



# WHARTON AEROSPACE & DEFENSE REPORT

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## **Expect Export Controls to Loosen for Defense Contractors Momentum Is Building among Key Stakeholders to Streamline Today's System**

*April 2010*

President Barack Obama last month outlined a plan to double U.S. exports over the next five years by introducing the administration's National Export Initiative. The President outlined measures to spur U.S. trade, including the formation of an Export Promotion Cabinet -- with high-powered members like the Secretaries of State, Treasury, Commerce and other top officials. Obama also said that the administration plans to substantially increase access to trade financing for small- and medium-sized businesses that wish to export.

The defense and aerospace industries, however, are most closely watching the initiative's measures to overhaul the U.S. Export Control System, which restricts the sales of "dual-use" technologies -- those with military and commercial applications -- to countries like Iran and North Korea. The President acknowledged that the controls have had a detrimental impact on U.S. exports in his speech at the Export-Import Bank's Annual Conference in Washington, D.C. "What we want to do is concentrate our efforts on enforcing controls on the export of our most critical technologies, making America safer while enhancing the competitiveness of key American industries."

Defense and aerospace industry leaders, policy analysts and many lawmakers now see this Cold War Era system -- the most stringent export controls in the world -- as a hurdle in addressing new security threats, and as a barrier to trade with allies. Modernizing the controls could propel U.S. real GDP by more than \$64 billion by 2019 and create 160,000 manufacturing jobs, according to a recent study published by the Milken Institute and the National Association of Manufacturers.

The study says these controls were set in 1940 when Congress gave the President authority to restrict the sales and access of certain technologies that could be used in weapons systems. Successive administrations pushed through tighter restrictions as Cold War tensions mounted. The Export Control Act of 1949 was followed by the Export Administration Act of 1969, and while this act expired in 1989, it has been kept alive with presidential authority.

Even as successive administrations renewed the controls, the end of the Cold War rendered many of the protections useless. For example, many of the protected dual-technology systems have already entered the commercial sphere across the world and are freely available. Often, a country restricted from buying certain technologies from an American company can easily purchase them elsewhere.

### **Outdated and a Drag on Innovation**

A Wharton School alumnus, who works at one of the world's largest defense companies, outlined some of the top issues that increasingly make export controls outdated. He asked not to be named because he is not authorized to speak on behalf of the company. One of the biggest reasons the rules are now outdated, he says, is because new weapons makers worldwide have put pressure on the U.S. producers. The rules date back to a time when the vast majority of the defense industrial complex resided in the U.S. and there was little real competition, but now a big international market exists with a growing defense industrial base outside the U.S. that can

supply that market. "While we could once get away with it -- to put it bluntly -- we can't anymore," he said. "To stay competitive today we have to be able to sell" our military goods beyond the U.S. military or someone else will supply a similar product anyway.

The U.S. needs to tap into the growing knowledge and expertise of this overseas industrial base -- a vast majority of which is based in the countries that are allies or friends -- to advance its own technologies and to remain on the cutting edge, according to Baker Spring, the F.M. Kirby Research Fellow in National Security Policy at the Heritage Foundation. "Right now, that collaboration is next to impossible," said Spring. "In other words, the problems of the export control system as a whole -- both arms control and dual-use -- have come back to bite the interest that it was supposed to be serving."

A real-life example from the Wharton alumnus underscores the situation. His company has research and manufacturing facilities around the globe, as do nearly all top defense and aerospace companies. He often receives research data from a unit based in the United Kingdom, one of the U.S.'s most steadfast allies. "The overseas unit sent me a PowerPoint presentation of some material we were working on within our company," said the alumnus. "My team marked it up but we were unable to send it back to them because of export control issues. It just happened and it keeps happening to us."

He said he is worried that without the ability to collaborate across borders, some of the research that these multinational companies conduct will become stunted. "You have to have the ability to transfer internal proprietary information back in force," said the alumnus. "There had to be a more logical way because we all have to go global to be relevant in today's market."

The problem can be even more severe when U.S. defense and aerospace companies have to agree to "offsets" to win contracts with overseas groups. Under offsets, a country that is buying, say, a fleet of aircraft or tanks will require that the U.S. defense company set aside a percentage of the required manufacturing for in-country vendors, suppliers and manufacturers. Offset collaboration gets complicated because you have to "control and exchange technical information" at the same time, says the Wharton alumnus. "And you have to worry about not getting sideways with the U.S. government or the foreign government."

Another consequence of the outdated export controls, critics contend, is that they keep the best minds in academic science, space and technology research away from important data and development. Many highly qualified foreign scientists are working outside the U.S. where they are more able to access and share the information they need to pursue breakthroughs in their fields.

Some worry that the export controls will be updated to benefit big business at the expense of U.S. national security. They note that the effort to reform export controls comes at a time of growing attempts to ship controlled dual-use components to countries like China, Iran and North Korea.

The U.S. Immigration and Customs Enforcement (ICE) statistics show that law enforcement agencies and federal prosecutors have redoubled enforcement in recent years, leading to 149 export-related arrests in 2007. The Commerce Department reports that in 2007 more than 80% of its export convictions were related to weapons of mass destruction proliferation, terrorist support or for military use.

But industry and others who want to reform the system say they are not suggesting recklessness in the overhaul. "I would never leave it just in the hands of industry to draft our export control laws," said Baker. "The U.S. government should establish a way for businesses to pursue their economic interests in ways that are not contradictory with U.S. security interests."

### **Pentagon Now Agrees**

Even the Pentagon, which has traditionally played the protective role by pushing for continued export controls, is beginning to change its perspective. Defense Department watchers note that the agency is now acutely aware that U.S. defense and aerospace companies need to the ability to collaborate with companies outside U.S. borders to maintain their cutting edge. The Pentagon also realizes that defense spending alone can no longer subsidize the R&D of innovative weapons systems. In addition, companies must also be allowed to seek greater profits by marketing commercial uses for their defense technologies, many officials acknowledge.

"Senior flag officers are recognizing that they cannot by themselves create enough work -- if you will -- to feed the defense industrial base," said the Wharton alumnus. "To have a strong and stable industry, especially in aerospace and high-end defense technology, the industry must be allowed to export more."

Defense Secretary Robert Gates is a strong supporter of reforming export controls, giving President Obama's efforts the legitimacy needed to push through reform. The President outlined two steps to begin reforming the system when he announced the initiative in March. "First, we're going to streamline the process certain companies need to go through to get their products to market," he said, referring to products with encryption capabilities like cell phones and network storage devices. At present, companies trying to export such items endure a technical review that take from 30 to 60 days, according to the administration, putting them at a significant disadvantage to foreign competitors. The new review system, says the Ppresident, will take 30 minutes online, making it "quicker and easier for our business to compete while meeting our national security requirements."

Another step involves eliminating "unnecessary" obstacles for exporting products to companies that have dual-national and third-country national employees. "We're moving towards harmonizing those standards and making it easier for American and foreign companies to comply with the requirements without diminishing our security," the President said.

Most details, however, still need to be hammered out and the complexity of overhauling a long-entrenched system will become more daunting. Gates "will outline the reform proposal within the next couple of weeks," Obama said during his speech, adding that he would also consult with Congress on these export control reform efforts.