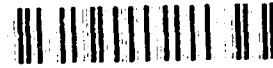


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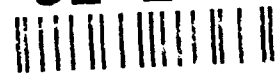
Strategic Outreach Conference Report

Reconstitution:

Force Structure and Industrial Strategy

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**RECONSTITUTION:
FORCE STRUCTURE AND INDUSTRIAL STRATEGY**

A CONFERENCE REPORT

BY

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On May 7-8, 1992, the Economics and National Security Program of Harvard's John M. Olin Institute for Strategic Studies, in collaboration with the Army War College and Federal Emergency Management Agency (FEMA), held a conference in Cambridge, Massachusetts on "Reconstitution: Force Structure and Industrial Strategy." This report documents the major findings that came out of the conference, and provides suggestions for future research. The report does not represent a consensus document; it reflects solely the understanding of the author with respect to the critical points raised during the presentations and discussions.

I. What is Reconstitution?

As Professor Samuel Huntington of Harvard's Olin Institute stressed during his keynote address, the world remains an uncertain and dangerous place despite (or perhaps because of) the end of the Cold War. Regional conflicts, ethnic violence, and new challengers will all pose potential security problems for the United States. In this context, it is critical that the United States maintain the forces needed for a variety of contingencies. Huntington questioned, however, the ability of the United States to "reconstitute" wholly new forces in the event of a newly emerging threat, given the historic inability of policymakers to predict crises and to respond in a timely fashion. Throughout American history, the country has been slow to respond to security threats, and mobilization has proceeded more slowly than anticipated.

During the question and answer period that followed Huntington's address, the discussion opened up with regard to the definition of reconstitution. Some stressed that mobilization was different from reconstitution; the latter implied that the United States would have ample time to analyze and counter an emerging threat. In other words, reconstitution could not occur under conditions of surprise attack.

According to the 1992 National Military Strategy, Reconstitution involves forming, training, and fielding new fighting units. This includes initially drawing on cadre-type units and laid-up military assets; mobilizing previously trained or new power; and activating the industrial base on a large scale. Reconstitution also involves maintaining technology, doctrine, training, experienced military personnel, and innovation necessary to retain the competitive edge in decisive areas of potential military competition.

The purpose of a national reconstitution strategy is to provide the resources needed to meet any threat that requires more firepower and logistical support than that which the Base Force, as currently planned, can supply.

The conference focused primarily on the industrial dimension of reconstitution. According to the DoD's Office of Strategic Competitiveness:

we will need a production base to produce new systems and a maintenance and repair base to support them. As we make procurement and investment decisions,

we will have to place a value on the assured supply and timely delivery of defense materials in time of crisis. In the near term, we should retain and store equipment from units being deactivated. Over the longer term, we must increase our capability to expand production or use alternative sources of supply. We need the capacity for industrial surge, and must plan for production from new or alternative industrial capacity. We need the capacity for industrial surge, and must plan for production from new or alternative industrial capacity. We must reduce unneeded military specifications and ensure corporations continue to have incentives to engage in innovative defense work.

In the preceding paragraph, the words "need" and "must" are frequently used. The critical question, however, is whether public policies are being fashioned which will support the reconstitution requirement for the industrial base. On this point there was considerable debate.

II. Reconstitution and the Industrial Base

The morning panel, and luncheon keynote address by Bernard Schwartz, chairman and chief executive officer of Loral Corporation, focused on the relationship between reconstitution and industrial strategy. There was general agreement among the conference participants that a substantial build-down was underway, but Professor Murray Weidenbaum cautioned to remind us that the U.S. would "maintain high levels of defense spending." Indeed, his view was that the build-down could lead to a leaner, more efficient defense industry, if appropriate policies are adopted. Specifically, the DoD must streamline procurement, upgrade its contracting personnel, and change the rules of the game. With respect to the latter point, Weidenbaum urged the DoD to "throw out" its hefty procurement regulations and replace them with "100 pages" of simple guidelines.

Mark Sullivan of McDonnell Douglas expressed skepticism about the ability of defense officials to maintain the industrial base without ongoing production. Sullivan noted that his firm spent millions of dollars each year to maintain or improve buildings and equipment and to train personnel. These overhead costs were being absorbed against four manufacturing lines--those of the F-15, F-18, T45, and AV8B. Sullivan asked: how can the company cover its overhead costs in the absence of production? Further, he emphasized that once workers were let go, it would be difficult to re-hire and re-train them in the event of a future conflict.

With specific reference to reconstitution, Sullivan noted that it takes six years for his firm to go from prototyping to production. From concept exploration to production takes fifteen to twenty years! Thus, once the assembly lines are shut down, it would take the firm many years to rebuild the capability needed for actual production. In short, the United States would have to respond well in advance to an emerging threat if it was to reconstitute the industrial base. But this, Sullivan cautioned, is something the country has never done particularly well in the past.

Richard Daly of Raytheon added to this picture by describing the plight of the nation's

subcontractors. In his view, many of the prime contractors would survive, even if they became smaller, at least in their defense lines of work. But he noted that many subcontractors will disappear altogether, many of which are "critical" to defense production. Daly emphasized that it is not the case that all subcontractors provide commodity goods and services. Raytheon, for example, relies on subcontractors for certain areas of specialized, technical expertise, and when they go out of business it will be difficult for the company to replace them.

Overall, Daly warned that the defense "cuts are going faster than industry can absorb them." This is leading to substantial dislocation, and a lack of planning. Further, in an environment of over-capacity, the DoD may be tempted to create bidding wars over new contracts which would lead to self-destructive behavior by defense firms.

What can be done? Daly noted three alternatives. First, government could lend greater support to the promotion of export sales, through, for example, an increase in Export-Import Bank financing. Second, it should slow the shrinkage process, allowing the firms to build-down more efficiently and more thoughtfully. Finally, defense firms can convert some of their resources to other areas, both within and outside defense. Raytheon, for example, was playing a leading role in the destruction of outmoded weapons.

Byron Callan of Prudential Securities provided the conference with a view from Wall Street. Callan argued that the most powerful force shaping the defense industry may not be public policy, but rather shareholder interests. The two, he observed, do not necessarily coincide, and this makes it all the more important for policymakers to be aware of the financial forces acting upon defense executives.

As a case in point, Callan examined the recent behavior of senior management at General Dynamics, a major defense contractor. In early 1991, these managers adopted an incentive program in which they would be awarded substantial bonuses based on stock performance. Their strategy, according to Callan, has been interpreted by some observers as one of "liquidation," in which valuable assets have been sold and spending--including research and development spending--has been slashed. The result is that the company is sitting on a pool of cash, a portion of which will be returned to the shareholders in the form of a special dividend. (On June 9, 1992, General Dynamics announced it would purchase 30% of its stock in a "Dutch Auction").

The example of GD provides a case study in which the shareholders' benefit may be the nation's loss. As Callan notes, the management policies adopted at GD "can cause morale problems in organizations, result in elimination of capabilities that many not be in the national interest, and spur managements at other defense firms to adopt similar policies." In short, private and public interests are now beginning to diverge in many defense companies.

To put them back on a common track, Callan made the following recommendations: "First, there should be more support for mergers in defense industry sectors where little commercial product potential exists. Second, Congress and the Executive Branch should better support

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export of defense products and tailor a procurement policy that enables the industry to respond to international market needs. Third, companies must be allowed to make a competitive return when doing business with the DoD."

The conference keynote speaker, Bernard Schwartz of Loral Corporation, provided a number of additional insights into the future of the defense industrial base during his luncheon address. Schwartz said that the market was a "capricious arbiter," and criticized the government for not showing more leadership on defense industrial issues. Specifically, he said that government must help as the industry downsizes, that it must "restore fairness in contracting," that it should aid displaced workers, and that it should help promote exports. He also suggested that the DoD should do more by way of amortizing research and development costs.

Schwartz expressed skepticism about industrial reconstitution policy as presently articulated. Specifically, he said that it was misguided for public officials to focus on research and development without production. In an environment where production was not rewarded, Schwartz stated that firms would simply sell assets. The result will be an industry that simply cannot be reconstituted to meet emerging threats.

III. The Policy Response

The afternoon session gave a panel of policymakers the opportunity to respond. The panel was moderated by Dan Goure of the Pentagon's Office of Strategic Competitiveness, and included Deborah Christie and Nicholas Torelli from DoD, and Joseph Moreland from FEMA. They each provided some brief comments, and a lively discussion period followed.

The policy panelists focused on two key variables: time and money. In his opening comments, Dan Goure suggested that the point of reconstitution was to both deter any future threat and, in the event deterrence fails, to meet the threat with superior forces. Critical to our response, however, was time. Goure argued that the major issue with respect to the industrial base would be the expansion of capacity; this leads to the question, what are the capacity drivers? A greater understanding of these "capacity drivers" was critical to an understanding of whether reconstitution was sensible from the perspective of the defense industrial base. In his comments, however, Goure expressed optimism that time would be available to respond, and in the face of the conventional wisdom he said that, from an historical perspective, countries are responsive to external threats.

Deborah Christie focused on the problem of money. For her, the key question was "how much money do I have to spend on particular capabilities?" Another way of asking the question would be in terms of resource allocation; how do I allocate the scarce resources available to me? According to Christie, there has been a fundamental change in our expectations of the conditions under which this nation would need to call on the industrial base for a surge in production of most items. In the past, we were concerned with the ability to surge production to meet the needs of ongoing or imminent combat. Now we are concerned primarily with being able to increase military capabilities fast enough to maintain deterrence or to defend against some hostile

nation or coalition that is increasing its capabilities. The problems we would have increasing our industrial capacity also would be faced by this opponent. Thus we should have time, if we use it effectively. Preparedness measures can shorten our response time and facilitate a decision to respond. On the issue of whether the nation will respond, Christie thought one point was missing. She personally found it inconsistent to believe our nation will not respond to an emerging threat but will pay to preserve excess capacity as an insurance policy against the possible emergence of such a threat unless the price of that insurance is very low. One current problem (what Dan Goure called understanding capacity drivers) is a lack of understanding of the cost and effectiveness of most of the preparedness measures that are proposed.

Torelli, drawing from his personal experience in the defense business, was perhaps the most optimistic panel member with regard to the prospects for industrial base reconstitution. He observed that the procurement and R&D budgets would still remain substantial for the foreseeable future, and that the challenge was to use those funds as efficiently and effectively as possible. He stated that the Pentagon would continue to acquire weapons systems and would continue to invest in R&D; the challenge was thus to promote the capabilities we really need. To that end, Torelli said that the DoD had a number of initiatives underway (CALs--Computer-aided logistics and support, Technology for Affordability, etc.) which held out the promise of making better use of defense dollars. In short, Torelli, like everyone else, looked to a smaller defense industry, but he believed it could remain adequate to meet the nation's needs in the event of a reconstitution requirement.

Joseph Moreland rounded-out the policy discussion by emphasizing the civil dimension of reconstitution planning. He noted that twenty-eight agencies of government support the DoD in times of national emergency, and that their requirements must be considered in order to ensure that the demands of reconstitution can be met. Clearly, during a reconstitution exercise there would be conflicting demands on manpower and material, and it is important that these be considered before the actual event occurs. Moreland pointed out that the United States government had witnessed coordination problems in the past at the outbreak of major conflicts, and there was no reason to be sanguine that these could be avoided in future.

IV. Discussion

The discussion during the conference is not easy to capture, since a variety of viewpoints were expressed. There is obviously no consensus when it comes to reconstitution policy and what, if anything, should be done to maintain the health of the defense industrial base. Nonetheless, some common themes reappeared during the discussion periods, and they are the focus of this section.

A prominent subject of conversation concerned defense exports. To the extent that exports can help to maintain production lines during periods of lower domestic demand, the representatives from industry felt the time was ripe for government to give greater support for arms sales. It was pointed out by Gilbert Croze of Matra Aerospace that European defense firms have adopted a similar perspective, and will look increasingly to export markets as

as European demand decreases.

But several government representatives expressed the view that the arms industry cannot look to exports as the "savior." Moray Stewart of the United Kingdom's Ministry of Defence argued that concerns with proliferation would certainly force governments to limit arms sales, and further he said that if every firm expects to export more than they will find tremendous competition for overseas markets. This competition will reduce margins and profitability. John Tyler of the Pentagon's Defense Security Assistance Agency expressed a similar view, stating that arms exports would not be a "panacea." Further, Tyler pointed out that the United States, despite the arms cuts, would remain by far the largest defense market in the world.

A second set of comments focused on the theme of "building down smartly." Again, as Moray Stewart said in response to one presentation on this theme by a U.S. government official, "I wish you luck." Questions about building down smartly revolved around two issues: first, can it be done in practice? Second, even if we knew what capabilities we wished to maintain, would we know what policies to adopt? There was debate on both these topics.

With regard to the first issue, Nicholas Torelli made perhaps the strongest statement that we can build down without sacrificing capabilities. As manager of a missile system division of a defense firm, he had to close down plants with an eye to re-opening them at some future date. On the basis of his successful personal experiences, he believed that the difficulties of building down smartly were exaggerated.

Others from industry expressed skepticism. Mark Sullivan emphasized that once people were let go, it was almost impossible to replace them. Sullivan further said that once the subcontractor base was shattered, it could not be rebuilt. He noted that McDonnell Douglas used 3,000-4,000 subcontractors on its F-15 project; how would they be kept in business once the line was shut-down? Richard Daly made similar points with respect to people. He and others noted that Torelli closed his plant in the expectation of re-opening it again in a year or two. Reconstitution, however, involved a much longer time horizon. The question was what to do with engineers whose talents you might need fifteen years hence!

Imagining, however, that those problems can be solved and that policymakers can identify the capabilities they need, the question remains as to whether they can adopt appropriate policies. Robert Art of Brandeis University pointed out that there were several different methods by which capabilities could be maintained, e.g. by fully funding certain prime contractors; promoting government laboratories; or prototyping several defense technologies. Which is the best approach? The answer was not forthcoming from the policymakers who were present.

Ethan Kapstein added that, even if an answer was reached, structuring a contract that could be enforced in the future would be almost impossible. Let us imagine that defense officials wished to maintain a capability for a reconstitution scenario, and contracted out to that end. What assurance would they have that the capability in fact would be maintained and ready to go

on M-Day? As Kapstein said, the officials wish to purchase an "option," as speculators buy stock options, but whether such options are available in the defense market over these time horizons remains an open question.

Finally, the discussants debated the question of timing. A presumption of the nation's reconstitution strategy is that policymakers will have ample time to foresee an emerging threat and respond to it. There was considerable skepticism on this score, even among some of the participants from government. As one said, it's not difficult to imagine new kinds of threats arising that don't permit us strategic warning time. Further, many participants questioned the ability of governments to respond to emerging threats. As Byron Callan noted, "history is littered with examples in which nations found themselves at war on short notice with an adversary they had not expected."

V. Concluding Remarks

The conference wrap-up was provided by Professor Stephen Peter Rose of Harvard's Olin Institute. Rosen stated that during the presentations and discussion periods he had heard two distinctive perspectives on the industrial base issues: that of the defense industries and that of the policymakers. As a political scientist, he asked: "What are the political implications of each side getting what they want?"

The preferred strategy of the defense industry, Rosen argued, was to maintain their business with low-unit production, exports, and mergers and acquisitions. The result would be an industry with excess capacity, quasi-monopolistic suppliers, and high costs. Further, the industry would be selling arms to "many countries who won't always be friendly." In the absence of a military threat, Rosen said that this strategy would court domestic political opposition that would make "fraud, waste and abuse" seem trivial. He reminded the audience of the debate in the 1970s over the "merchants of death" and the calls for greater regulation of the arms industries. He also stated that by increasing exports the United States would make potential adversaries stronger during a period of American drawdown; how do you solve this problem, Rosen asked.

The government's strategy had a different set of preferences and outcomes. It focused on warning time, deterrence, and the prevention of a new global threat from re-emerging. The problem with this approach, Rosen argued, was three-fold. First, any enemy we face in future will wish to defeat us during the planning period; if the U.S. needs ten years to reconstitute, the enemy will seek to achieve its objectives within that time frame. The enemy's goal, therefore, will be to seize the initiative, forcing the United States to respond before it has reconstituted. Second, even though the United States hopes the next war will be short, it should plan for a long war and ultimately will have to prepare its people for a long war. One problem with Desert Storm, he suggested, may be that people will come to believe that all wars in the future will be this easy. Third, Rosen claimed that American strategy continued to rely heavily on allies, demanding that we build consensus during and after future wars. He observed that although the United States helped win World War I, it had relatively little say over the outcome at the Paris

Peace Conference.

Going forward, Rosen had several suggestions for those concerned with future strategy. First, he argued that more interaction with congressmen was needed. Second, he called for improved coordination between industry and the executive branch. He noted that in the past policymakers and executives shuttled between the public and private sectors; conflict of interest regulations had made this much more difficult at present. He viewed this communication between industry and government as vital not simply because of the technical issues involved but also for "sociological reasons," so that the two sides become more familiar with the incentive structures each faces. Finally, Rosen said we must focus more on officer training. The junior officers today will be those responsible for reconstitution tomorrow. How do we train and keep these young officers. During a period of drawdown, and given the incentives of the free market, we face the flight of many fine officers from the military, leaving us exposed to an inexperienced officer pool.

VI. Future Research

Every academic conference ends with a call for more research. In the case at hand, however, the call would seem especially justified. The future security of the United States will rely heavily upon strategies and doctrines developed before the next conflict begins; in other words, on the planning and training done today. In that current work on national security is being undertaken during a period of enormous structural change, the research challenge is truly daunting.

Within the specific context of reconstitution and the industrial base, the following questions are among those that could profitably be pursued by researchers:

1. How can policymakers structure contracts which ensure that specific capabilities will be maintained by defense industries?
2. In what ways do the interests of policymakers and defense industry shareholders diverge? Is there anything that public officials should do to make these interests more convergent?
3. Reconstitution strategy demands that the nation's research and development and production base be kept "warm" in the event of a new threat. How can today's policymakers determine those requirements which may be needed in the future?
4. A representative of the U.K. Ministry of Defence observed that the conference presentations were very "nationalistic." The question arises, what role do alliances--both military and industrial--play in reconstitution strategy?
5. Finally, what, if any, historical examples provide insights into the reconstitution process? Can we develop historical case studies that would focus policymakers' minds on the critical issues they might face in a reconstitution scenario?