

Written evidence submitted by Jag Patel

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INTRODUCTION

1. Far from discouraging foreign business entities from trading in defence goods and services in the UK, this government is doing the exact opposite.
2. It is opening up the defence equipment market to all and sundry – not because it is complacent about the risk of letting-in undesirable elements into the defence supply chain, but because it desperately wants to enhance the competitiveness of indigenous players, large and small, who have been delivering appallingly poor value for money over the last several decades.
3. This submission looks at the rationale behind the government’s decision to take this drastic action and finds that, in the event businesses from adversary states were to buy out struggling defence SMEs for the purpose of pursuing a hidden agenda, corrective market-based defence mechanisms will automatically come into play which will tackle the problem, without the need for government intervention.

ATTRACTING FOREIGN DEFENCE CONTRACTORS

4. The government now believes that there is room to accommodate *additional* participants in the UK defence equipment market, both at prime contractor level and right down the extended supply chain – a stark contrast from the narrative that has been perpetuated endlessly by vested interests. This view, confirmed by the government’s own words expressed in the Defence Industrial Policy,¹ says that:

“The MOD and wider government are committed to increasing inward defence investment. We are already home to many multinational defence companies, and encourage these companies to grow their investment in the UK and new suppliers to base themselves here.”

5. But of course, the real reason why the government is inviting offshore entities to stake a claim in the domestic market is to *sharpen* competition, which has been woefully lacking over the last several decades – largely, because it has been dominated by just a handful of players, the Select Few, who have monopolised all the major big-ticket acquisition programmes – and as a consequence, become notoriously inefficient and therefore seriously uncompetitive. In so doing, this government has abandoned the tried-and-failed policy of talking and cajoling, to try to convince indigenous defence contractors to become more competitive.
6. Enhancing the competitiveness of existing players so that they begin the task of boosting the economy by exporting to countries beyond the EU is the need of the hour, as the UK heads towards its Brexit destiny on 31 December 2020.

FOREIGN DIRECT INVESTMENT

7. Not only will new entrants bring much needed *Foreign Direct Investment*, but they can also “reach back” to their home bases for the latest technology, top talent and highly desirable off-the-shelf products.² Additionally, foreign companies will have little choice but to employ British

¹ Defence Industrial Policy document, *Industry for Defence and a Prosperous Britain: Refreshing Defence Industrial Policy*, published December 2017, p28, PDF file (1.28 MB)
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/669958/DefenceIndustrialPolicy_Web.pdf

² Discussed in written submission to the Public Accounts Committee, Inquiry into *Defence Equipment Plan 2018-*

nationals as locally-engaged staff to assemble their project performance teams to bid for MoD defence procurement programmes – either by poaching the brightest employees from domestic players or recruiting from the immediate vicinity, thereby increasing regional employment.

8. But the greatest benefit to be derived from inviting these outsiders is simply because they are so much *more* productive. Indeed, it has been reported that the Office for National Statistics has found that British businesses with foreign owners are up to *three times* as productive, as those with only UK investors.³

PROTECTIONISM AND FAVOURITISM

9. This government’s refreshing approach to sharpening competition is a far cry from days of the past which were marked by state-sponsored protectionism and favouritism.

10. Consider the case of the Terms of Business Agreement on naval shipbuilding signed by the Gordon Brown government with BAE Systems during the dying days of the 2005-2010 Parliament which left the incoming administration no room for manoeuvre at all, as it set about undertaking a comprehensive Strategic Defence & Security Review – the first in 12 years. In fact, this agreement was signed in *secret*, in 2009, precisely because it locked the government into an appallingly poor 15-year contract laced with a punitive get-out clause which, if made public at the time, would have attracted criticism and negative publicity in the press and media during the run-up to the 2010 general election, potentially swinging the result in favour of the other party.

11. The existence of the TOBA was only revealed to Parliament in 2011 by the Cameron-led coalition government, when it was confronted with the undeniable truth that MoD finances were in pretty bad shape and needed to be declared openly, to garner public support for deep cuts in the defence budget that ensued.

APPLYING POLITICAL PRESSURE SPLICED WITH THREATS

12. It is an open secret that even the most fiscally prudent people in government are prone to softening their hard-line stance just *before* a general election, when they are up for re-election, which makes them more likely to open-up the public purse. Equally, defence contractors are aware of this weakness in top politicians and will take full advantage, by surreptitiously intensifying their lobbying efforts in cahoots with labour trade unions, to apply political pressure spliced with threats of massive lay-offs, timed to coincide with the electoral cycle, to relieve politicians of taxpayers’ money and maximise their take – which is exactly what happened with this TOBA.

13. So, instead of exposing defence equipment manufacturers to the full rigours of the free market, that is to say, not shielding them from “feeling the heat” of competitive market forces, the Brown government chose to engage in protectionism and favouritism by handing out uncontested shipbuilding contracts worth about £3,450 million up to 2024, on a preferential basis⁴ – with virtually no checks and controls, or even guarantees which has come to haunt the government. In so doing, future governments have been denied freedom of manoeuvre in the management of public finances.

14. It is only right that this government deploys all the policy levers available to it to increase competitiveness in the defence equipment market.

2028, 3 December 2018, PDF file (556kB).

<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/public-accounts-committee/defence-equipment-plan-201828/written/92912.pdf>

³ The Telegraph article, “*Foreign-owned firms up to three times more productive than UK-backed rivals*” by Tim Wallace, 23 July 2018. <https://www.telegraph.co.uk/business/2018/07/23/foreign-owned-firms-three-times-productive-uk-owned-rivals/>

⁴ Fully examined in written submission to the Public Accounts Committee, Inquiry into *Defence Equipment Plan 2017-27*, 13 March 2018, PDF file (294 kB).

<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/public-accounts-committee/defence-equipment-plan-201727/written/79612.pdf>

MARKET FAILURE IN DEFENCE PROCUREMENT

15. Conventional wisdom has it that competition among vendors in the private sector is the foremost driver of innovation, productivity growth, prosperity and opportunity. Even the government has bought into this narrative of wealth creation and trickle-down effect.

16. Indeed, the government has been pretty frank in its Defence Industrial Policy about the role of competition in the defence equipment market. It says (on page 23):

“Competitive tension is the greatest driver for innovation, productivity and earning power in any economy. It is our policy to develop and foster competition, and to preserve strategic choice in the market, including over the longer term.”

17. But, in the very next sentence, it goes on to admit that all is not well with defence procurement:

“There are, nevertheless, particular challenges and constraints in doing this, causing various levels of market failure in defence procurement.”

LACK OF A DESIGN & DEVELOPMENT CAPABILITY

18. One of the most striking features of market failure in defence procurement is the total lack of a design & development capability on the premises of defence contractors in the UK today. This has come about because the last several decades has seen the transfer of *thousands* of people in the pay of the State to the private sector via the “revolving door”, in particular, defence equipment manufacturers’ organisations, largely due to the resounding success of the policy instituted by Defence Secretaries of all political persuasions – to encourage for-profit organisations in receipt of government defence contracts to take-on people who were *previously* in the pay of the State.

19. Indeed, this mass migration would explain why the workforce, at every level of the hierarchy within defence contractors’ organisations (right across the full spectrum of defence engineering businesses, government outsourcing contractors and foreign-owned entities, large and small) is now made-up *entirely* of people who were previously in the pay of the State.

20. The lack of a design & development capability is due to the fact that those who have come across from the public sector, in their middle-age (armed with a generous government pension), have *no* experience whatsoever of advancing the developmental status of the starting-point for a technical solution from its existing condition, to a point where it will satisfy the qualitative and quantitative requirements expressed in the technical specification requirement – not least, because they were *never* required to do so, during the first half of their career.

21. But the most obvious sign of this missing design & development capability can be found in the products being marketed by these contractors – they were largely designed in the 1960s and 1970s, with *none* seeing their origins in the new millennium that can be said to have export potential.

VALIDITY OF DEFENCE INDUSTRIAL POLICY

22. Since the formation of this government under Boris Johnson, producer interests have been calling for a new Defence Industrial Strategy to replace the existing one introduced by the Theresa May government.

23. Least there are any doubts about the continued validity of the Defence Industrial Policy, this answer to a written question in the House of Commons settles it.

Q Asked by **Gerald Jones** (Merthyr Tydfil and Rhymney) [N]

Asked on: 14 January 2020

Ministry of Defence

 3259

Defence: Industry

To ask the Secretary of State for Defence, whether his Department plans to revise the Defence Industrial Strategy policy.

A Answered by: **James Heapey**

Answered on: 20 January 2020

Our refreshed Defence Industrial Policy, published in December 2017, sets out our commitment to encouraging a thriving and globally competitive UK defence sector. The Ministry of Defence keeps its approach under constant review to ensure that the implementation and impact of our policies remain effective. We have decided in the past to adopt alternative approaches in specific areas, as we have done in Shipbuilding and Combat Air, and we continually assess our approach to other sectors to determine whether we need to develop separate strategies. Our approach to the Land sector is no different. Last year the Army launched the Army Industrial Engagement Framework which defined how the Army will develop a more cohesive and effective relationship with industry throughout the procurement and development process. The refreshed Defence Industrial Policy from 2017 remains the overarching policy document which describes our approach to industry more broadly.

24. In effect, it is saying that *all* previous defence industrial policies have been superseded by the December 2017 version.

A PRO-MARKET, PRO-COMPETITION GOVERNMENT

25. Competition is the essence of enterprise and free market capitalism. In Adam Smith's use, the "free market" is not a market free from government, but one that is free from *rents* – these rents include distortions borne of market power, privileged access and position.

26. It is therefore heartening to know that senior members of this government, including the Prime Minister, are self-confessed free marketeers and are willing to go out of their way to praise the virtues of the market over the State at every opportunity.

27. The central tenet of capitalism is that those participating in it do so in the expectation that they will profit from their *own* labour and initiative. Yet, the last several years has seen the widespread belief that individuals at the top of big business and corporate houses are benefiting at the expense of their customers, employees, supply chain partners and the local community.

COMPETITION-AVERSE BUSINESSES

28. To this end, the subsidy-seeking, competition-averse businesses which are *permanently* on the hunt for taxpayer funds will resort to a whole host of devious means to persuade the governing elite to underwrite the highest category of risks associated with their business activities – by skewing public spending decisions in their favour.

29. The post-second world war experience has repeatedly vindicated the view that the single most powerful driver of prosperity is profit-seeking businesses trading within a law-governed and competitive market environment. However, the recently exposed frailties of capitalism are all too evident in markets in which the *government* is the main or only customer, which happen to be some the most closed in the world with significant barriers to entry. Indeed, such markets are more often than not, dominated by just a handful of players, the Select Few.

30. It is hard not to conclude that this stranglehold by the Select Few has been the cause of poor performance and a lack of competitiveness – characterised by persistent delays, cost overruns and chronically weak export performance.

TWIN EVILS OF LOBBYING AND CORRUPTION

31. The problem with markets in which the government is the main customer is that they are highly susceptible to *cronyism* – the nexus between the governing elite and the business elite that contrives to put the interests of business first, *ahead* of the wants, needs and expectations of ordinary citizens. Not least, because the twin evils of lobbying and corruption rear their ugly heads every time taxpayers' money crosses the boundary between the public sector and the private sector.

32. Unlike the market in consumer goods and services, there is only one customer for defence equipment – the government. Consequently, the purchasing decisions taken by the government has a significant bearing upon the composition and diversity of players in the defence equipment market. And because taxpayers money is used by the government to procure military equipment for the Armed Forces, the condition of the defence equipment market should be of concern to anyone who has an interest in the proper functioning of open and free markets, and in particular, securing best value for money as it relates to the expenditure of public funds.

33. What has been clear for many years is that public subsidies handed out to defence equipment manufacturers over several decades is the reason why they have failed so miserably, to deliver equipment to the Armed Forces which is fit for purpose, adequately sustained in-service and constitutes value for money through-life.

STATE CAPTURE

34. In the UK, as in many western countries, the means of defence production, distribution and exchange is exclusively in the hands of private interests, that is to say, the State is entirely dependent on for-profit organisations for the design, development, manufacture and delivery of new military equipment to the Armed Forces. Consequently, the government has no choice but to rely on the private sector for *all* its military equipment needs, including its subsequent upkeep, when in-service with the user. The harsh reality is that, no department of state in Whitehall is as dependent on the private sector, as is MoD – putting it at serious risk of *capture* by private interests (if it hasn't already been) which allows them to bend policy to their will, as it relates to the expenditure of public funds. Equally, these private interests are entirely hooked on a steady flow of taxpayer funds for their very *survival* – no least, because they have not bothered to diversify at all.

35. It may be that senior executives seconded from the defence industry and embedded within MoD, who remain in the pay of their employers, may have something to do with this skewing of spending decisions, to favour their narrow commercial interests – at the expense of taxpayers and the public interest.

36. For those not familiar with this concept of state capture, *Transparency International*, the anti-corruption non-profit organisation, defines it as:

“A situation where powerful individuals, institutions, companies or groups within or outside a country use corruption to shape a nation’s policies, legal environment and economy to benefit their own private interests.”

MACHINERY OF GOVERNMENT CHANGES

37. It is precisely to prevent this state capture from occurring that prompted this pro-market, pro-competition government to remove the competition policymaking responsibility from MoD (where it has always been) and put it in the hands of the Business, Energy & Industrial Strategy department, alongside the latter’s longstanding responsibilities to regulate the wider consumer goods market.

38. This machinery of government change also means that oversight of any mergers and acquisitions activity in the defence sector now falls within the remit of BEIS – which opens up the possibility that the Business Secretary could exercise his powers to direct the Competition and Markets Authority to, not only examine individual, high-profile and sensitive M&A cases as they arise, but also conduct an investigation into the state of the entire defence equipment market which some people, including the current MoD Permanent Secretary, believe has become much more concentrated.⁵

39. Market concentration occurs when a small number of firms capture a significant portion of the market in a particular line of goods or services. It is the manifestation of a *lack* of competition in that particular sector and because these firms are confident that no one can take

⁵ See answer to Q80, oral evidence from MoD officials before the Public Accounts Committee, Inquiry into *Defence Nuclear Infrastructure*, HC 86, 11 March 2020, Microsoft Word file (472kB)
<https://committees.parliament.uk/work/36/defence-nuclear-infrastructure/publications/oral-evidence/>

their market share, they see no reason to invest in innovation, product research and development, create intellectual property or upskill employees.

DEFENCE INDUSTRY PERSPECTIVE

40. As for the likelihood that some defence SMEs, struggling to survive in the coronavirus age, may have become susceptible to takeovers from foreign parent companies based in adversary states, the views of defence prime contractors are clear – there is no evidence to suggest that such activity is taking place right now, but they are alert to the possibility.⁶
41. In addition to carrying out due diligence checks when placing new subcontracts, it is the job of defence prime contractors (not MoD) to police the conduct of their existing subcontractors and supply chain partners, including maintaining a healthy interest in changes in controlling ownership rights.

CORRECTIVE, MARKET-BASED DEFENCE MECHANISMS

42. In any case, if such an event were to take place, there is every chance that corrective, market-based defence mechanism facilitated by incumbents dominant position will automatically come into play, in the sense that, defence prime contractors will go out of their way to *exclude* such entities from their supply chains, which means that they will probably go out of business.
43. Indigenous defence contractors have a vested interest in keeping foreign defence SMEs out of the UK defence equipment market – not because they are concerned about being held hostage during times of crises, but because they don't want a foreign SME to someday grow big enough to take their domestic market share.

CONCLUSIONS

44. Despite indulging UK-based defence contractors with a steady stream of uncontested contracts for many years, the government has been rewarded with appallingly poor performance, characterised by persistent delays and cost overruns.
45. The government now believes that there is room to accommodate additional participants in the UK defence equipment market and to this end, it is seeking to attract foreign defence contractors.
46. The government is pursuing this policy notwithstanding the possibility that it opens the way for adversary states with malicious intent to buy or take a controlling stake in domestic defence contractors.
47. The government has admitted that the inability of defence contractors to satisfy its military equipment requirements corresponds to market failure in defence procurement.
48. The mass migration of people previously in the pay of the State to the private sector via the “revolving door” has served to deny contractors a design & development capability.
49. This government has acted swiftly to remove the policymaking responsibility on competition from MoD and place it in the expert hands of BEIS where it rightly belongs.
50. This risk of infiltration of the defence supply chain is overblown.

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About the Author

Jag Patel has considerable experience of researching, analysing and solving a wide range of entrenched procurement problems.

⁶ See answers to Q86-89, oral evidence from the defence industry before the Defence Committee, Inquiry into *Defence industry policy: procurement and prosperity*, HC 163, 23 June 2020, PDF file (318kB) <https://committees.parliament.uk/oralevidence/576/pdf/>