

**Statement before the House Armed Services Committee
Panel on Business Challenges within the Defense Industry**

***CREATING A 21ST CENTURY DEFENSE
INDUSTRY***

Written Statement by

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Chairman Shuster, Congressman Larsen, and Members of the Panel: I appreciate the opportunity to appear before you this morning to offer my views on creating a defense industry for the 21st century. I should note that the data I use in this statement are from the work of the Defense-Industrial Initiatives Group at the Center for Strategic and International Studies (CSIS), but the views and comments are my own.

Mr. Chairman, it is well known to this committee that the U.S. depends on the defense industry for national security. I will focus this morning on the following:

- How we define and measure the U.S. defense industry
- The challenges facing industry today
- What is needed to sustain and retain a healthy industry

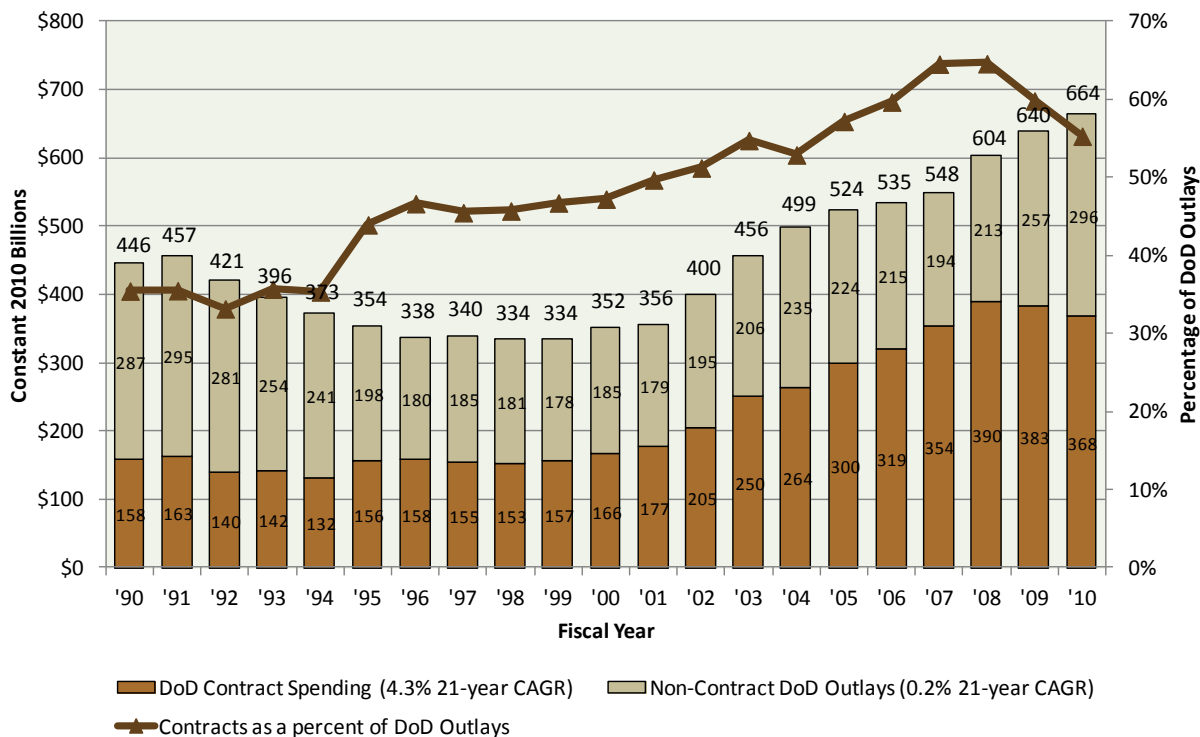
Defining the U.S. Defense Industrial Base

Chart 1 provides an overview of defense spending for the past 20 years, in constant FY 2010 dollars. Spending is divided into two categories: contract outlays at the bottom of each column and non-contract outlays at the top.

Non-contract outlays are mostly pay and benefits for active, reserve, and retired military personnel and pay and benefits for government civilian workers. You can see from the chart that the total outlays for non-contract expenses was almost identical in real terms for FY 2010 as it was for FY 1990, even though the size of the force is one third smaller. We are spending as much today as we were 20 years ago for two thirds of the people, which is a concern but not the subject of today's hearing.

Today's focus is on the bottom part of each column, on contract outlays. All of these expenditures are for contractors, and our definition of the U.S. defense industrial base is the companies that receive funds and deliver performance on these contracts.

Chart 1: Top Line DoD Contract Spending, 1990-2010 (in Constant FY2010 Dollars)



Note: Dollar figures may not sum due to rounding.

Source: DD350 and FPDS; CSIS analysis.

When we speak of the U.S. defense industrial base generally, it often means the subset of companies that produce weapon systems, but CSIS takes that definition more broadly and breaks down the data by contract spending on products, R&D (research and development), and services. Because it includes only data on prime contracts and not subcontracts, not all tiers of suppliers are visible.

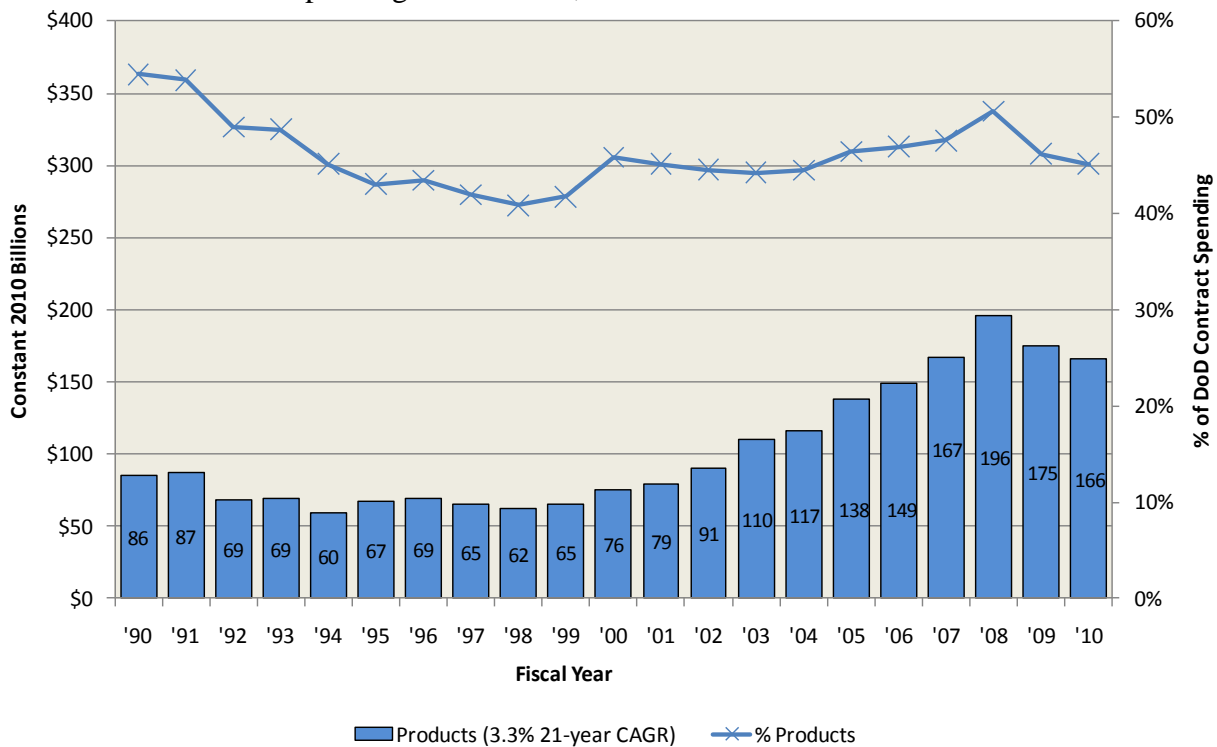
The data come from the government's own reports of contract spending in a public data base called the Federal Procurement Data System, or FPDS. This data base was directed by Congress in the 1974 act which created the Office of the Administrator of Federal Procurement Policy, and it is a rich source of necessary information for the public.

FPDS breaks down all contracts into two broad categories: products and services. Under FPDS guidelines, R&D is classified as a "service". Under that definition, the largest "services" contract in the federal government would be for the F-35 Joint Strike Fighter. Because most R&D in DoD is an investment, not a service, it is better to track contracts in three categories rather than two:

- products,
- R&D (research and development), and
- services

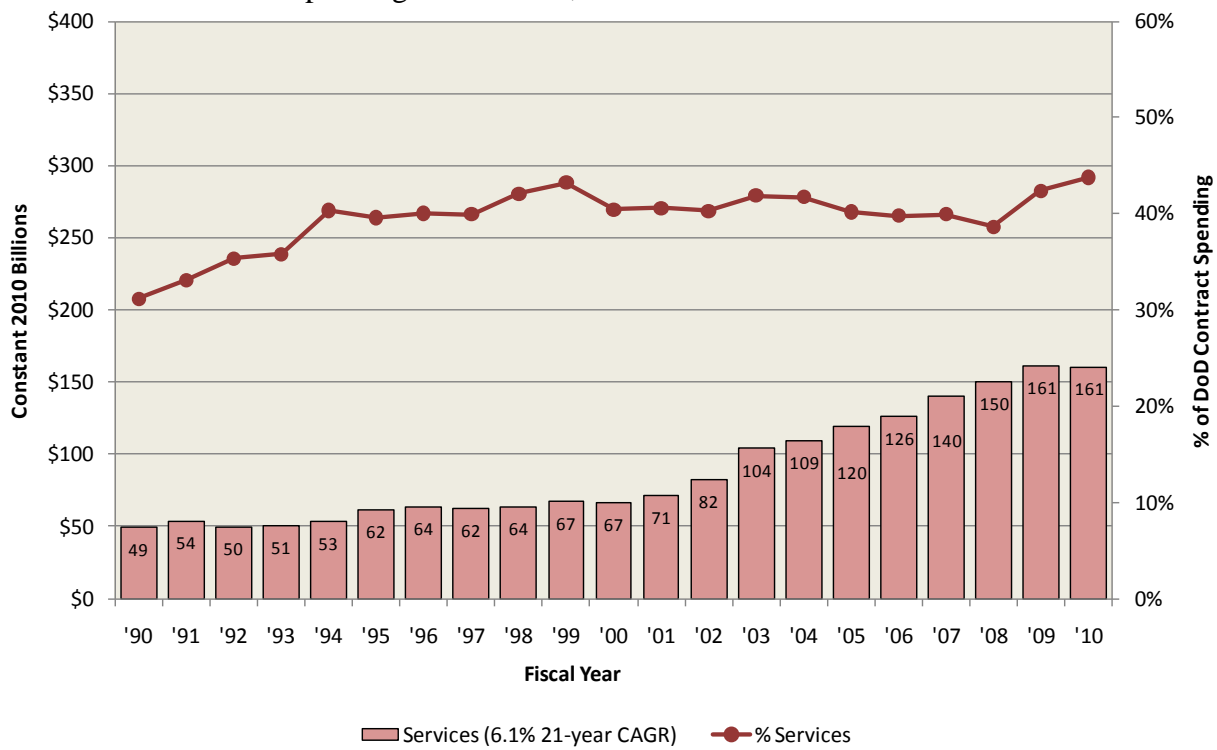
Charts 2, 3, and 4 show the trends for defense contracts in these three categories.

Chart 2. DoD Contract Spending for Products, 1990-2010



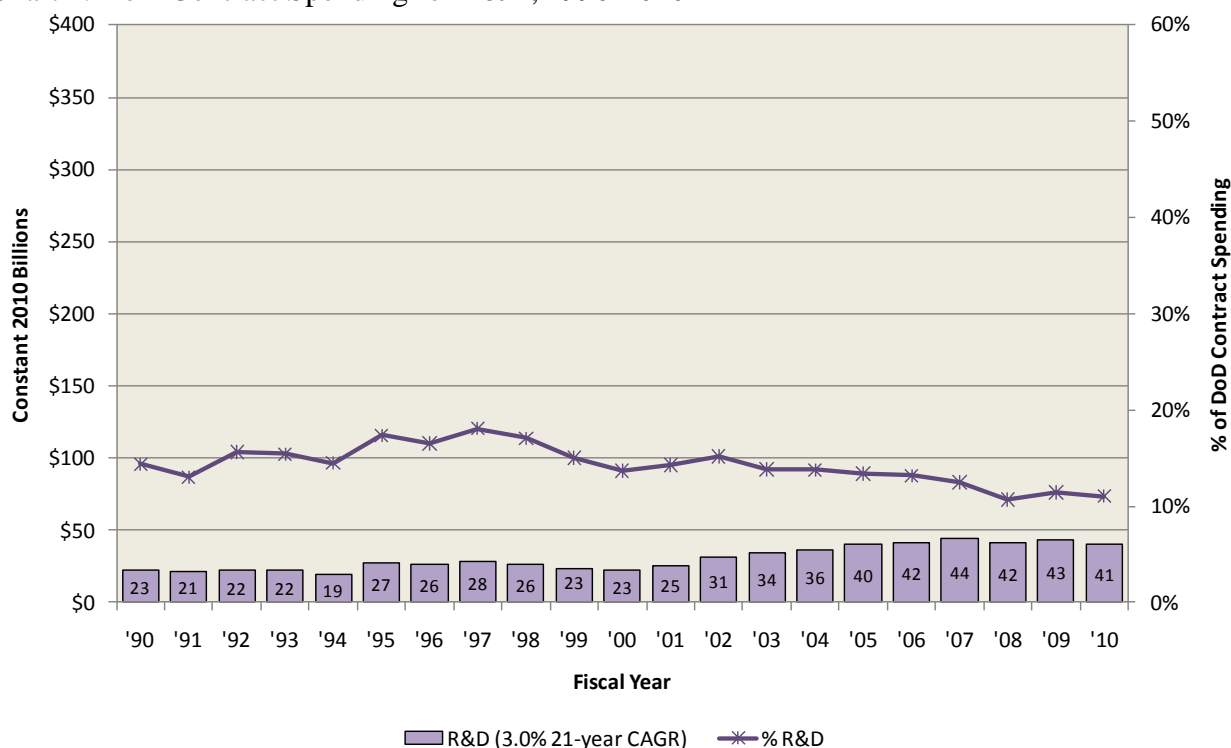
Source: DD350 and FPDS; CSIS analysis.

Chart 3. DoD Contract Spending for Services, 1990-2010



Source: DD350 and FPDS; CSIS analysis.

Chart 4. DoD Contract Spending for R&D, 1990-2010



Source: DD350 and FPDS; CSIS analysis.

You can see from the charts that in FY 2010 roughly equal amounts of funds are spent on products and services. This means that the U.S. defense industrial base includes a large services industry sector, which is a broader definition than simply those firms involved in the manufacture of weapon systems.

In addition, it is worth noting that contracts reported in FPDS are not required to include classified contracts. As a result, data for R&D (Chart 4) are significantly less than appropriated funds would indicate. Other sources show that roughly an additional \$22-25 billion is spent on classified DoD R&D contracts.

The Challenges Facing the U.S. Defense Industrial Base Today

The U.S. defense industrial base today faces three critical challenges. The chief challenge is one with which we are all familiar, and that is the impact of planned and potential reductions in defense spending. The second challenge is the need for industry to remain competitive in global financial markets. The third challenge is in retaining technical and innovative leadership. Let's look at each in turn.

Budget reductions are not new for defense industry – we have been through four of them in the past 65 years, and we are entering the fifth. There are some significant differences this time, though, that warrant your awareness.

There are fewer tools available today to DoD and the industry. Industry survived the last budget drawdown in part by consolidation. For example, in the mid-1980s, there were seven manufacturers of military aircraft. By 2000, there were two or three, depending on your definition. There were six shipyard companies in 1990 and two in 2000. Few factories were shut, but the corporate structure was consolidated. That is less of an option today, and in fact the Under Secretary of Defense for Acquisition, Technology, and Logistics has publicly stated that DoD would not support consolidation among the top defense firms.

The second challenge has to do with the operating climate for defense companies. For decades, defense companies were somewhat insulated from global financial markets. The U.S. government provided financing for contracts through prompt payment of invoices and through a mechanism known as progress payments, whereby firms could invoice on work done even before the product was delivered. Today, though, any firm of substantial size depends on the global financial markets, which base their judgments on return on investment, not on national security. Many of our government policies, though, have yet to recognize this changing reality.

The third challenge is in innovation and the advancement of technology. For decades, most good new defense technology was developed first in the United States, usually for defense purposes by defense companies. That is no longer true, both for platforms like rotary wing aircraft and for systems in communications, sensors, data fusion, etc. Technology with value for defense is just as likely to be developed for global commercial markets as it is for U.S. national security, yet our policies on issues ranging from foreign ownership of defense firms, to security of supply, to national export controls have not recognized this reality nor kept up with its implications.

What Is Needed To Sustain and Retain a Healthy Industry

There are no easy solutions to the challenges facing defense industry, but there are a number of key steps that can be taken. First, we need a clearer articulation of our future national security strategy, one that can permit better prioritization of budget and force structure needs and guide reductions. Absent a clear statement of strategic priorities, industry is looking to DoD for signals. What are we going to need? What are we going to develop and procure and deploy, and where? Without these demand signals, it is hard for industry to know where to invest. Those signals, however, have yet to be communicated.

Second, we need a change in incentives, both in DoD and in industry. Requirements need to reflect tradeoffs of engineering, cost, and performance in use. Today, they often do not. Budgets need to reward those who control costs. Today, cost control is punished by smaller budgets. Companies need to gain from reducing costs, not end up with less revenue and lower margins.

Third, the government needs to have a better idea of which elements of the industrial base are most vulnerable and a better way of including that information in budget decisions.

Finally, as technology development continues to occur outside the U.S., we need an export control regime that recognizes the global origin of innovation.

Conclusion

Chairman Shuster, Congressman Larsen, and Members of the Panel, that concludes my remarks, and I look forward to your questions and our discussion.