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Deputy Secretary of Defense
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"Managing the Defense Enterprise in a Drawdown"
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Thank you Jonathan.

Normally I begin by saying how refreshing it is to get out of Washington. But I have to tell you, this month it has been very gratifying to have stayed in Washington, witnessing our military do what it does best. Bringing Osama bin Laden to justice was a moment long in coming, for the 9/11 families, for this city, and for our nation. It was also a moment that began here, on the Intrepid, where hundreds of FBI agents set up a temporary headquarters to begin the investigation after their own field office was destroyed at the World Trade Center.

In the ten years since, our whole government has worked to finish what those FBI agents began. The CIA, the Seals, those in uniform, and those in intelligence and law enforcement make a team unlike any other. We can all be so proud of what they did, and what we continue to do every day, to protect the American people.

I would like to thank Rob Stallard and his team for inviting me to speak this evening. It is a pleasure to be with all of you on the Intrepid.

Tonight, I would like to discuss the central challenge that we face in current defense planning: how to manage a slowdown in defense spending responsibly in the midst of two active conflicts, other commitments, and numerous threats.

Let me start by saying that it would certainly be desirable to defer this challenge until a later date when the transition in Iraq is complete and we are closer to handing off the combat mission in Afghanistan to local forces. But the deficit crisis does not allow us that luxury. We need to begin putting our fiscal house in order now.

This is in fact a matter of national security. Our security begins with a strong economy. Our ability to exert global influence and protect our interests abroad will be threatened if we do not reduce the deficit and keep federal debt within sustainable bounds. No great power can project military force in a sustained manner without the underpinnings of a sound economy. Our economy is truly the wellspring of our military might. And it is reeling from an overall imbalance between revenues and expenditures and the expenses of a decade of conflict. With deficits approaching 10% of the economy, austerity measures are now required to ensure its long-term health.

As a nation, these circumstances present a thorny dilemma. We must, over time, bring the federal budget back into balance. But we must do so while both preserving our competitiveness in the global economy and maintaining our national security. As the President has made clear, achieving this will require painful cuts in federal spending. Everything must be on the table: revenues, entitlements, domestic discretionary spending, and defense spending. Although reducing the defense budget cannot alone solve our deficit problem, it is hard to envision an overall solution that does not include some contribution from the 20 percent of government spending that goes toward defense.

Our task is made more difficult by its timing. Ordinarily, drawdowns occur after wars, not amid them. Yet we must accomplish this drawdown while engaged in Afghanistan, transitioning security responsibility in Iraq, and still remaining ready to intervene elsewhere when our national security interests are at risk.

Managing the department under these circumstances is a high wire act. It poses a tremendous challenge to defense policymakers and industry executives alike. For us, the issue is how to slow defense spending responsibly while retaining the most effective fighting force in the world. For industry, it is how to adjust to a less robust defense market while maintaining their technological prowess. Together, we must manage resources in ways that do not hollow out the capabilities of our armed forces or recklessly jeopardize our industrial base. In short, we must accommodate our changing fiscal circumstances without undercutting our military effectiveness, now or in the future.

For guidance on how to slow spending responsibly, history is instructive. Several lessons from prior drawdowns can inform how we manage this one.

LESSONS FROM HISTORY

We have arrived at the fifth inflection point of post-World War II defense spending. The first three drawdowns came at the end of wars—World War II, Korea, and Vietnam. Then in the mid-1980s we faced a situation somewhat analogous to today. Deficits during the Reagan Administration led Congress to impose spending caps. The end of the Cold War then accelerated defense reductions.

What these transitions in defense spending have in common is that DOD suffered a disproportionate loss of capability as a result. Each time we had to rebuild much of the capability we lost, often at great expense and under urgent circumstances. Each time, our industrial base struggled to rapidly reverse course. In other words, we have gone 0-for-4 in managing the drawdowns to date.

With troops deployed in active conflicts, we must do this better this time around. And we can do better, by learning the lessons from prior drawdowns and applying them to our thinking today.

I would draw four broad lessons from prior drawdowns.

The first is to make hard decisions early. Things are not going to get better. In a drawdown, there will be less money than we anticipate in the future, not more. Moreover, even well-managed programs experience some cost growth. The bottom line is that if we cannot afford it now, we will certainly not be able to afford it in the future. Given our difficult budget challenges, it is irresponsible to embark on programs that we cannot afford. To live within our expected resource levels, we need to make the hard decisions now.

The second lesson from prior drawdowns is that it is impossible to generate the needed savings through pure efficiencies alone. By pure efficiencies, I mean where you perform the same function for less money. We can generate some savings that way. For instance, cloud computing holds out the potential of generating greater capability at lower cost across our information technology enterprise. But we are not going to find enough pure productivity gains to generate all the required savings. This means that we have to prioritize. We will have to eliminate programs that, while valuable, are not valuable enough to sustain in this budget environment. The "nice to haves" must go. We must pare back to our essential missions.

The third lesson is that reductions must be done in a balanced way. Reductions focused on a single area, like operational accounts, hollow out the force by depriving it of needed training and maintenance. Similarly, reductions that single out investment accounts, which are easy to target, effectively force a procurement holiday, causing a modernization bulge to develop. This bulge of outdated equipment then needs to be replaced at great expense a decade or so later. The bill that comes due is far larger than it would otherwise be. To avoid this from coming to pass, we need to balance reductions across force structure, operating, and investment accounts. We do not want a force that is the same size but does everything less well.

The final lesson from prior drawdowns is not to cut too much, too fast, especially from core mission areas. Rebuilding capabilities five, ten, or fifteen years later comes with a cost multiplier. And cost alone is not the only price we pay. We have paid for some of our prior decisions with the lives and welfare of our troops who find themselves in conflicts for which they are neither prepared nor equipped. This was particularly true in the 1950s, when the drawdown after World War II caused our forces to pay a high price in the initial stages of the Korean conflict. We do not want to make precipitous cuts today that we will come to regret in the future.

Secretary Gates anticipated the circumstance we find ourselves in and shifted our fiscal and strategic approach in accordance with the four lessons I just described. For two years, we have been making tough decisions and been making them early. We ended the buy of the F-22 and C-17 and terminated the Presidential helicopter program. We closed less essential organizations, like the Joint Forces Command. To ensure we balance cuts across accounts, we have proposed conditions-based reductions in the Army and the Marine Corps for fiscal year 2015 and 16. Finally, we are phasing reductions in over several years, thereby avoiding precipitous cuts. If we continue this approach and take seriously the lessons of history, we can avoid going 0 for 5.

INDUSTRIAL BASE IMPLICATIONS

As we work through the implications of managing the defense enterprise during a slowdown in spending, it is crucial that we preserve the capabilities resident in our industrial base.

The industrial base we have today is a relatively recent development in our nation's history. Before World War II we relied largely on an arsenal system, where the government itself designed and produced most of the weapons and munitions we needed. The arsenal system was a corollary to our reliance on mass mobilization in times of war—with no large standing army to serve, there was no foundation for a defense industry. The risks inherent in such a system became clear during World War I. With no ability to ramp up production quickly, our forces were largely dependent on the British and the French for supplies of advanced munitions.

World War II constituted a paradigm shift. In a time of crisis, we engaged the ingenuity of American industrial base, producing a tide of weapons and material that won the war. The achievement largely eliminated the arsenal system. And the enduring partnership between science, industry, and the military has meant that our forces have always taken to the battlefield with a technological edge.

The USS Intrepid where we meet tonight is itself a testament to this history of industry-led technological prowess. Commissioned at the height of World War II, she saw action in some of the most brutal battles in the Pacific. The ship was then transformed in the Cold War to an anti-submarine carrier. Later, her flight deck, the first fitted with steam catapults, launched planes during the air campaign over Vietnam. The technological innovation that occurred across her thirty years of service is a testament to the marriage of science and industrial might that endowed—and continues to endow—America with superpower status.

Our defense industrial base has emerged in the past three generations as a national strategic asset—an asset that is not a birthright and cannot be taken for granted. Thousands of firms and suppliers—some big, others small—help equip our military. These firms, their suppliers, and their suppliers' suppliers, are each links in a chain that, if broken, can have outsized consequences on our military capabilities. To ensure the nation has the industrial capacity it needs, we must understand the different supplier tiers, their interdependence to one another, and the programs they serve.

As we consider the future of our defense base, we must recognize that it is more global, more commercial, and more financially complex than ever before. A one-sized-fits-all approach to industrial policy no longer holds, if it ever did. So together with Ash Carter, our Undersecretary of Defense for Acquisition, and Brett Lambert, our Deputy Assistant Secretary for Industrial Policy, who is with me tonight, I am leading an effort to provide a roadmap for ensuring the health of the industrial base.

We are doing a sector-by-sector and tier-by-tier review of the defense industrial base. The goal is to assemble a long-term policy to protect that base as we slow defense spending. This detailed review will inform our budget decisions, our acquisition decisions, and our industrial policy. It will help us determine what stake the Department has in mergers and acquisitions, and how we can create enduring value for the taxpayer in each sector.

Already, three themes are emerging about how to maintain a vibrant industrial base.

COMPETITION

The first is the importance of preserving competition. Since World War II, vigorous competition in the defense industrial base has provided our armed forces with more reliable equipment and better technology than our adversaries. Normal market forces should continue to shape defense industry, ensuring that it remains exposed to the 21st Century currents of technology, creativity, and capital markets. This is not only good economic theory. It also yields the best goods and services for the warfighter.

In 1993, during the last slowdown in defense spending, one of my predecessors, Dr. William Perry, called industry leaders to a dinner meeting at the Pentagon – the now fabled "Last Supper." There, Perry explained that lower defense spending would require industry to consolidate Given the coming reduction in demand, the taxpayer could no longer afford to underwrite the overhead associated with so many independent firms. In less than a decade, more than 50 major defense companies consolidated to only six.

The value we derive from competition means there will be no second last supper. We are not looking for further consolidation in the top tier of the defense industrial base. Fewer major defense suppliers would not strengthen industry, nor would it benefit the government.

This does not mean that we oppose all or even most future industry consolidations. Mergers and acquisitions are a normal response to changes in the defense budget. We should not reflexively oppose this market reaction. But we will be scrutinizing any proposal that comes forward to ensure the government's interests are protected. Adjustments that lead to greater efficiency and innovation overall will be welcomed. We are seeking to promote strong, well financed businesses that avoid the dangers of over-leveraging and poor balance sheets. Our intent is to ensure that the defense industry as a whole emerges stronger as a result of any significant structural changes.

In this context, it is important to recognize what differentiates the defense industry from the rest of the economy. Most fundamentally, a market composed of one primary buyer and many sellers is what economists call a monopsony. The term was coined in a 1933 treatise titled "Economics of Imperfect Competition." What monopsony means is that the buyer exerts more influence over suppliers than would ordinarily hold in a free market. The defense market is different in three further ways: its complexity creates higher barriers to entry; the government pays for the majority of firms' research and development costs; and the Department provides its suppliers with greater insight into future needs and requirements. Our intention is to use these dynamics—our position as a buyer, our subsidy of research, and our ability to forecast future needs—to boost investment, competition, and innovation to the maximum extent possible, while still allowing pure market forces to propel the sector forward.

From the Department's perspective, we need firms and suppliers interested in sustained performance, not highly leveraged companies who ignore risk in pursuit of profits.

We are in this for the long-haul, and need industrial partners and financial backers who think and act likewise. In this respect, our viewpoint is similar to long-term investors, not short-term speculators. Think Warren Buffet, not Gordon Gekko.

GLOBAL DEFENSE MARKET

The second theme emerging from our study of the industrial base is the contribution international sales make in stabilizing our defense industry when U.S. defense spending slows. To keep our base healthy, it is in our interest for it to compete globally.

A significant impediment to our international competitiveness is the archaic export control system. That system frequently fails in its central purpose of preventing states of concern from acquiring sensitive technologies. It also makes it difficult and time consuming for our closest allies—many of whom fight alongside us today—to buy our weapons. We need an export control system that reverses this dynamic. It should build higher walls around the fewer sensitive technologies truly needed to protect national security. But it should also allow U.S. companies to compete when the technology they aspire to sell is freely available on the international market.

Toward that objective, the Obama Administration is undertaking comprehensive export control reform. This reform will entail changes to how we as a department regulate sensitive technology, how the interagency system works together to vet and approve sales, and how the Congress structures export control legislation. The foundation of the Administration's proposal is what we term the "four singles:" a single export control licensing agency, a single tiered list of controlled items, a single coordination center for enforcement, and a single, unified IT infrastructure. The President, the Secretary of Defense, and the Secretary of State are committed to seeing reform through. And the Administration has already make progress on related fronts, including the passage of Defense Trade Cooperation Treaties with the UK and Australia.

In parallel with export control reform, we are changing our policies for technology security and foreign disclosure. How we transfer sensitive information to foreign partners is currently governed by thirteen separate processes. Since these processes are neither integrated nor synchronized, they often impede our ability to equip coalition partners with the defense capabilities they urgently need. Streamlining these processes will help U.S. firms and the allies they sell to, while ensuring our technology does not fall into adversaries' hands.

The corollary of ensuring our firms are competitive abroad is welcoming international firms to the U.S. market. The recent KC-X tanker competition shows why a level playing field is so beneficial. EADS, a European firm, bid without an American partner. A strong competition ensued. Boeing ultimately prevailed. But the winners were our warfighters who got a great tanker and the American taxpayers who saved billions of dollars.

TARGETED R&D SPENDING

The third theme emerging from our study of the industrial base is the importance of targeted research and development spending even as budgets decline. Defense spending plunged in the 1970s after Vietnam. But even then, the Department made sure promising research and development continued. One product we kept investing in lowered the reflectivity of radar waves on aircraft. Stealth technology is one of our military's most important advantages today. If not for careful stewardship in the lean years of the 1970s, its development would have been put at risk, leaving it and other crucial technologies on the whiteboard rather than deployed in our force.

Examples of key technologies we must work with industry to continue incubating today include long range strike systems, unmanned aerial vehicles (UAVs), and cyber defense capabilities.

Over the past two decades, the Pacific has grown in importance in our future defense planning. Distances here are greater than in Europe, which dominated Cold War scenarios, and anti-access and area denial threats loom larger. This has underscored the need for capabilities that support robust long range strike forces.

Similarly, the importance of unmanned aerial vehicles has accelerated. When the Iraqi war began, we had only a few UAVs devoted almost exclusively to surveillance. Now in Afghanistan, we have hundreds of UAVs devoted to the full gamut of military capabilities, from intelligence and reconnaissance to strike. We need to maintain our technological lead in this sphere.

Finally, it is clear that future conflicts will include a cyber dimension. Given the U.S. reliance on information technology, for both our military capabilities and our economic growth, we need to ensure we are able to defend our networks and compete effectively in this new operational domain.

Each of these technology areas will be crucial to future conflicts. We do not yet know the exact shape they will take, or the precise advantages they will confer. But unless we shield the research and development funds that support them, we will deny future decision-makers the opportunity to deploy these technologies, and deny the nation the security gains that accrue as a result.

CONCLUSION

Each of the issues I have touched on tonight is an enormous challenge. And we are taking them on simultaneously, while fighting one war, winding down another, and enforcing a U.N. resolution. The road ahead will not be easy. But as Secretary Gates is fond of saying, difficult is not impossible.

As part of his deficit reduction plan, President Obama called for $400 billion in reductions to the defense budget over the next 12 years. The President also called for a fundamental evaluation of American's missions, capabilities, and role in a change world.

To undertake this evaluation, we have begun a comprehensive review to frame our choices in terms of strategy, missions, and capabilities rather than budget targets alone. This review will focus on how to ensure that we preserve a superb defense force to meet national security goals, even if fiscal pressure requires reductions in size. In particular, we must reject the traditional approach of applying across the board cuts that preserve overhead and force structure yet hollow out the force. As I discussed at the outset, history shows the danger of such an approach.

Accordingly, this review will lay out the policy choices that are incumbent with changed resources. What missions are we doing today that we will not do tomorrow? What are the implications for our force structure and overseas deployments? What capabilities will be essential to meeting future national security threats? How will we balance the threat from near-peer competitors against that posed by low-end actors?

In the end, this process must identify options for the President, the Department, and the Congress about where the nation is willing to accept risk in exchange for reduced investment in Department of Defense operations. Thus, the comprehensive review must explicitly address our best judgment on such risks—whether they be strategic, operational, programmatic, or budgetary.

The challenge for all of us is to manage the slowdown in defense spending without disrupting the capabilities of the world's most effective military force. The best outcome would be for contractors to earn fair profits for superior performance, the Department to get quality products for an affordable price, and the taxpayer to underwrite our security at an acceptable cost. I believe such an outcome is well within reach.

If we continue to execute the four lessons of tough choices, prioritization, balance, and avoiding precipitous cuts, and if we successfully preserve the capabilities in the base, we can successfully transition to the new fiscal environment.

Thank you.