The Future of the U.S. Defense Industrial Base

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Thank you, Ambassador Nitze, and thank you, Congressman McCurdy, and ladies and gentlemen for joining us this evening for what I hope will be a provocative and constructive discussion about the U.S. defense industrial base.

As we look forward to Thanksgiving next week, we Americans have much to be thankful for. Above all, we are at peace, a blessed state not enjoyed by many of our fellow citizens around the world who are losing family and friends, homes and homelands, in what seems like never ending regional strife. Last Thanksgiving, this country was preparing for war. We feared biological and chemical weapons and the onslaught of a massive army inflamed by religious and ethnic fervor. Mercifully, Desert Storm was short lived and a resounding military and diplomatic success for the United States.

Many things contributed to our victory in Gulf—public support, effective coalition building, superbly trained troops, an excellent win strategy, and finally, high tech weaponry that fit the mission and, critically important, worked. It all looked so easy that some might conclude that we do not need to insist on that much technology and that much readiness. Alas, the event proved the opposite.

Preparedness saved lives—and vigilance is the price of victory. The next regional conflict may not be so easy—we may not have six months to move our army or to train our troops. The next despot on the loose may use his Air Force, or have a Navy—or not mass his troops behind a fixed "Maginot" Line.

It is ironic, therefore, that at the same time that our high tech weapons are the envy of the world, we are haphazardly dismantling the industrial base that created and produced them.
We have spent the last two years producing a hefty stack of studies documenting what many already knew viscerally—the defense industrial base is in trouble—the industry is financially ailing, investments in capital and research and development have been drastically reduced, talented people and capable subcontractors have quit doing business with the Pentagon, and many, including Secretary Dick Cheney and National Security Advisor Brent Scowcroft, are skeptical about our ability to maintain the high tech winning edge we displayed in Desert Storm.

To manage the industry downsizing right this time, we need a new partnership among the DOD, the Congress and the defense industry. This would create a new compact that would lead to a more effective deterrent force at lower levels of defense spending.

The problem is not a smaller defense budget per se, though less overall spending will be achievable. But the requirement should drive the budget, not the other way around. This country can afford a proper defense and reap a peace dividend too, but this requires each partner’s active cooperation. Otherwise, business as usual in the defense arena will cause a meltdown of this country’s industrial base and therefore our ability to defend our nation.

Meanwhile, the massive restructuring of the defense industrial base is already well underway. According to Secretary Cheney, during his tenure he has cancelled outright or terminated production lines on over 100 programs, eliminated 85,000 civilian jobs from the DOD and is in the midst of closing 300 bases and cutting active military personnel by over 500,000. If all goes according to the current plan, by 1995, defense spending as a percent of the federal budget will have fallen from 27 to 18 percent, and defense spending as a percent of GNP will have fallen from 6 to 3 1/2 percent. The defense expen-

diture bite out of our economy, and the level of active duty military personnel, is the lowest it has been since Pearl Harbor.

This is not bad a thing. The Soviet super-power threat has diminished, and this country rightly deserves a peace dividend.

This country overarmed in the 1980s. The industry now has excess personnel and excess capacity to meet the new threat, so downsizing is the right thing to do. But we are going about it all wrong. To quote Secretary Cheney again, “The good news is...we can safely restructure our armed forces. The bad news is that we have never, ever before...gotten it right.

We’ve always blown it. Every time.... when we’ve significantly downsized the force, we’ve ended up in such a hurry to demobilize that we’ve forgotten the fact that nearly always, sooner or later, we once again find ourselves in the position where we once again have to go to war.”

In fact, with the crumbling of the Eastern Bloc, the world is less dangerous, but nevertheless less stable. Eastern Europe and the Soviet Union are hotbeds of regional conflict and the Middle East continues to be unpredictable. Some 20 nations will have ballistic missile capability—some with range ability to reach the continental territory of the U.S.—by the end of the decade.

Conclusion: Our nation’s military requirements have not all dissolved along with the disintegration of the Soviet Empire.

Before I get into some concrete suggestions about what each of the three partners can do to bring some rationality to the industry downsizing, let me first try to dispel four popular myths that are being bandied about as
cure-alls for what ails the defense industrial base.

Myth number one: We can maintain a viable defense industrial base by funding R&D but not production. This works nicely in theory but falls apart in practice because it underestimates the interdependence between production and engineering. R&D not translated into production is pure science, lacking the vitality of application. Defense capability requires production technology and experienced technicians. Engineering creativity does not end with the beginning of production; emphasis on value engineering—to make the product smaller, with more power, less costly—continues throughout its manufacture. The positive impact that manufacturing has on engineering cannot be underestimated.

Myth number two: Foreign dependency is not a problem—that our Allies will always put the U.S.'s national security interests before their own and sell us all the advanced technology that we need when we need it. If you believe that, I have several magnificent bridges in my hometown of New York that I'd like to talk to you about. But, in all seriousness, the problem extends far beyond components and subsystems. For example, by 1994, Turkey will be the largest producer and exporter of F-16 aircraft in the world. Four countries: Korea, Turkey, Belgium and the Netherlands will be producing F-16s. The F-16 line in Ft. Worth will be stone cold if we follow current plans.

I find it curious that at a time when aerospace is one of our largest exports and an area where the U.S. remains supreme, we are curtailing our labs and factories and then teaching the Japanese, Koreans, Taiwanese and others how to develop an indigenous aerospace industry to compete with us. This will be particularly onerous if our foreign policy interests no longer coincide with that of our F-16 producing allies. This same concern applies to A/C engines, components and other major systems. This

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is a superb example of the free market forces at work, serving neither our national security nor our economic best interests.

Myth number three: Diversification into commercial businesses will be successful for defense companies and allow them to quickly convert back to military production when needed. This is the DOD's position as stated in its report on the defense industrial base to Congress released last week. To quote "The ability of the base to meet future DOD needs will depend on an ability of the individual companies to shift from defense to commercial production—and then back again, when required."

My experience does not support this thesis, nor does the general experience of the industry.

Loral, for one, will not diversify into the commercial market except where our unique technology provides where a proprietary, unique advantage. Such opportunities for defense companies will be rare and will not sustain a broad policy. Defense electronics is what we know well and do best. Defense companies generally do not have the marketplace experience to move successfully into the commercial market.

The past record is not reassuring. Defense companies who have ventured into the commercial market have met with dismal and costly failure across the board. The U.S. is not like the Soviet Union, where excess defense capacity may fill a consumer or industrial need which is otherwise not being addressed by that backward economy.

Myth number four: That industrial darwinism, or letting the free market forces prevail, will lead to a downsized defense industry that will meet future DOD requirements.
Quite to the contrary, free-market restructuring is often motivated by profit and return on capital considerations with little regard for long-term investment, or performance, or serving the country’s national security needs.

**WHAT THE DOD CAN DO**

The DOD must take the lead in turning its adversarial relationships with industry and Congress into a partnership. The DOD must take the lead in determining future defense needs and what we need to fulfill those needs. It must plan more and better and share that information with Congress and the industry.

To this end, DOD should make itself into a world class customer. That means the DOD should:

1) Change atmosphere from adversarial and predatory to cooperative. Much progress has been achieved—we must continue to work this problem of mutual partnership—particularly at the working levels.

2) Provide more information about future DOD requirements so that contractors can invest their limited resources in DOD priorities. Even more important, plan and implement more consistently, on a multi-year basis, eliminating start and stops, and on and off again program behavior which destroys industry planning and intelligent investment.

3) Reward good program performance with incentives; penalize poor performance with cancellations. Abandon price only competitions. Take past performance into account. This best-value concept is beginning to work in the Air Force—it needs more support across all the services.

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4) Eliminate uneconomic second sourcing particularly as resources shrink and we can barely afford one source because quantity buys are being sharply reduced. Common sense procurement policies must supplant legislated competition when it is applied as a knee-jerk reaction.

5) Help U.S. defense companies market overseas. Expanded markets for U.S. defense systems strengthen our relationships overseas; lower the per unit costs for the DOD and contribute to a healthier industrial base at home. Exports of military hardware, within the framework of international arms limitation agreements, strengthen our national security by providing our government with an influence in foreign affairs. They also promote allied hardware standardization and interoperability and help our country’s balance of trade.

But, our industry faces international competition reinforced by a wide array of foreign government support, including direct marketing, low interest loans and guarantees, exclusionary contract provisions, demands for offset and work share. I understand the State Department has proposed loan guarantees of defense exports—a most laudable initiative.

6) Reform the U.S.’s foreign military sales (FMS) program process. When selling to a foreign government, we are at the mercy of a selection process that is unclear and largely uncontrolled, and the role of the DOD as intermediary is undefined and lacks regulation. There are no rules that clearly address the fairness or adequacy of the process. Proposals flow through the intermediary to the customer, creating ample opportunity to manipulate and misinterpret contractor information without the knowledge or permission of the contractor. The resulting confusion is not only inefficient and costly, it is often counterproductive to the interests of U.S. companies who
should be supported in their efforts to sell equipment internationally on a commercial basis.

I recommend that DOD immediately establish a joint DOD/industry team to address this issue, and in the meantime, establish interim ground rules. I can envision two possible solutions: the first would permit contractors to bid directly to the foreign government on a commercial basis with no “help” from the DOD. If this is not possible for national security reasons, we should establish a firm set of rules on the roles and actions of the relevant DOD agencies so as to secure an equitable and fair competition among all U.S. companies.

7) Build provisions for an export version of new weapons system produced in the U.S. into the original contract. DOD’s cooperation in working with contractors to determine what is releasable for export, particularly in the area of software and source code, will speed these systems to market.

8) And, finally, resist attempts to reduce progress payments to match the limited benefits of lower interest rates, at least until the defense industry is restored to a fair return on investment.

All of these actions, taken together, will result in a healthier defense industrial base which supports DOD priorities, even as we downsize our national capacity.

WHAT CONGRESS CAN DO

1) Cut back on excessive oversight and micromanagement. There were many questions about whether this country was getting its money’s worth from its investment in high tech weapons. Desert Storm proved irrefutably that our investment paid off in spades. We might similarly ask if this country is getting its money’s worth from the excessive hearings, voluminous requests for

information and committees and sub-committees who all have their fingers in the defense pie. These oversight excesses are very costly.

2) Encourage DOD to cancel programs that are no longer needed because the threat has changed or programs are not performing. Real, lasting cost cutting requires program cancellation and base closings. I admire Secretary Cheney’s courageous efforts in this area, and I recommend that Congress support him.

3) Institute multi-year funding to eliminate the costly chaos now prevalent in any industry planning.

4) Support DOD and industry efforts to promote the export of U.S. weapons systems while focussing arms control on weapons of mass destruction. Such support should include formulating rules for source selection in the FMS process and providing low interest rate loans for export sales.

5) Support an acceleration of the new IR&D ceilings, presently proposed to kick-in over three years.

6) Propose a more constructive tax policy, particularly as the code applies to delaying liability on profit from long-term defense contracts.

WHAT INDUSTRY CAN DO

Industry must shape up—improve productivity, improve quality, and make sure our conduct is exemplary.

We must put our financial house in order. Contrary to popular belief, defense is not a not-for-profit industry. We must only bid on programs where we can make money and perform on those programs so that we do make
money. We must understand that performance is the key to success. Sloppy program management, cost overruns and schedule slips will lead to program cancellations, not to bailouts.

New programs are so large, complex and costly that we must look to more teaming and shared research and development, not only here in the U.S. but with overseas partners as well. We must only invest in those programs and technologies for which there is a real, and preferably funded, requirement.

We must vigorously resist procurement practices that prey on our industry. And, finally, we must work in good faith with the DOD to bring about the truly revolutionary transformation of our defense industrial base.

I am absolutely certain this partnership can work—we certainly saw it during Desert Storm as military and contractor personnel worked side by side around the clock—animosities, paperwork, rules and regulations temporarily thrown aside in the face of a common enemy, and a common cause.

Today the DOD and industry, as well as every American who cherishes our freedom, share a common goal—to transform our defense industrial base into a smaller, but healthier producer of the world’s finest weaponry for the world’s finest peacekeeping force.

Now is the time for a new compact among DOD, Congress and the industry. Now is the time to end adversarial relations.

Finally, there are two issues that must be addressed as we restructure our industry. One is our nation’s obligation to soften the cost of conversion.

Part of our peace dividend should be applied to retraining programs, to extended unemployment insurance payments and to family health and insurance benefits in order to ease the shift from defense activities.

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Millions of Americans invested their careers, their talents, their lives in the defense industry. As we realize our national victory, let us soften the cost of family dislocation, ended careers and dismal reemployment prospects, worsened by a slow growth economy. Part of our peace dividend should be applied to retraining programs, to extended unemployment insurance payments and to family health and insurance benefits in order to ease the extra burden caused by the shift from defense activities.

Secondly, it is not in our best national security interest to allow a free fall in the downsizing of our industry. A free fall may result in the best companies departing because the investment return is not favorable or the risks too high. We cannot leave to free market forces how the industry will be restructured. We will want, at the end, a viable industry consisting of good performers, creative management and innovative technology. I do not advocate the DOD choose winners and losers. What I am advocating is an industry environment that allows for fair treatment that will in turn allow a fair return on investment thereby encouraging a well balanced industrial base. And I am calling for a DOD initiative to work with industry to examine industrial base issues as we proceed to a smaller defense capability.

Thank you.
About the Author

Bernard L. Schwartz is chairman and chief executive officer of Loral Corporation, a $1.5 billion defense electronics manufacturer headquartered in New York City. The company, with headquarters in New York City and facilities across the United States and overseas, designs and manufactures advanced electronic systems for the U.S. and foreign governments.

Mr. Schwartz, 66, joined Loral as chairman in 1972 after serving as president of Leasco, now Reliance Group, from 1968 to 1970 and chairman of Reliance’s executive committee from 1970 to 1972. He is chairman and chief executive of K&F Industries, a privately held concern that is the world’s largest supplier of aircraft braking systems. He is also a director of The Reliance Group and Sorema N.A., Reinsurance Company.

Mr. Schwartz is a member of the Defense Policy Advisory Committee on Trade (DPACT) and is chairman of its subcommittee on subsystems, components, and materials. He is the author of Foreign Ownership of U.S. Defense Companies: Where Do We Draw the Line? (a previous FPI Policy Brief), and a signatory of the Project on Monitoring Defense Reorganization’s Making Defense Reform Work, which was co-chaired by former Defense Secretaries James Schlesinger and Harold Brown.

A native of New York City and a graduate of City College of New York, Mr. Schwartz is a trustee of the New York University Medical Center, a director of the New York City Partnership and a member of the advisory board of the City University of New York School of Engineering.
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