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# Issue Paper

*Exploring Topics of Interest to the Policy Community*

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## Do We Need Special Federal Programs to Aid Defense Conversion?

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Among the actions being urged on the new administration are special steps to assist "defense conversion"—the process by which the workers and firms engaged in the production of defense-related goods and services are converted to constructive civilian pursuits. A recent report by the Defense Conversion Commission<sup>1</sup> suggests caution in this regard. Such caution is in order. There is an unquestioned national interest in speeding the transfer of valuable resources from military to civilian pursuits. But federal assistance aimed specifically at the defense sector or at firms within the defense sector will almost certainly not prove the most effective mechanism for facilitating this transfer.

### The Problem

The collapse of the Soviet empire and the end of the Cold War have made possible major reductions in U.S. military forces. Smaller forces require less equipment, and U.S. defense procurement spending has started a decline that will probably continue for the next few years.

This is good news. Over the long haul, reductions in defense procurement spending will benefit the U.S. economy. Resources once used for the production of military goods will be redirected to other purposes and to meeting other national needs. In the short run, however, this redirection of resources—a process that we have come to call defense conversion—forces workers, firms, and communities to make painful adjustments. Defense-industry workers,

often with years of experience and training, must find new jobs. Sometimes they must learn new trades, and even then their new wages may be lower than what they had been earning. Sometimes finding a new job means uprooting a family and moving to a new city. Firms that have specialized in meeting the military's needs must shrink, merge with other firms, or attempt to develop new lines of business. Communities and regions that used to enjoy heavy concentrations of defense-related industries must attract new industries or see their populations and tax bases decline.

Besides the personal, corporate, and municipal pain, failure or delay of the conversion process imposes real economic costs on the nation. Resources left idle or unemployed because of reductions in defense procurement are effectively wasted. Until these resources find new uses, our total output of goods and services—our ability to meet national needs—is reduced. For both humanitarian and economic reasons, then, we have a national interest in seeing that the process of defense conversion happens as smoothly and quickly as possible.

### The Policy Question: Special Assistance for the Defense Industry?

Change in the U.S. economy is, of course, nothing new. Firms and entire industries are constantly going out of business, to be replaced by new firms and new industries that make use of many of the resources made redundant by the decline of the old ones. It is only through such transitions that the economy changes to meet new demands and circumstances. Mostly, this change is accomplished without direct intervention by the government. As one firm closes

<sup>1</sup>*Adjusting to the Drawdown: Report of the Defense Conversion Commission*, December 31, 1992.

its doors, market forces allocate displaced workers, machinery, financial capital, and other resources to new productive uses. Government policies are typically aimed at smoothing the transition of resources from one use to another (for example, by providing bankrupt companies an opportunity to liquidate assets in an orderly manner) and at easing somewhat the pain of transition (through such mechanisms as unemployment compensation). Usually, there is no explicit government effort to direct resources to new uses.

Within the new administration, a broad policy consensus seems to be emerging in favor of a more activist government role in facilitating economic change. A particular emphasis, it appears, will be placed on retraining workers to meet the challenges of a changing economy. Programs to encourage the diffusion of advanced manufacturing techniques are also being considered. There will undoubtedly be heated debates over the best ways to achieve these ends, but the basic policy decision to provide increased *general* assistance to workers and firms seems to have been made. Still contentious, though, is whether some *special* government support should be offered to ease the transitions facing workers and firms in the defense-goods sector.

### Some Perspective

The decline in defense procurement spending since its Cold War peak in 1987 has been modest compared to the declines we saw after the Korean and Vietnam wars (see Figure 1). Within three years after the end of the Korean War, for example, defense procurement spending declined by an amount equivalent to 1.3 percent of then-current GDP. Eventually, the decline was equal to 2 percent of GDP. The decline following the Vietnam War was equivalent to 1.5 percent of GDP. So far (through FY1993), the post-Cold War decline has amounted to only about one-half of one percent of GDP. Moreover, since defense procurement spending accounted for a smaller share of total GDP at the peak of Cold War spending than during the Korean or Vietnam conflicts, there is less room for defense procurement to fall this time. In 1987, defense procurement spending accounted for about 1.8 percent of GDP. Thus, even a complete cessation of defense procurement spending (obviously improbable) would have a smaller impact on the economy than the reduction that actually occurred after the Korean War.<sup>2</sup>

Neither is the economic dislocation associated with the current round of cuts in defense spending large compared to the consequences of other recent economic developments. Between 1980 and 1986, for example, a rise in the value of the dollar and sluggish economic growth among our major trading partners brought about a decline in U.S. net exports

<sup>2</sup>A noteworthy difference between the current round of defense spending cuts and the round that followed the end of the Vietnam War is that in this round, spending on defense-related R&D has remained virtually untouched. In the eleven years following the peak of Vietnam spending (1968), outlays for defense R&D fell 32 percent in real terms. In the six years that have followed the Cold War spending peak (1987), real defense R&D outlays have fallen by less than 1.5 percent. So far, the defense R&D community is not hurting.

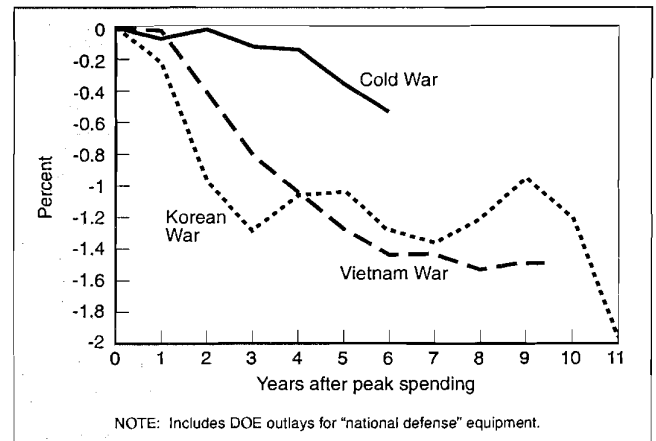


Figure 1: Postwar Reductions in Real Defense Procurement Outlays (as a fraction of GDP in year of peak outlays)

equivalent to 5 percent of U.S. GDP—a shock to the economy *ten* times larger than what we have seen so far as a consequence of reduced defense spending.

No special programs to facilitate defense conversion were put in place after either the Korean or Vietnam wars. Neither, for the most part, were special programs instituted in the early 1980s to redirect resources from industries faced with severe foreign competition. The U.S. economy survived on those occasions without special government conversion assistance, and would presumably do the same this time.

### Is the Defense Industry Special?

But simple survival of the economy is not really the issue. The question is whether government efforts specifically aimed at easing the conversion of defense industries to civilian pursuits are required or desirable. Is there something about the defense industry that justifies special assistance programs? Do its workers, for example, have some special claim on public assistance that should entitle them to more generous relief programs than are available to workers in other industries? Alternatively, do the firms that formerly produced defense goods constitute a unique national asset that should be preserved, in whole or in part, for the national good? Is there some reason to believe that the natural market forces that routinely reallocate resources from shrinking to growing industries will not work for resources once employed in the defense sector, or that we will not like the results these market forces will produce? Three arguments are advanced in support of special assistance for defense conversion. Ultimately, none is fully convincing.

**1. We must "keep faith" with defense suppliers.** Behind this argument is a notion that the workers and the firms of the defense industrial base have served the nation with distinction and therefore deserve some special assistance. Although some would disagree, the notion is widespread that the technological prowess of U.S. defense suppliers

contributed importantly to ending the Cold War. Unable to bear the economic consequences of remaining competitive with the United States in the area of military technology, the Soviet Union finally threw in the towel.

It is more difficult to argue, though, that defense suppliers have not already been rewarded for their service to the nation. There is no evidence that shareholders in defense firms received lower returns than did shareholders in other industries. Neither is there any reason to believe that workers in the defense industry were systematically asked to make sacrifices in terms of wages or benefits to advance the national good. On the contrary, defense sector jobs have generally been seen as very attractive and relatively high paying; that is part of the reason why there is so much consternation about their loss.

It may be true that the nation owes some special consideration to men and women who joined the armed forces, reasonably expecting to have the opportunity to make a career there and on occasion putting themselves in harm's way, only to be turned out as the military's personnel needs decline. It is hard, though, to see a special obligation to relatively well-paid defense workers who were free to enter or leave the industry as they chose or to stockholders in defense industries who presumably earned a fair rate of return on their investments.

**2. Reductions in defense spending create particularly severe local problems.** Certainly, some geographical areas of the United States have been harder hit by reductions in defense procurement spending than others. Southern California, for example, is suffering unemployment rates well above the national average and will continue to do so for some time, largely (but not entirely) as a consequence of the contraction of the local defense aerospace industry. Without question, the negative consequences of demand reductions are magnified when the affected industries are geographically concentrated. Secondary business failures become more likely. Displaced workers have a harder time finding new jobs locally. State and municipal tax revenues decline just when the demand for social services is swelling.

But is defense industry more geographically concentrated than other industries? Despite such obvious examples as Southern California, there is no clear evidence that it is, or that the job losses associated with reductions in defense procurement are particularly concentrated. Surely other areas, where other industries are concentrated, have suffered severely because of economic change. Consider, for example, the plight of some cities in the industrial northeast or the upper midwest (the so-called Rust Bowl) when manufacturing jobs were lost in the early 1980s as a consequence of macroeconomic policies that brought about an appreciation of the dollar.

What perhaps makes sense is a policy of providing federal adjustment assistance for regions or municipalities and workers in those regions and municipalities that suffer severely concentrated economic losses for any reason—an economic counterpart to the federal disaster relief that is

available in the wake of natural calamities. It is hard to understand why a town whose economy is ruined by the closing of an auto plant or a steel works is less deserving of federal adjustment assistance than a town suffering from the closure of an aircraft assembly plant. Similarly, it is hard to understand why workers dismissed from a defense plant should be expected to face a harder time finding new employment—and therefore to have a greater claim on adjustment assistance—than workers at a civilian production facility who lose their jobs because, for example, ill-judged federal policies precipitate a recession. In this respect, it is difficult to see in what respect defense industries or workers require or deserve special assistance.

### **3. Defense suppliers are more than the sum of their parts.**

Behind many calls for government support of defense conversion is the (often unstated) notion that market forces will fail to recognize the full value of defense firms. The suspicion seems to be that if market forces are allowed to operate, defense firms will be broken up, sold off piecemeal, or simply liquidated and their workers scattered. But, the argument goes, defense firms are more than just collections of workers, managers, plant, and equipment. If they are broken up, something important will be lost. There may, then, be a justification for government intervention to keep the firm together.

The proposed intervention is usually some sort of government policy that encourages the firm, as a whole, to undertake new kinds of activities. For example, special preferences might be extended to former defense suppliers in the awarding of contracts for large-scale public infrastructure projects such as urban transportation systems, data transmission facilities, civilian satellites, etc.<sup>3</sup>

But what is the nature of this special value, and why is it not recognized by markets? Why is it that markets might mistakenly think that a former defense supplier is worth more in pieces than whole?

Certainly, any firm is more than a collection of human and physical assets. Experience at working together makes interactions among different parts of the firm more efficient than interactions among strangers. Experience also generates know-how that is not or cannot be written down and transferred to new owners, particularly if the owners acquire only some of a firm's assets. Unquestionably, firms do have intangible assets that would be lost in liquidation. But why might these assets be undervalued by potential buyers?

The principal intangible asset possessed by defense suppliers is accumulated skill and experience in the production of military equipment. In an era of declining defense production, however, potential buyers might place a rather low

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<sup>3</sup>Actually, bankruptcy laws already provide an incentive for keeping firms together rather than selling them off piecemeal in certain circumstances. Someone who buys an entire firm that is already in bankruptcy may get a bargain: some of the debts of the purchased firm will likely be written off. Purchasers of specific assets of the bankrupt firm, however, typically pay full market price. There is thus an incentive to buy the entire firm rather than just pieces of it.

value on such skill and experience—and they would be right in doing so. But couldn't this skill and experience be put to good use in executing large, complex, and technically demanding civilian work? Unfortunately, most of the available evidence suggests not. There are almost no examples of successful moves by defense suppliers into nondefense businesses.<sup>4</sup> The resources, experience, and management styles of defense suppliers have been shaped by the peculiarities of government contracting. The firms have frequently enjoyed positions as near monopolists, making products that were seldom required to face serious market tests. Consequently, they may not be well suited to the rough-and-tumble of competitive civilian markets. Few firms seem to believe that experience or success in the military market will increase the chances of success in the civilian market; it is an often-noted strategy of firms that produce for both the military and civilian markets to take special pains to isolate the two sides of the business from each other. Once again, then, it is difficult to argue that potential buyers are systematically wrong in discounting the intangible assets of defense suppliers.

Might there not be a national interest in preserving the unique experience and know-how of defense suppliers in producing military hardware? In particular, would keeping defense-contracting firms whole make it easier to reconstitute U.S. military forces if this ever became necessary? About this matter we know very little. We do not know, for example, how easy it would be for a one-time airplane manufacturer that has converted to making, say, subway cars to return in a crisis to making aircraft. Would a quick startup of aircraft production be easier or cheaper for such a firm than it would be for a firm that has always made subway cars?

We do have an important national interest in maintaining a capability to reconstitute U.S. military forces if the need should arise. The Soviet empire is gone, but the world remains a dangerous place, and new threats may well arise. Among other options, it might be worthwhile to give some thought to what sorts of civilian activities particular defense producers might engage in and still maintain the equipment and the labor skills necessary to return quickly to their former pursuits. We might even wish to consider some kind of industrial version of the Civilian Reserve Air Fleet (CRAF) program, whereby producers were subsidized by the government to maintain equipment in particular configurations, to store particular tools and dies, to maintain certain labor skills, and to agree to make all of these available for resumed defense production if the need arose.

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<sup>4</sup>Norman Augustine, chief executive officer of Martin Marietta, has remarked that "the U.S. record on defense conversion is unblemished by success."

On the face of it, though, a strategy like this would appear to be rather risky. We could not have much confidence in a firm's capability to resume defense production unless we tested this capability from time to time by actually requiring a reconversion. Such tests would be very expensive and would, to some degree, defeat the original aim of encouraging conversion of defense industry to productive civilian uses. A more reliable and efficient way to maintain a reserve capacity for defense production might simply be to avoid conversion of certain defense production facilities in the first place, keeping these facilities in the business of producing (perhaps at a low rate) defense hardware.

### What Are We to Do?

The pain and dislocation caused by declining defense production is real. Output lost because productive resources—either human or physical—are idled is lost forever. For both human and economic reasons, then, we should seek to facilitate the process of defense conversion and the reabsorption of associated resources into other activities. As the above discussion suggests, though, there seems little reason to approach the conversion of defense industries any differently than we approach the conversion of any industry that faces sharply declining demand. *There is no good justification for programs designed to aid only the conversion of defense industries.* To the extent that government conversion or adjustment assistance is justified, such assistance should be triggered by economic dislocation, regardless of the cause of the dislocation or what industry is suffering it. Rather than seeking specific policies to speed the process of defense conversion, the economy would be better served by policies that improve the quality and flexibility of *all* U.S. workers and that reduce barriers to the movement of people and resources among *all* sectors of the economy.

But even here, some caution is necessary. The ultimate aim of defense conversion policy is to bring conversion about as quickly and as smoothly as possible. Conversion will be complete only when individual workers, managers, and investors are satisfied that they have taken the jobs or acquired the assets that will yield them the greatest returns. To the extent that government policies (with the noblest of intentions) shield workers, managers, or investors from the consequences of changing economic circumstances, they weaken incentives for individuals to get on with the private decisions that will finally result in the conversion of resources to new and productive uses. Excessive efforts to take the pain out of the conversion process will ultimately prove counterproductive. They will only slow down the conversion that we should be trying to facilitate.

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