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Summary of Echoes Across the Pond: Understanding EU-US Defense Industrial Relationships

Raymond (Chip) Franck



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**SUMMARY OF ECHOES ACROSS THE POND: UNDERSTANDING
EU-US DEFENSE INDUSTRIAL RELATIONSHIPS**

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by

BG Raymond (Chip) Franck (Ret.), Dr. Ira Lewis, Dr. Bernard Udis

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Summary of Echoes across the Pond: Understanding EU-US Defense Industrial Relationships

Presenter: Raymond (Chip) Franck, PhD, Senior Lecturer, Graduate School of Business & Public Policy, Naval Postgraduate School, retired from the Air Force in 2000 in the grade of Brigadier General after 33 years commissioned service. He served in a number of operational tours as a bomber pilot; staff positions—which included the Office of Secretary of Defense and Headquarters, Strategic Air Command; and was Professor and Head, Department of Economics and Geography at the US Air Force Academy. His institutional responsibilities at NPS have included the interim chairmanship of the newly formed Systems Engineering Department from July 2002 to September 2004, teaching a variety of economics courses and serving on a number of committees to revise curricula for both the Management and Systems Engineering disciplines. His research agenda focuses on defense acquisition practices and military innovation.

Raymond (Chip) Franck
Senior Lecturer
Graduate School of Business & Public Policy
Naval Postgraduate School
Monterey, CA 93943
Phone: (831) 656-3614
E-mail: refranck@nps.edu

Author: Ira Lewis, PhD, is Associate Professor of Logistics, Graduate School of Business and Public Policy, Naval Postgraduate School, Monterey, CA. His interests include transportation, public policy, and the impact of information technology on logistics.

Ira A. Lewis
Associate Professor
Graduate School of Business & Public Policy
Naval Postgraduate School
Monterey, CA 93943
Phone: (831) 656-2464
E-mail: ialewis@nps.edu

Author: Bernard Udis, PhD, is Professor Emeritus of Economics at the University of Colorado at Boulder and Visiting Research Professor at the US Naval Postgraduate School at Monterey. He has also served as Distinguished Visiting Professor of Economics at the US Air Force Academy, and as William C. Foster Fellow at the US Arms Control & Disarmament Agency. His NATO Research Fellowship examined the costs and benefits of offsets in defense trade.

Professor Udis' published work includes three books: *The Economic Consequences of Reduced Military Spending* (editor, 1973), *From Guns to Butter: Technology Organizations and Reduced Military Spending in Western Europe* (1978), and *The Challenge To European Industrial Policy: Impacts of Redirected Military Spending* (1987). In addition, he has published numerous articles in scholarly journals on defense industries and military power. These include "Offsets as Industrial Policy: Lessons from Aerospace" (with Keith Maskus, 1992), and "New Challenges to Arms Export Control: Whither Wassenaar?" (with Ron Smith, 2001). A number of his works are considered classics in defense economics and have been reprinted in collections such as *The Economics of Defence* (Todd Sandler & Keith Hartley, 2001) and *ARMS TRADE, SECURITY AND CONFLICT* (Paul Levine & Ron Smith, 2003).

Professor Udis' current research focuses upon competition and cooperation in the aerospace industries of the US and the EU.



Bernard Udis
Professor Emeritus
Graduate School of Business and Public Policy
13 Camino Real
Sandia Park, NM 87047
(505)286-2789
E-mail: Bernard.Udis@colorado.edu

Abstract

This report represents the authors' efforts to provide a useful, albeit partial, understanding of the international defense marketplace—which we view as growing increasingly complex. In pursuit of that objective, we provide a brief overview of international defense markets in the context of both changes in military affairs and the various defense industrial bases.

In analyzing the defense market, we essay multiple analytical frameworks (along the lines of *Essence of Decision*). Our analytical models are: (a) a sophisticated view of offsets in a public policy context with market imperfections, (b) transaction cost economics, with our unit of analysis being the nation-state instead of the firm, and (c) two standard corporate strategy models.

To test the models' explanatory powers, we consider three ongoing "cases": F-35 Joint Strike Fighter, the UK Defense Industrial Strategy, and the Northrop-Grumman-EADS KC-30 proposal. Interestingly, we find all three hypotheses have some explanatory power, but none of the three is demonstrably better than the others (in this small sample).

Summary

This is a summary of the report cited above for inclusion in the *Proceedings of the Fifth Naval Postgraduate School's Annual Acquisition Symposium* (2008, May). (The report itself greatly exceeds the length guidelines for the *Proceedings*. The topics raised here are discussed in greater detail within the body of that report.)

The motivation for this particular project was our conviction that standard explanatory paradigms for understanding global defense trade, e.g., offsets and related subjects, have been strained—perhaps to the breaking point. Accordingly, we hypothesized that analysis of this increasingly complex market system would be improved by the application of multiple models (as was done by Graham Allison in *Essence of Decision*).

Section I is a brief introduction.

Section II is an interpretative discussion of ongoing developments in the international defense market place. In this section, we discuss the following.

- A. Military Affairs. There are two ongoing Revolutions in Military Affairs—one lead by the US DoD, the other by contemporary terrorist and insurgency movements. Accordingly, the international defense market has been significantly affected by the ongoing competition between between two groups that are deliberately engaged in processes of rapid military innovation (both underpinned by contemporary information technology).



- B. Developments in the Global Defense Marketplace (in general)—including acquisition reform and the globalization of defense industrial production. We noted in particular the systemic tension between globalization and national sovereignty—an issue that’s especially acute for defense-related goods.
- C. US and EU Defense Industrial Developments (in particular). These include the role of US and European defense firms in the world market, recent trends in defense budgets, and patterns of reorganization (generally consolidation). We noted the dangers of relying solely on detailed quantitative analysis to analyze a complex and changing system in the absence of well-defined analytic paradigms.

Section III presents multiple analytical frameworks as a basis for the analysis of complex systems. We then present our three paradigms.

- A. We first summarize Allison’s use of multiple analytical frameworks.
- B. *Offsets* and International Industrial Participation. We hypothesize that although the offsets perspective was not able to offer comprehensive understanding of the international defense market, we believe it still has explanatory power (and are, in any case, obliged to assess its usefulness).
- C. *Transaction Cost Economics* (TCE): TCE was originally developed to study vertical boundaries of firms (the make-or-buy decision in particular). We summarize the relevant considerations for that decision. We expand the standard TCE model somewhat and consider the nation-state as a military enterprise. (One would then view a decision to buy military equipment as a decision to import—as opposed to a decision to rely on domestic sources.)
- D. *Corporate Strategy*: Finally, we introduce two standard models of corporate strategy: Five Forces (Porter, 1980) and “Co-opetition” (Brandenburger & Nalebuff, 1996).

Section IV provides narratives of three ongoing “cases”: the Joint Strike Fighter (JSF), the UK Defense Industrial Strategy, and the KC-30 Proposal. For all three cases, we provide an interpretive narrative (up to report publication) and then provide explanations based on the three frameworks (from Section III).

Joint Strike Fighter

Offsets: The JSF seems structured to operate in an offsets-free model. Among other things, the JSF consortium is intended to change foreign military sales customers to stakeholders (who share both in risks and rewards). This arrangement, in turn, is intended to drive the consortium’s focus toward productive efficiency rather than the side payments negotiated in offset agreements. The viewpoints of the JSF stakeholders (expressed in anonymous interviews) is not fully consistent with that objective.

Transaction Cost Economics: From the prime contracting firm’s perspective, international trade in defense goods frequently involves the formation of long-term relations—the consequences of which are one of the main concerns of the TCE literature. The JSF strategy is, in a very real sense, intended to delay the “fundamental transformation” from competitive market to something similar to bilateral monopoly.



Corporate Strategy: The JSF model addresses every defense industrial firm's concern with buyer power—sovereign entities in this case. The aim is to mitigate this threat to profits by recruiting stakeholders who are well placed to influence the sovereign buyers' behavior—in this case, domestic defense firms in a number of countries.

UK Defense Industrial Strategy (DIS)

Offsets: Taken at face value, the DIS is intended for a post-offsets trading regime. However, a more in-depth reading reveals a careful preparation for negotiations over industrial participation (as tacit offsets). For example, the DIS identifies core industries in which there must be domestic defense participation.

Transaction Cost Economics: One of the major purposes of the DIS is protection from the costs and risks associated with outsourcing (importing) major portions of the UK's defense equipment. From this perspective, there are many serious areas of concern associated with importing modern defense systems. The DIS' insistence upon "appropriate sovereignty" in the lifecycle management (and operational use) of this imported equipment is a serious effort to manage and mitigate those risks.

Corporate Strategy: The contemporary defense marketplace poses significant threats to the profits (and, therefore, viability) of the British defense industrial base. The DIS first reserves certain categories of defense products to domestic firms. It also insists upon the ability to upgrade, modify and generally manage defense systems throughout their operational life. This is well understood as a strategy for mitigating (foreign) supplier power.

KC-30 Proposal

Stealthy Offsets: The details of the KC-30 proposal, which included provisions for extensive US industrial participation, were really intended to insert offsets into a proposal to a customer who ostensibly did not engage in offset agreements. The evolution of the KC-30's industrial participation component is best understood as a tacit negotiation over offsets.

Corporate Strategy: Standard models of corporate strategy clearly reveal the rationale for EADS' entry to the US defense market—with a view to changing its environment by redefining its market niche. The USAF's KC-X project provided EADS with a high degree of market power relative to both its rival and its prospective buyer. The buyer (the US government) insisted upon competition, with EADS being the only reasonable competitor other than Boeing. Hence, the success of the KC-30 in the initial Air Force source-selection process is the result of a very well-crafted corporate strategy (regardless of final outcome).

Transaction Cost Economics: The risks the US would assume in choosing the KC-30 include an international politics of a "holdup"—denying support to KC-30s in US military operations because of source-country disapproval. Hence, the partnership with Northrop-Grumman and extensive KC-30 production work located in the US are readily understandable as means to assure the US government that such risks are not serious.



Some Conclusions

Basically, we found support for our hypothesis about the international defense market being an increasingly complex system, the study of which usefully involves the application of multiple analytical frameworks.

We conclude, first, that all three of our perspectives have explanatory power in all three cases considered. Second, and also interesting, is that relative explanatory power varied over this small sample. We concluded that the offsets paradigm was best for understanding the Joint Strike Fighter project; that TCE did best for the UK's DIS; and corporate strategy models provided especially good insights into the KC-30 proposal.

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