidnapping.
16. A common root of military involvement in business activities is to supplement low salaries, including low or non-existent

pensions, or to finance operational activities. However, problems are exacerbated when military involvement in business is institutionalised, further made possible by the breakdown of the rule of law and state economic regulatory frameworks. In contexts where rulers have been unwilling or unable to invest adequately in the security services, or wish to ensure their

support, soldiers are often given free rein to supplement their incomes through engagement in either formal or criminal economic activity. The political incentive for unpopular (and insecure) regimes to overlook the 'freelance' fund-raising activities of the security forces that protect them is the biggest barrier to reforms.

Box 2 – Indonesia

The problem of off-budget military spending and revenue in Indonesia is most commonly associated with military involvement in the formal business sector. This has served a number of purposes including ensuring the political loyalty of the military and limiting its burden on Indonesia's revenue base. The military business complex, which enjoys charitable status and is tax-exempt, provides an estimated 75 per cent of all military financing, though leakage is high. Led by the IMF, donors are currently engaging the

government in discussion about eventually bringing these businesses on-budget, in exchange for which they would accept a significant increase in the official defence budget. At 1% of GDP, this is currently low. As a result, donors are paying less attention to budgetary mechanisms for disguising military spending. There is, however, evidence to suggest this is an issue due to the significant political role played by the military and the weakness of financial accountability in the public sector.

Dilemmas of addressing the problem

17. Governments in developing countries, in particular finance ministries, face the same problems as donors in obtaining information on off-budget military revenue. In some cases, where donors have placed pressure on foreign militaries to be more transparent, more information has been

made available to donors than the finance ministry itself. Often lacking is a robust legal framework, including both clear constitutional provisions and a functioning judicial system, to regulate military activity in the commercial sphere. This problem is further exacerbated by the acceptance in some countries that the military has a legitimate role to play outside the remit or strict definition of security issues.

Box 3 Budgetary mechanisms for disguising military spending

1. Contingency funds

Used to pay military 'debts', fund 'urgent' military commissions to resolve border disputes, repair military hardware (substantiation of spending rarely provided).

2. Supplementary budgets

PM can top up a reserve budget line during the year by passing a new sub-decree; money is taken from other budget lines that still have funds due to a lack of 'absorptive capacity'; spending justified to Parliament at year's end in vague terms

3. Spending under non-defence budget lines

- military units commissioned to build roads which may not get built; disbursements under Public Works/Rural Development budgets
- Defence spending placed under police budget line
- Spending for military vehicles recorded in social budgets as either for use in 'peace operations' or as 'ambulances'

4. Non-transparent or highly aggregated budget categories

- Repair of military equipment paid for by non-concessional loans and funds recorded under public investments
- Government bailed out highly-indebted banking sector which covered many military businesses
- Accumulation of wages arrears, including military salaries, covered under a non-defence budget line

5. Diversion of resources from non-defence budget lines

- due to lack of absorptive capacity in social sectors, unused funds diverted to military spending
- Military personnel working on development projects have salaries paid for through social budgets

6. Procurement of military materiel funded through non-defence budget lines or not accounted for in the budget

Box 4 Extra-budgetary sources of military revenue

1. Parastatals

Non-military (including firms owned by ruling parties) which are used to fund security services; state-owned firms are decapitalised to release funds for the military, and then recapitalised the following year;

2. Military-owned businesses/involvement in non-military activity

- tax-exempt foundations serve as holding groups for commercial enterprises to provide funding for the military
- military interests run private security companies/serve as suppliers of various materiel to government departments

3. Creation of funds

Special funds ostensibly created for civilian purposes used to divert resources to military

4. Barter trade

Agricultural commodities bartered for military equipment

5. Direct financing of military in field through extraction of natural resources

Involves the use of state/military organisational structures; includes exploitation of diamonds, precious stones, timber, fisheries, oil etc.

6. War levies

Security levy raised from citizens and businesses not recorded in budget

7. Foreign military assistance

- Military equipment received as a grant not recorded in capital budget
- Multi-national companies finance state security personnel

8. Donor support for military demobilisation and reintegration programmes

9. Informal/criminal activities including fuel smuggling; casinos; trafficking in drugs, humans, arms, timber, kidnapping; protection rackets; prostitution; printing of money; piracy

10. Under-valuation of economic resources

Conscript labour paid below market rate is used to construct military infrastructure

III. IMPACT ON SECURITY AND DEVELOPMENT

Magnitude and scope of the problem

18. The problem of off-budget military spending and revenue problem varies from country to country in terms of its scope and magnitude, the forms which it takes, the priorities which donors place in addressing it, and the way they go about doing this.
19. It is extremely difficult to quantify the off-budget military expenditure problem. However, based on the evidence collected during this study, there is reason to believe that the problem is much more common than is generally recognised². Off-budget military spending will be a problem of some magnitude when:
 - There is a large and autonomous military sector;
 - The military are directly represented in political institutions;
 - There is a strong executive decision-making culture;
 - There are significant security problems, including armed conflict;
 - Countries are emerging from a period of protracted war;
 - The government/military is involved in the commercial exploitation of natural resources.
20. The impact of off-budget military spending and revenue can be understood at three levels that impinge on national efforts to

reduce poverty and maintain security:

Overall budget planning and execution process

21. A well-functioning budgetary process is critical for achieving aggregate fiscal discipline. This process includes controlling aggregate expenditure, prioritising expenditure among different sectors, ensuring that the public sector operates in a cost-effective and accountable manner and conducting sound economic management. From a poverty reduction perspective, an issue of critical importance is that budgets for the social sectors – particularly health and education – are not raided to supplement the official defence budget.

Macro-economic stability

22. Large off-budget military expenditure can also impact negatively on macroeconomic planning and efforts to maintain macroeconomic stability. Heavy borrowing to address short-falls in public revenue occasioned by unnecessarily large defence budgets, and particularly by the procurement of unaffordable military equipment, can increase both debts and budget deficits. This problem is particularly acute when defence spending decisions are presented to finance ministries after they have occurred. The less accountable defence forces are to civil authorities, the bigger this problem will be.

² This conclusion is based on interviews with government officials and donor representatives; research conducted by others; and news reports and other written materials available in the public domain.

Box 5 – Sierra Leone

There is a long history of poor governance in Sierra Leone's security sector where the armed forces have generally been 'self accounting'. For over 30 years, expenditure requests were neither justified to civil authorities nor subject to any civil oversight. For this reason, actual outlays can be assumed to have been significantly higher than figures reported by the government during the 1970s and 1980s. With the outbreak of the war in 1991, defence-related outlays increased dramatically, often at the expense of social programmes. Even so, successive governments found

it difficult to finance an effective army or maintain control over military activities. Groups within the army became increasingly involved in illicit commercial activities, including diamond mining. It is unlikely that the armed forces as an institution is systematically involved in such activities today. But the return of the lucrative diamond mining fields to government control, in the event that the RUF are decisively defeated, would require transparent internal security arrangements which protect the military from the temptation to exploit these resources.

Military accountability and effectiveness

23. Significant levels of off-budget military spending and revenue suggest that there may be severe problems with regard to the effectiveness of the rule of law and the accountability of the security forces. Where there is poor oversight over the security forces, this increases the possibility that the power and the resources at their disposal will be used in ways that are not consistent with protecting the interests of the state and the communities within it. For instance, off-budget resources create opportunities for the funding of militias and para-military forces which are invariably linked to different political interests. This adds to the problem of the state not holding a monopoly of violence.
24. In addition, a consequence of military involvement in business is that military personnel are diverted into business management. This has a direct impact on their ability to fulfil their primary security mandate in a professional manner. This will in the long-term make it difficult to achieve a secure environment that is conducive to poverty reduction.

IV. THE CHALLENGES OF RESPONDING

25. Donors are often reluctant to address the off-budget military spending problem publicly and in some cases even to acknowledge that it exists because of internal institutional policies and politics and because of their relations with host governments. A particular dilemma which arises is that increased transparency in the security sector would likely result, in a number of countries, in a significant increase in official defence spending. This would put host governments in a difficult position vis-à-vis the donor community in terms of making a case for more assistance; it would also place donors in a difficult position within their own governments in terms of sustaining the political argument for providing this assistance.
26. However, even this brief study demonstrates that off-budget spending can impact negatively on poverty reduction efforts and that it is likely to be a problem in a large number of countries. In consequence, donors need to shift from assuming that off-budget military spending is not a problem to undertaking to prove that it is not a problem. Where off-budget military spending does occur, donors need to consider how it can best be addressed.
27. Among those donors who recognise the significance of the off-budget military expenditure problem, there is widespread agreement that it should be addressed in the context of improving economic and political governance. There is also agreement that strengthening governance in the security sector requires a multidisciplinary approach and thus the involvement of the full range of external actors: development, security, political, and financial; official and non-state.
28. Efforts to operationalise this approach have, however, raised a number of issues that need to be addressed if the benefits of donor assistance are to be maximised. Chief among these are:
- The risks associated with a “business-as-usual” approach in public expenditure management;
 - The need to clarify the relationship between sensitivity and confidentiality;
 - The importance of avoiding unintended consequences; and
 - The desirability of incorporating supply-side approaches.
- Business-as-usual**
29. Development assistance agencies are becoming increasingly involved in supporting improvements in economic governance, especially public expenditure management (PEM). There is also a growing sense that expenditures in the security sector should be subject to the same basic rules of budget formulation, implementation, and monitoring as other portions of the public sector. However, the security sector has generally not been included in PEM work to date. Thus, continuing “business as usual” in the area of public expenditure management will not adequately address the problem of off-budget military spending.
30. First of all, although comprehensiveness is a central PEM principle, it has rarely been extended to the defence sector. The IMF’s efforts in Indonesia to bring on-budget the various military-related funds and foundations are still the exception rather than the rule. Second, the true scope of resources allocated to the defence sector will not be known until the entire process of developing and monitoring defence budgets is strengthened.
31. As long as the armed forces are able to generate income to be used at their discretion, the budgeting process will lack

credibility. The same is true as long as expenditure for the ministry of defence is concealed in the budgets of other, non-defence ministries and the emphasis remains on "getting the budget right" rather than on taking a hard look at budget execution.

Sensitivity versus confidentiality

32. A major reason given by many donors for not tackling the defence budgeting process is the sensitivity of security-related issues. The notion that dealing with defence-related issues will complicate the task of providing assistance for development and the promotion of financial stability is widespread among development practitioners. This is a short-term view that is based on what is best for the donor agency, not for the partner country. The failure to address defence-sector governance is one of the factors that have contributed to the economic problems facing partner countries. Equally important, allowing inadequate defence-sector governance to persist makes it more difficult for donors to achieve the results they seek – whether these relate to governance, public expenditure management, poverty reduction, or conflict management.
33. It is clear that some degree of confidentiality is necessary in the area of national security. However, there appears to be a tendency to conflate sensitivity and the need for confidentiality. Defence-related issues – in particular, around military intelligence – are sensitive in all societies. Even long-established democracies retain varying degrees of confidentiality in the realm of national security. It is important to be clear, however, about the distinction between confidentiality and the lack of public scrutiny. It is possible to retain a high degree of confidentiality in highly sensitive areas without compromising the principle of public accountability.
34. It is also important to be clear about what

is being held in confidence and why it is considered sensitive. War plans should be held in confidence. That the armed forces are regularly exceeding their budget allocations, are purchasing expensive military equipment with scant attention to need or ability to maintain this equipment, or are engaged in illegal, off-budget activities are clearly sensitive matters, but should not be held in confidence.

Unintended consequences

35. As the donor community has become more vocal about its concerns regarding defence expenditure over the last decade, the approach it has adopted has produced some unintended consequences. Rather than strengthening governance in the defence sector, some donor actions have in fact further undermined the quality of defence-sector governance.
36. The main problem is that while a growing number of donors correctly view off-budget defence spending as a governance problem, they nonetheless remain excessively focused on the level of expenditure in their dealings with partner countries. As discussed above, an unsustainable level of spending in the defence sector is a legitimate cause for concern in view of its impact on macroeconomic stability, high-quality growth, and poverty reduction.
37. However, there are two problems associated with focusing solely on level of spending rather than on the process by which spending is determined. First, it avoids addressing the underlying unequal division of political power and the institutional and human-resource weaknesses of which high levels of defence-sector spending are only a manifestation. Second, it creates a perverse incentive for governments to resort to creative accounting in order to conceal portions of this expenditure. As the UK Secretary of State for International Development noted in the February 2000 conference: "If countries

that need international assistance are pressed to cut defence spending regardless of the threat they face, they will hide and disguise this spending in secretive budgeting arrangements. This simply encourages mutual misunderstanding, inefficiency and waste”.

38. Additionally, the tendency of donors to channel aid through social funds in order to increase the efficiency of resource use without due attention to PEM principles and budget execution can have negative effects on defence spending. When these and other funds are allowed to function off-budget or in a non-transparent, unaccountable manner, they

send the message that PEM principles are not important.

39. The same dilemma arises where donors tacitly permit governments to divert public resources from non-defence budget lines in order to respond to a legitimate and urgent security threat. In some cases, donors have increased budgetary support in order to facilitate military activities or a military reform process. However, this places donors in a difficult position unless they can be confident that these resources are being used effectively, namely that the government is protecting the state and the communities within it in the most efficient way possible.

Box 6 – Uganda

A series of brutal dictatorships, presiding over the deaths of hundreds of thousands of Ugandan citizens in the 1970s and 1980s, reduced the country to a state of anarchy. As the National Resistance Army, Uganda’s current armed forces were instrumental in bringing Museveni’s National Resistance Movement to power in 1986 since when exceptional progress has been made in restoring internal security, promoting economic development and reducing poverty. Uganda faces continuing security problems, including insurgency from the Lord’s Resistance Army in the north, and rebel groups in the west of the country. Uganda has also played a major role in the conflict in the Democratic Republic of Congo (DRC), with thousands of UPDF troops operating deep inside the DRC. A significant proportion of these troops were withdrawn

in the first part of 2001, and the Ugandan government announced in May 2001 an intention for a near complete withdrawal.

Uganda has been under strong pressure from donors who fund a large proportion of the Government budget to limit its defence expenditure to 2% of GDP which they feel is not excessive in relation to the African average of 2.3% and the scale of Uganda’s security problems. There are concerns over the efficiency and effectiveness of spending under the defence budget, in particular in the area of procurement. Unusually, Uganda has been open to external scrutiny of these issues through the conduct of an externally-financed study of defence spending in 1998, on which further donor-financed follow-up work is planned in 2001.

Supply-side approaches

40. Coordination of policies within donor countries is both difficult to achieve and of considerable importance in the area of security-sector reform. Some of the governments pressing most insistently for reductions in the level of defence expenditure are major exporters of weapons and providers of military assistance. A range of stakeholders has noted the contradiction inherent in this dual approach, especially bilateral development agencies, interna-

tional financial institutions, and civil society organisations.

41. Governments have the responsibility to provide their citizens with a safe and secure environment, and therefore a degree of expenditure on the armed forces is legitimate. This includes the purchase of arms and other military materiel as well as accepting military assistance from a foreign country. However, decisions about equipment purchases need to be made within the overall context of the

availability of resources to the state. Requests from the armed forces need to compete for funding within the budget process on an equal footing with requests for other purposes.

42. If donors were to adopt a governance approach to the security sector, they would promote sector needs assessments (known as security environment or threat assessment) as the first step in the resource allocation process. Such an assessment would help governments to determine for which threats it might be necessary to involve the security forces (military or police), and which threats could be primarily met by other means. Once it was clear what threats the armed forces would be expected to protect against, purchases of weaponry and other military equipment would be measured both against the security environment and against the resource envelope based on life-cycle costs, not simply purchase price. Military materiel might continue to catch the eye of the chief of staff or the chief of state. But it would be more difficult for those individuals to drive through agreements to purchase equipment without demonstrating that it is needed and can be procured without jeopardising the economic and social welfare of citizens.
43. Even though foreign military assistance is often provided in the form of grants, this must also be transparent and brought on budget if there is to be an accurate accounting of defence expenditure. This also includes assistance provided by donors for military demobilisation programmes. Another important category is military assistance provided by multi-national companies for the purposes of equipping and paying the salaries of state security personnel who protect their in-country operations. In the absence of transparency, there is a heightened danger that this assistance can be misused for activities that violate human rights.
44. The use of 'offsets' as part of military export strategies is a common practice that can distort military budgeting. Offset is the requirement set by the purchaser of defence equipment for the seller to make an investment in the country or to accept commodities as part payment. Where an investment is made in a government-controlled defence industry, for instance, this is often not accounted for in the military budget. Where commodities such as rice are accepted in part payment for military equipment, this may not be reflected in the military budget. When offset is used as a sweetener to facilitate defence sales, this makes it more likely that the military equipment which is purchased is either not needed or does not represent value-for-money.
45. Supply-side approaches to addressing off-budget military expenditure should be set in the broader context of efforts to promote alternatives to military expenditure. Some donors, including DFID, are placing greater emphasis on strategic conflict analysis to identify 'conflict reduction' strategies. This encompasses a broad range of measures designed to improve security for all, including sector-wide social and economic programmes that create an environment in which conflict is reduced. Specific strategies include peace-building initiatives; constitutional and political reform; strengthening of rule of law; traditional conflict resolution and reconciliation mechanisms; and efforts to enhance participation in policy-making processes.

V. POLICY RECOMMENDATIONS

46. It is clear that in many countries the available data on defence expenditure understates the true amount of financial and economic resources absorbed by that sector. In some countries, the deviation is probably modest. In other cases, it is likely to be significant and to have the potential for undermining efforts to strengthen governance, reduce poverty, and manage conflict. However, the central issue is not about improving data collection so as to better hold governments to count for off-budget military spending problems. While data collection and dissemination can be an empowering force for change, the priority for donors should be to help countries address the underlying governance problems that reduce transparency within the defence sector.
47. Addressing the off-budget problem involves creating incentives for both militaries and governments to keep military spending on budget, strengthen fiscal management and the management of the defence sector, and develop alternatives to military spending. In many cases, the binding constraints will be political in nature requiring fundamental changes in civil-military relations that are long-term in nature. Increased transparency in defence spending will not be achieved unless there is effectively a demand for this from the civilian sectors, including finance ministries, parliaments, non-governmental groups, the press, etc.
48. This section begins by proposing a number of priority actions that can be taken by development actors concerned with these issues. It then addresses several issues specific to the World Bank and the IMF. Finally, openings for bilateral development agencies and their governments are identified.

Priorities for all development actors

- Improve understanding of off-budget military spending and revenue problems; evaluate more systematically the causes, scope and magnitude of these problems and the barriers to addressing them; assess the impact on public expenditure management, broader poverty reduction programmes and political governance.
- Develop a governance approach to military spending that recognises that a full accounting of the resources applied to the armed forces extends beyond ensuring budget comprehensiveness to effective and efficient fiscal management and oversight of the defence sector.
- Develop operational procedures for strengthening the financial management of the defence sector and undertake operational work. In particular, work with ministries of finance and defence, the auditor general, relevant legislative committees and the office of the president to strengthen their capacity to fully incorporate defence planning and budgeting into the government-wide budgeting process.
- Incorporate the defence sector into anti-corruption policies and programmes.
- Create incentives for national stakeholders to reduce off-budget defence expenditure and improve the effectiveness and efficiency of financial and economic resources allocated to the defence sector. One approach may be for donors to agree not to press for rapid reductions in defence spending in countries that take steps to strengthen defence resource management systems. Such a plan should go hand-in-hand with efforts to strengthen the country's overall financial management and

information systems, including greater transparency on the classification of budget expenditures. To be successful, this will ultimately require devising appropriate incentives at the personnel level, including appropriate enforcement mechanisms and terms and conditions of service.

- Develop a holistic approach to strengthening the rule of law in order to create an environment conducive to sound fiscal management in all sectors, including the defence sector.
- Encourage development partners to pursue conflict reduction strategies to provide alternatives to military expenditure.

World Bank and IMF

- Revise both organisations' 1991 guidelines on military expenditure to reflect a governance approach to the management and oversight of military resources.
- Engage operationally in strengthening the financial management of the security sector, for example by incorporating the security sector into public expenditure reviews, poverty reduction strategy papers (PRSPs), the

Comprehensive Development Strategy, and other relevant diagnostic tools and operational activities.

Openings for bilateral donors

- Strengthen the coherence of foreign policies, including development, political and security policies and agendas; undertake consultations to identify comparative advantages of the relevant government bodies in addressing off-budget issues.
- Encourage the World Bank and the IMF to incorporate the defence sector into public expenditure reviews, PRSPs, Medium-Term Expenditure Frameworks, and public-sector reform programmes; provide the Bank and the Fund with data demonstrating the magnitude and nature of the off-budget problem in individual countries; and encourage – through incentives to the extent possible – host governments to cooperate with the World Bank and the IMF in this area.
- Encourage host governments to strengthen the financial management of the defence sector and seek ways of supporting this process.

VI. NEXT STEPS

49. Further research and analysis of off-budget military spending problems will help donors to devise more effective responses, but the priority should be on mainstreaming this issue into the policy debate. At the operational level, this issue should be incorporated more systematically into dialogue with host governments. This will require donor personnel

to adopt a more critical view of government data – which is often accepted at face value – while recognising that host governments themselves are often poorly informed of the scope and nature of the problem. At the policy level, donors need to consider more carefully among themselves the implications of not addressing this problem.

ANNEX – EXAMPLES OF OFF-BUDGET MILITARY SPENDING AND REVENUE

The following examples of off-budget military spending and revenue were derived from the countries examined in this study. In certain countries, such as Cambodia, 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 which governments or military organisations can use to keep military spending 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-defence 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
- Defence 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 programme requiring counter-part funding does not materialise, 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-defence 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 labour 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 decapitalised to release funds for the military, and then recapitalised the following year; another method is simply for governments to bail out enterprises which 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 organisational 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 neighbouring countries in order to 'avoid destabilising 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 defence 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 demobilisation

- Donor assistance provided to support military demobilisation and reintegration programmes not recorded in the defence 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