

**Statement of
Barry Watts
Senior Fellow
Center for Strategic and Budgetary Assessments
Before the House Armed Services Committee
October 24, 2011**

Chairman Shuster, Mr. Larsen, and Members of the Defense Business Panel, thank you for inviting me to testify at today's hearing on the imperative to preserve essential elements of U.S. defense industrial base.

As you are aware, I and my CSBA colleague Todd Harrison recently published a report on the challenge of sustaining the most critical components of the U.S. defense industrial base (DIB). This report focused on the need to develop a coherent, long-term government strategy for sustaining design and production capabilities in a small number (less than ten) of areas critical to meeting the principal challenges to American national security during the next couple decades.

I should point out that our analysis was based on examining major defense acquisition programs and first-tier or "prime" suppliers. We did not delve into lower-tier subcontractors, materials suppliers or the services aspects of the DIB. Nor did we address, as Jacques Gansler has done in his 2011 book, *Democracy's Arsenal*, regulatory constraints affecting the DIB—particularly the International Traffic in Arms Regulations (ITAR) or the "special metals" restrictions in Title 10 of U.S. Code that grew out of the Berry Amendment.

The Nature of the U.S. Defense Industrial Base

Before discussing the prospects for developing a strategy that will preserve the few truly critical elements of America's arsenal, it is important to understand what sort of an economic enterprise the defense industrial base is. In the Department of Defense's September 2011 report to Congress on the defense industry, the Office of Manufacturing & Industrial Base Policy (MIBP) stated that maintaining a "strong, technologically vibrant, and financially successful defense industry is . . . in the national interest." I wholeheartedly agree. As Norm Augustine, the former chief executive officer of Lockheed Martin, has observed, the U.S. defense industry helped to win the Cold War and has produced weaponry and equipment that have been the envy of the world's militaries. I believe that a healthy defense industrial base will continue to be a source of strategic advantage for the United States in the decades ahead.

Nevertheless, the prospects for the continued success of for-profit defense firms in providing the U.S. armed forces with superior weaponry and equipment—especially at affordable costs—may be at risk unless both the defense industrial base itself and the business practices of the U.S. government undergo fundamental restructuring. The Department of Defense’s (DoD’s) current approach to the needed transformation is “in the main . . . [to] rely on normal market forces to make the most efficient adjustments to the defense industrial base.”¹ If one assumes that the U.S. defense industry operates like a normal free market with many customers, many suppliers, and price sensitivity driven by competition, then this approach would accord with good economic theory.

However, there is no persuasive evidence for thinking that the U.S. defense industry functions like normal free markets such as consumer electronics or the automobile industry. In reality, the defense industrial base is highly regulated by both DoD and Congress to achieve maximum risk avoidance. Structurally, it is unique in having a monopsony buyer—the U.S. government (which is also the regulator)—and a few oligopoly suppliers in each sector due to the consolidations of the 1990s.²

These facts about the regulation and structure of the U.S. DIB should surprise no one. In their seminal 1962 analysis of the U.S. weapons acquisition process, Merton Peck and Frederick Scherer not only emphasized that the DIB did not function at all like a normal free market, but went on to argue that a market system in its entirety could *never* exist for weapons acquisition.³ The uncertainties and risks inherent in weapons acquisition not only made the defense industry unique, but vitiated the use of free-market concepts such as “competition,” “price,” “buyer,” and “seller.” Consequently, policies or strategies for transforming the U.S. defense industry that assume this sector of the American economy operates like a normal free market fundamentally misunderstands the defense industry’s nature and are unlikely to succeed. As Jacques Gansler pointed out in 1980, this misunderstanding has more often than not proved harmful rather than beneficial

Deciding What To Keep in a Period of Fiscal Austerity

Since the September 11, 2001, attacks on the World Trade Center and the Pentagon (9/11), Congress has authorized over \$1.28 trillion for military and diplomatic operations

¹ Office of Manufacturing and Industrial Based Policy, DoD, “Annual Industrial Capabilities Report to Congress,” September 2011, p. 2.

² Jacques S. Gansler, *Democracy’s Arsenal: Creating a Twenty-First-Century Defense Industry* (Cambridge & London: The MIT Press, 2011), pp. 9, 347, 357.

³ Merton J. Peck and Frederic M. Scherer, *The Weapons Acquisition Process: An Economic Analysis* (Boston, MA: Harvard University, 1962), pp. 57-60.

in Iraq and Afghanistan, enhanced security, and medical care for veterans.⁴ From Fiscal Year (FY) 2001 to FY 2011, the Defense Department's base budget, which excludes supplemental funding for Overseas Contingency Operations (OCO), grew over 40 percent. Including OCO funding, defense spending grew over 70 percent from FY 2001 to FY 2011.

In March 2011, the president's baseline defense budget request for FY 2012 was \$553 billion. The Budget Control Act of 2011 passed on August 2nd reduced the Pentagon's base budget by around \$450 billion over ten years (relative to the president's FY 2012 budget request). If the Joint Committee created by the Budget Control Act cannot agree on another \$1.2 trillion in deficit reduction, or if their recommendations fail to be enacted by Congress, then around half of the deficit-reduction shortfall will be imposed as a further cut to DoD's base budget over the next ten years.⁵

On the one hand, there is considerable uncertainty about about what the level of DoD's base budget will be from FY 2013 through FY 2021. On the other hand, in the wake of the financial meltdown in 2008, the subsequent recession in the U.S. economy, and the explosive growth in the federal debt, it is clear that the post-9/11 period of long-term growth in defense budgets is over. Both DoD's base budget and OCO funding are declining, and the Pentagon is now facing a protracted decline in defense spending that could last a decade or longer.

In such circumstances, the natural inclination in both Congress and the Pentagon is to concentrate on identifying individual programs to cut or eliminate. The first question, however, should be not what to cut but what to keep. Given the complex range of security challenges the United States is likely to face over the next couple decades, what are the core capabilities that the Defense Department will need to preserve or create to meet these challenges? For example, the U.S. military has enjoyed a near monopoly on long-range precision strike and the associated reconnaissance and targeting networks. Would it be wise to sacrifice this important area of military capability to defense budget cuts? And if not, what sectors and elements of the defense industrial base should the Defense Department continue investing in preferentially—even at the likely expense of other, less critical portions of the defense industry?

The question of what to keep, rather than what to cut, is the fundamental strategic issue that needs to be given top priority by Congress and the Pentagon in coping with the

⁴ Amy Belasco, "The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations since 9.11," Congressional Research Service, RL33110, March 29, 2011, p. 1.

⁵ Todd Harrison, "Defense Funding in the Budget Control Act of 2011," CSBA Update, August 2011, pp. 2-4.

emerging era of declining defense spending. It is unlikely that a sound strategy for preserving the truly critical elements of the U.S. defense industrial base will emerge, despite the best intentions of all concerned, unless this question is given top priority.

Recall, in this regard, the case of the British Navy's efforts to field a new nuclear-powered attack submarine (SSN). The program to develop and build four *Astute*-class SSNs began in the late 1990s, but some three years into development it became clear that the United Kingdom's defense industry no longer had either the design or production skills to complete the program. Fortunately, the British were able to turn to the Electric Boat division of General Dynamics to provide the missing expertise. But if the United States finds itself in a similar situation in a critical area of defense capability, to whom would the country turn?

A Long-Term Strategy for Sustaining the Critical Elements of the U.S. Defense Industrial Base

Strategies are fundamentally about choice: favoring this over that, especially in terms of resource allocation. Effective strategies rarely, if ever, make every constituency or organization with a stake in the enterprise happy. Among other things, this understanding of strategy means that the number of sectors of the defense industrial base that can be deemed critical or essential cannot be very large. A DIB strategy that seeks to preserve 50 or 75 "critical" sectors and their underlying components cannot be an effective strategy because it avoids making the hard choices that are the essence of strategy. As a rule of thumb, a strategy for preserving the U.S. defense industrial base has little chance of succeeding if the number of critical elements exceeds a single digit. In other words, the total number of critical sectors cannot be more than eight or nine if the inherent demands of effective strategy are to be satisfied. This upper limit seems all the more compelling given the period of fiscal austerity the Pentagon is now facing. Attempting to preserve every sector of defense industry without regard to prioritization would be unaffordable.

Getting Congress, the Office of the Secretary of Defense, the Departments of the Army, Navy and Air Force, and the Marine Corps to agree on such a short list of critical military capabilities and the corresponding elements of the DIB is no easy task. The first step in this direction would be an assessment of the main challenges to American security over the next several decades, remembering that prediction is difficult, especially of the future. The next step would be to link those broad challenges to the critical sectors of the defense industry needed to field the weaponry and capabilities to address these challenges.

However, neither assessing the main challenges to U.S. security nor linking them to the critical sectors of the defense industry is easy. To illustrate the difficulties that would beset any attempt to reach consensus on these matters, consider the question of whether the Defense Department should continue to invest in the kinds of “legacy” high-end capabilities that might be needed to offset China’s growing anti-access/area-denial (A2/AD) capabilities in the western Pacific. *Democracy’s Arsenal* argues that while China is likely to seek dominance in Asia, it will do so “not militarily so much as politically and economically” by focusing “more on the the soft use of power (backed by military strength)” to draw Asian countries into its orbit.⁶ China’s leaders are by no means neglecting these “softer” methods short of war.

That said, *Democracy’s Arsenal* rightly emphasizes the need for balance between high-intensity conventional capabilities and those tailored for less traditional conflicts along the lines of what the British general Rupert Smith has characterized as “war amongst the people.”⁷ Here *Democracy’s Arsenal* emphasizes the fleeting opportunity to negotiate a way out of descending “into a new dark age of anarchy and violence and a new cold war between the United States and China.”⁸ But in light of China’s 2007 demonstration of a kinetic anti-satellite capability and the ongoing build up of the Second Artillery Corps’ conventional and nuclear capabilities, how real is this opportunity? Moreover, even if the United States never fights China and avoids being drawn into a Cold War-like military competition with China, U.S. forces are almost certain to come up against Chinese weaponry—including their A2/AD capabilities—somewhere else in the world.

Finally, even if consensus emerged on the most important threats facing the United States in coming decades, exactly which sectors of the defense industrial base would best (and most affordably) meet them? If a critical challenge is A2/AD capabilities, would the best response lie in hit-to-kill missile defenses, directed energy weapons, facility hardening, long-range strike, a new generation of submersible combatants, changes in operational methods, or some combination of these? Again, not everyone is likely to agree on the answer to the linkage question.

Government decision makers and informed observers of the U.S. defense establishment can—and do—differ over the answers to core questions about America’s future security needs. And without answers, it is unlikely that much bipartisan consensus will be reached on what seven or eight or nine sectors (and underlying elements) of the defense industrial base are truly critical enough to warrant preferential investment. Nevertheless, such

⁶ Gansler, *Democracy’s Arsenal*, p. 88.

⁷ Rupert Smith, *The Utility of Force: The Art of War in the Modern World* (London: Allen Lane, 2005), pp. 4-6, 19-20.

⁸ Gansler, *Democracy’s Arsenal*, p. 89.

choices appear to be unavoidable if the U.S. government is to craft an effective strategy for preserving the vital sectors of the nation's arsenal—especially in the current budgetary environment.