

COUNTDOWN TO UK'S GENERAL ELECTION

We continue our look at major issues concerning defence systems that will have to be tackled by the next government. Professor Andrew Graves returns to the charge over the vital role that manufacturing plays in any national economy, and calls for leadership, vision, professional knowledge and integrity. Antonia Cox believes that politicians can, and must, make a case in the lead up to the Election for increasing, rather than cutting, the defence budget, while the RUSI Acquisition Focus examines the huge financial hole in that budget. Clark Vasey follows his article in the last issue on Labour's Defence Quagmire with a look at the challenges facing the Conservatives. And David Faddy brings out several issues arising from the Gray Report on acquisition.

Defence Procurement in Crisis: A Call for Leadership

by Professor Andrew Graves

Andrew Graves is Professorial Fellow in Technology Management in the School of Management at the University of Bath, setting up research programmes, inter alia, under both the Agile Construction and the Lean Aerospace Initiatives. In this article, which leads on from his article in RUSI Defence Systems in 2007, he identifies what is wrong with our approach to procurement and calls for better leadership with the key attributes of vision, professional knowledge and integrity.

This paper reflects upon the radical changes that have occurred since the article 'Making a Success of the UK Industrial Manufacturing Base' was published in *RUSI Defence Systems* in June 2007. This argued for a fundamental reappraisal by government of manufacturing as a key for sustained growth. It maintained that manufacturing has five areas that make the sector unique. These are:

- An infinite demand for goods.
- Drive of innovation.
- Generation of exports.
- Generation of high value jobs.
- Support of the service sector.

It also argued that an over-reliance upon service-sector jobs and the notion that the 'knowledge economy' would create a sustainable future was a fallacy. Finally, it proposed investment in a national manufacturing strategy across all sectors in order to compete and outperform international competition. It was suggested that the UK's economic, social and military security could only be secured through a strengthening of its scientific, technological and manufacturing base.

The response to this article was both emotionally highly charged and polarised. Many industrialists applauded the overview, but argued that it was now 'too late' to influence

policy or that somehow this argument was 'talking down Britain'. Many politicians and public servants argued that 'manufacturing' represented 'sunset industries' and that the UK strategy was to import manufactured goods at the most competitive prices. One senior government minister suggested that we might like to "join the 21st Century and admit that the future for the UK was financial institutions and the service sector"! He, of course, was partly correct, for since the 1980s, the USA and the UK had built a banking system largely 'too big to fail'. This extraordinary concentration of financial power had led to excessive leverage of lending and a 'casino mentality' with little conception of integrity or moral hazard.

This 'lending game' finally stopped in September 2008 with the collapse of Lehman Brothers, the takeover of Merrill Lynch by the Bank of America, and the effective nationalisation of Fannie Mae and Freddie Mac who owned, or guaranteed, about 50% of the \$12 trillion mortgage market in the US. The Bank of England was forced to offer £5Bn of emergency lending – and £50Bn was wiped off London shares, with the FTSE 100 falling over 212 points. Job losses at Lehman's in London alone ran to over 5000, the largest single redundancy since the collapse of the Rover Group. The resulting recession, together with the balance of payments deficit, both at their worst since records began, has put the UK at a significant structural disadvantage against other major economies. By the end of November 2009, the UK economy had contracted by nearly 6% and suffered a larger recession than Germany, due to its over-reliance upon the financial sector and its policy of de-industrialisation. Economies based upon manufacturing have proved to be not only more productive, but more flexible to the downturn. IMF data shows that the UK had the world's third-largest current account deficit in 2007 and is at severe risk from rising commodity prices and



The Typhoon assembly line at Wharton. China, India, Russia and Brazil have set a vision to industrialise and overtake the West within 25 years [BAE Systems]

the banking meltdown. The UK, therefore, has been in recession longer and deeper than all member states of the G20.

The UK has a £175Bn budget deficit and a national debt forecast to reach £1.3 trillion within five years. The interest alone on such debt will be larger than the defence budget by 2014. The UK may be in the position of borrowing more money than it did to fund World War Two – and that was only paid back in December 2006. Finally, the recent NAO report argues that HM Treasury spent £117Bn buying bank shares and lending to financial institutions and, together with additional guarantees, insurances and loans, the UK taxpayer could be responsible for up to £850Bn of liabilities. This would take the liability of every UK family from the present £5530 to nearly £40,000!

How Did We Get Here?

Much has been written over the past year with regard to the financial crisis, and a significant 'blame culture' has been generated against individuals and institutions. This paper, however, will focus upon one area of concern which we believe, from our research, has been a major contributory factor to Britain's relative decline and will need to be addressed to rebalance the economy and provide confidence in the future.

The issue is one of leadership. Our findings are derived from extensive research with both government and industry and

informed through action research with key industrialists, civil servants, government ministers and senior military commanders. Almost without exception, the difference between organisations that succeed and those that fail is down to leadership, or lack of it. From our studies of successful organisations we have attempted to identify the key attributes necessary for successful leadership. These can be summarised as follows:

- Vision
- Professional knowledge
- Integrity

Vision

The key attribute required of leaders is to have the right vision and goals. Targets need to be clearly and concisely articulated and informed by professional knowledge. The UK crisis is largely the result of a lack of vision regarding how wealth is created and how the UK would thrive as a service economy – outsourcing its R&D and manufacturing overseas. This has led to low growth and low-value jobs. On the other hand, China, India, Russia and Brazil have set a vision to industrialise and overtake the West within 25 years. These are similar visions to those pursued by Japan and Germany with great success post-World War Two.

Vision for successful organisations builds short-, medium- and long-term strategies for survival and not, as so often in the West, a series of 'joined-up' tactics driven by short-

term shareholder value. World-class organisations such as Ford, Toyota, Boeing, IBM and Microsoft, dominated or still dominate their chosen sector, driven by a forward vision of customer needs and a strategy for change.

Professional Knowledge

All organisations require professional knowledge to achieve their vision. This can be created by a cadre of 'specialists' within the organisation or outsourced. Too often, however, those in a leadership role are separated from those with knowledge by a 'frozen layer of management' whose sole purpose is to restrict information in order to protect their positions and therefore control the agenda. This use of power is particularly prevalent in organisations dominated by outdated management thinking, where significant layers of 'command and control' managers still exist. Government departments display similar tendencies due to their 'risk averse' nature and a focus upon measuring activity and not outcomes. Maintenance of the status quo becomes inevitable in such organisations with little sense of direction. Politicians often collude in this arrangement for short-term advantage, either with colleagues or the electorate.

This 'beggar my neighbour' policy extends not just across Whitehall, but also within the Armed Services

Equally disturbing over recent years has been the rise of economists who have dominated the agenda by producing econometric models of how markets and the economy work. Many of these models appear to bypass or ignore the 'scientific method' favoured by scientists, which relies on experimentation or observations, together with the collection of data – for testing against reality. If this test fails, their hypothesis is revisited and retested, until successful. However, many economic models relied upon by financial institutions, often exclude key inputs and make extraordinary assumptions about 'efficient markets' and human behaviour. When they fail the reality test, it is too often assumed that reality is incorrect and not the models.

This heavy reliance upon econometric modelling and forecasting placed banks in a position where they vastly overvalued their portfolio of assets, and governments were left with no alternative but to underwrite the losses and revert to old failed tactics, such as 'Quantitative Easing' or printing money. This mechanism has been used by the Bank of Japan to fight their deflation since 1999 with little success and raises the danger of inflation for Western economies when the upturn arrives.

Integrity

The global financial crisis had many complex causes, but it is agreed that US sub-prime lending and the collapse of the 'housing bubble' in 2006 exposed not only senior managers, who failed to understand the econometric models, but also those in leadership positions who encouraged 'financial innovation'. The complexity of products such as Collateralized Debt Obligations (CDO), Credit Default Swaps (CDS) and Mortgage-backed Securities (MBS) allowed the bundling of toxic assets in such a way as to circumnavigate regulation. These activities allowed players to conceal reality, legitimised the corrupt pricing of risk and produced a culture driven by a bankruptcy of integrity. It was not the lack of vision or professional knowledge that led to the crisis, but the lack of honesty that was regarded as 'normal behaviour'. This trend was encouraged by some Western governments who permitted only a 'light-touch' regulation regime in order to attract international banking to their shores.

History, of course, is littered with examples of dishonest business practices. However, it is clear that since the early 1990s examples of successful business enterprises which have collapsed, from Robert Maxwell to Enron and Lehman Brothers, have all illustrated failings of corporate social responsibility and a lack of integrity. As stated by McKinsey in their recent quarterly report: "A company's reputation has begun to matter more now than it has in decades... Some companies in certain sectors have violated their social contract with consumers, shareholders, regulators and tax payers". In order to redress the balance, both business and government will need to reassess the transparency of existing arrangements and construct a strategy to avoid such excesses in the future.

Implications for Defence Procurement

Two key aspects of the current crisis will have a significant impact on future performance for defence procurement. First is the preoccupation of politicians to 'outperform' each other with respect to budget cuts and to be seen to redistribute the 'national cake'. Instead of developing a post-crisis strategy for increasing national wealth, these initiatives are designed to reallocate resources on an almost ad-hoc basis to government departments that have the most influence. As Lord Guthrie points out: "With regard to the Defence Review ... The longer they put these decisions off, the harder they will become ... the bow wave becomes higher". He goes on to argue that we are partly in this position because: "Defence has fared badly in the good times, whilst other departments did well".

This 'beggar my neighbour' policy extends not just across Whitehall, but also within the Armed Services. Not since the Navy took command of the UK's nuclear deterrent from the RAF have we seen such internecine warfare. This is hardly surprising as defence budget spending is the lowest since the 1940s. In 2007–8 spending totalled £37.4Bn or 2.2% of GDP. In 1987 the figure was 4.4%.



There are 300,000 highly skilled jobs in the defence industry, despite the fact that the defence budget has fared badly in the good times [SBAC]

According to Bernard Gray's analysis of the MoD Procurement Plan, the average project is five years behind schedule and £300M over budget. The total overspend on the order book will be approximately £35Bn. This not only undermines inter-Service morale, but jeopardises military operations, both current and future. The Treasury, which now oversees MoD spending with a £736M cap on operations in Afghanistan and Iraq, will require the MoD to find any shortfall in expenditure.

This situation clearly cannot be allowed to continue, particularly as the UK has been engaged in land operations almost continuously since the first Gulf War and increasingly since 2001. However, only about 10% of the equipment budget has been allocated for fighting land systems for the period 2003–18. Balancing resources with political objectives and commitments will need to be at the centre of defence policy in the future if the UK's projection of military power is to be meaningful.

The second issue relates to value-for-money and the change in culture and leadership required to produce a procurement system 'fit for purpose'.

Defence acquisition, like most government procurement, is characterised by a culture of 'initiative fatigue' and dominated by the measurement of activity and not outcomes. Although employing more public servants than any other Western Alliance country, the UK, according to the NAO and the public accounts committee, fails to secure value from contracts, due to lack of commercial skills. These gaps are often filled by combinations of seconded staff and consultants, which leads to an inability to build a 'learning organisation'. Constant changes in tactics to improve procurement have a demoralising effect on staff, and initiatives such as

'Modernising Government' (1999) through 'Transformational Government' (2007) to the most recent 'Smarter Government' (2009) have largely failed to effect outcomes.

Significant progress was achieved in the late 1990s, however, under strong leadership from HM Treasury's Procurement Group. The 'Government Client Improvement Study' analysed all construction procurement projects in order to obtain a step-change in performance. The report concluded that procurement performance was poor due to:

- Poor management – lack of leadership
- Risk-averse culture
- Lack of integration
- Poor project flow
- Non-value approach to procurement
- Misinterpretation of need for public accountability

The required level of improvement could only be achieved through a focus upon:

- Management
- Measurement
- Standardisation
- Integration

These changes were driven through with a 'stick and carrot' approach. The 'carrot' was to offer private construction firms an 'on-line stream of income' to rebuild hospitals, schools, roads, defence estates, etc. over the following 30 years. The 'stick' was to measure and enforce behaviour akin to a 'Toyota supplier', demanding improved productivity and cost down year by year. Change orders, which had historically caused massive overspend and time delays, would be eliminated. However, after a significant reorganisation of responsibilities in government, post 2001, the scheme was largely abandoned, but the massive spending on public rebuilding continued. Performance of the contractors has remained at previous levels and the delivery of value-for-money not achieved.

Defence procurement is little different. Without constant measurement of productivity and quality of performance, we are unable to judge progress, either with regard to defence inflation or the ability to provide weapon systems at the right place and time, and to budget. History teaches us that when faced with wars for national survival – 1914 and 1939 – the UK took approximately two years to learn lessons to provide a procurement system and fighting strategy 'fit for purpose'.

New Thinking Required

Today's conflicts fail to focus the minds of those responsible in such a way, but it is clear that bundling a revised set of tactics will not work – what is required is new thinking, refreshed leadership and a comprehensive strategy for change for the 21st Century, or in the words of the 5th-Century BC military strategist, Sun Tzu:

"Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat." ■