



INTERNATIONAL POLICY REPORT

RISKS AND RETURNS: THE ECONOMIC ILLOGIC OF THE OBAMA ADMINISTRATION'S ARMS EXPORT REFORMS

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EXECUTIVE SUMMARY

In the near future, smugglers will likely have an easier time of it due to the Obama administration's plans to dramatically loosen U.S. arms export controls. The stated purpose of the reform effort is to simplify arms export procedures while boosting the sales and profits of the arms and aerospace industries. But the Obama administration's proposed reforms threaten to undermine a carefully crafted system of arms export controls and increase the risks of weapons technology falling into the wrong hands. This is far too high a price to pay for any marginal economic benefits that may result from an easing of controls.

Early in its first term, the Obama administration announced the outlines of a new approach to arms export controls designed to reform “what we control, how we control it, how we enforce those controls and how we manage our controls.” The stated goal of the reform effort was to focus on “controlling the most critical products and technologies” while “enhancing the competitiveness of key United States manufacturing and technology sectors.”

A central element of the administration's approach has been to move items from the United States Munitions List (USML) – a compendium of arms and arms-related technologies monitored by the State Department – to the Commerce Control List (CCL), which subjects equipment destined for export to less rigorous scrutiny.

The Obama administration's loosening of controls goes far beyond anything contemplated by the Clinton or Bush administrations. The White House has asserted that, “At the end of this process, we anticipate that a significant percentage of the items that are transferred off of the USML would be permitted to be exported without a license.” This means that oversight would be lifted from these items.

It is generally agreed that existing export control laws and regulations need to be simplified and updated, but human rights groups and the Government Accountability Office (GAO) have raised serious concerns over the potential for the Obama administration's reforms to undercut current laws designed to keep U.S. defense articles out of the hands of terrorists, human rights abusers, or countries or groups seeking to develop nuclear weapons.

The arms and aerospace corporations' perspectives overwhelmingly drove the export reform initiative, and the administration has touted its economic benefits as an important factor driving the entire reform effort. For example, a former Assistant Secretary of State for Political-Military Affairs, Andrew Shapiro, has argued that the administration's export control reform would “have a real impact on our economy at a time when competition is even more fierce and at a time when our manufacturing base could really use a boost.”

The administration's claims of major economic benefits from export control reform have not been substantiated. In fact, there is strong evidence to suggest that export reform is unlikely to significantly increase U. S. sales of military-related technology. The United States already accounts for nearly 80 percent of the global market for items currently covered by the USML. Even a radical reform of arms export controls is unlikely to push that figure much higher.

In any case, just three percent of U.S. exports are subject to export licensing controls. It is unreasonable to expect that changes in export procedures governing that small a fraction of U.S. exports are likely to have a major economic impact. As one business analyst has noted, the economic benefits of arms export reform, if they exist at all, are likely to be "infinitesimal." This may be why, when asked by House Foreign Affairs Committee Chairman Ed Royce whether the administration could quantify the expected economic impacts of export control

reform, Kevin Wolf, the Assistant Secretary of Commerce for Export Administration, replied that "we don't have an estimate for that particular economic benefit."

It is even possible that arms export reform could reduce U.S. employment. The reform will make it easier to produce components of U.S. weapons systems overseas and to sell U.S. production technology to potential competitors. Thomas Buffenbarger, the president of the International Association of Machinists, the union that represents the bulk of the workers in the arms and aerospace industries, has warned that

[T]he less stringent controls provided under the CCL could lead to further transfers of technology or production from the U.S. to another country. The transfer of technology and production can have long-term consequences as other countries utilize that transferred technology and production to develop their own commercial and defense industries at our expense.

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A Bell Huey helicopter

RECOMMENDATIONS

- The Department of Commerce should undertake a detailed analysis of the employment impacts that may result from transferring items from the USML to the CCL – or decontrolling them altogether. These economic effects should then be one factor utilized in determining whether to ease controls on a given item.
- Congress and the administration should take a second look at the impacts of the Export Control Reform Initiative in preventing sales to dictatorships and human rights abusers. They should strengthen those restrictions to ensure that items moved from the USML to the CCL receive the same level of human rights screening that currently applies to items on the USML. These changes should be embedded in law, not just left to the discretion of a given administration.
- There should be a moratorium on moving additional items from the USML to the CCL until strict safeguards have been developed that will prevent the transfer or re-transfer of U.S. arms and arms technology to terrorists, human rights abusers, or countries seeking to develop nuclear weapons.

INTRODUCTION

In October 2012, the authorities in Malaysia arrested an Iranian national named Alireza Moazami Goudarzi. According to the indictment against him, Goudarzi tried to purchase spare parts for civilian and military aircraft from a supplier in the United States and ship them to Iran. He offered to pay above-market prices because the United States has an economic and weapons embargo against Iran. After being notified by the supplier, an undercover agent from the United States government began corresponding with Goudarzi regarding the aircraft parts he was seeking. His shopping list included rotor blades for an older model attack helicopter and jet engine parts currently subject to arms export controls.¹

Over the past five years, the authorities in the United States have broken up dozens of such attempts to illegally export older aircraft parts to Iran, China and Venezuela. This October, however, it will become

easier for arms dealers to sell spare parts and other items – still much in demand by governments of concern, such as Iran and China – because the United States will no longer subject these kinds of transactions to high level scrutiny.²

Early in its first term, the Obama administration announced the outlines of a new approach to arms export controls. This new approach, the administration said, had been designed to reform “what we control, how we control it, how we enforce those controls and how we manage our controls.” The stated goal of the reform effort was to focus on “controlling the most critical products and technologies” while “enhancing the competitiveness of key United States manufacturing and technology sectors.”³

While it is generally agreed that existing export control laws and regulations need to be simplified and updated, human rights groups and the Government Accountability Office (GAO) have raised serious concerns over the potential for the Obama administration’s reforms to undercut current laws designed to keep U.S. defense articles out of the hands of terrorists, human rights abusers, or countries or groups seeking to develop nuclear weapons.⁴

The administration’s export reforms came in response to longstanding demands by the arms and aerospace industries.⁵ Organizations like the Aerospace Industries Association made export control “modernization” a top issue in the presidential campaigns of 2004 and 2008. And in March 2007, a who’s who of business lobbying groups gathered under the aegis of the Coalition for Security and Competitiveness to press for export control reform measures. Their unifying goal was to reduce the number of items included on the United States Munitions List (USML), a compendium of weapons and weapons-related items subject to monitoring and control by the State Department. The industry groups also wanted to increase the use of exemptions that would allow thousands of transactions to proceed without an export license. In fact, the vast bulk of the input regarding the ECRI came from the corporations that are subject to the regulations being revised. While these parties should certainly be consulted, their predominance in the bodies designed to give input to the process suggests a one-sided approach.

Years of industry pressure have finally paid off: the Obama administration's proposed reforms call for a sweeping liberalization of the arms export control process that goes far beyond anything contemplated during the Bush or Clinton years.

Current reform efforts began when industry representatives persuaded Robert Gates, then the Secretary of Defense, that the health of the country's defense industrial base was at stake. Export controls, a tool the United States had long used to protect national security, were now being described as a threat to national security.⁶ Gates took the issue to President Obama's first national security advisor, General Jim Jones, and the two men persuaded Obama that an extensive relaxation in arms export controls would produce a "win win" situation: Not only would it be good for the U.S. arms industry and the workers employed in it, but it would threaten neither national security nor United States military forces abroad.

The administration asserted that the overarching goal of the reform effort was to place "higher fences around fewer items" and eliminate or reduce controls on items of limited national security concern. The administration also asserted that the new policy would give licensing officials more time to focus their oversight efforts on truly sensitive items. In the administration's view, the country's peer competitors – meaning adversaries poised to challenge the United States on potentially equal terms – do not pose a significant security threat when they seek to obtain weapons and parts that are nearing obsolescence or are readily available from suppliers outside the United States. But this narrow focus on controlling the flow of modern equipment to peer competitors ignores the danger posed by making it easier to ship low-tech items to nations of concern. Iran, for example, wants spare parts to keep its aged American-made fighter jets and attack helicopters flying; China wants older model technology to copy and manufacture; and many regimes want the means of daily repression, like low-tech guns and communication and surveillance equipment. None of these items would be kept behind the "high fence" of United States export controls as envisioned by the Obama reform.

Despite these concerns, and with almost no debate, the administration has moved full speed ahead. In April

of 2013, it published the first permanent rule changes in the Federal Register. The changes will take effect in October.

THE EXPORT CONTROL REFORM INITIATIVE

The Export Control Reform Initiative (ECRI) seeks to achieve the administration's aims by reducing the number of items on the United States Munitions List (USML). The International Traffic in Arms Regulations (ITAR) governs the export of the items on the USML, and exporting them requires a license from the State Department. Exports of products and services on the USML currently receive considerable scrutiny with respect to their potential impact on human rights, terrorism, nuclear proliferation, and regional conflicts.⁷ This will change under the ECRI.

The White House has asserted that, "At the end of this process, we anticipate that a significant percentage of the items that are transferred off of the USML would be permitted to be exported without a license."⁸ This means that oversight would be lifted from these items.

In addition to controls on items included on the USML, a second level of export controls covers primarily "dual use" items, which are items that can be applied to either military or civilian purposes.⁹ These products and technologies appear on the Commerce Control List (CCL) and their exportation requires a license from the Department of Commerce. Dual use technologies receive a lesser degree of scrutiny than items on the USML, both with respect to human rights and other concerns and because the CCL allows for exemptions from key rules for specific countries.

As part of the arms export control reform initiative, roughly three-quarters of the items on the USML will be transferred to the less restrictive CCL. The items involved are mostly spare parts and weapons components, but some finished products, such as older model C-130 transport planes, Black Hawk and Huey helicopters, and engines for C-17 transport planes will also be removed from the USML.

In pursuit of its goal of "higher fences around fewer items," the ECRI is moving items that it views as non-sensitive from the munitions list to Commerce Department's control list. Non-sensitive items include items whose acquisition would not constitute a threat

to United States security or its military forces abroad, or items that are already available from other sources. Initially at least, these products will be placed on a sub-list of the Commerce list known as “Series 600” items. The administration has pledged that “Series 600” items will receive more scrutiny than regular CCL items. In parallel with the effort to reduce and re-focus the USML, many items will be removed from the CCL entirely, thereby placing them in the category of products for which no export license is required.

The ultimate goal of the administration’s reform effort is to produce a master export control list that includes items formerly appearing on either the USML or CCL. The Department of Defense (DoD) would act as the primary overseer of the new list and administer it by means of a single computer network and a set of definitions designed to expedite licensing decisions. The hope is that this system would provide adequate scrutiny over exports of sensitive items. Creating a single list and putting it under DoD control would require a change in current law.

Policy Concerns

Moving a defense product or service from the State Department’s USML to the Commerce Department’s CCL disassociates the transferred items from a body of protections enshrined in law by Congress over the years. As the American Bar Association’s Center for Human Rights has noted, “the USML – unlike the CCL – is part of a sophisticated regulatory regime designed to protect sensitive weaponry.”¹⁰

A transfer from the USML to the CCL might create considerable confusion about which military equipment is covered by existing legal restrictions and might put significant arrays of military goods and equipment beyond the reach of existing statutory restraints. The administration has argued that it will take measures to avoid this outcome, asserting that it will “continue to maintain the judicious use of export controls to deter human rights abuses and avoid contributing to civil disorder in a country or region.”¹¹ But as the ABA Human Rights Center report notes, these regulations are easy to amend and are not an adequate substitute for laws enacted by Congress.¹²

In addition to human rights considerations, moving USML items to the CCL will eliminate the need

for prior reporting of significant sales to Congress, thereby eliminating the possibility of a Congressional veto.¹³ The administration is developing a process to notify Congress of exports of certain dual use items.¹⁴ But so far, the new CCL reporting policy will include only those items whose sale requires reporting under the Wassenaar arrangement, a multilateral agreement on conventional arms transfers, as well as *certain* items of Major Defense Equipment (MDE), which is defined as any item of significant military equipment on the USML having a nonrecurring research and development cost of more than \$50,000,000 or a total production cost of more than \$200,000,000.¹⁵

The administration’s proposal covers a much narrower range of equipment than current law requires. At a minimum, a new process should provide for the same reporting requirements and Congressional veto power for *all* items of Major Defense Equipment transferred to the CCL as had applied to those same items when they were on the USML. And these requirements should be embedded in law, so they cannot be eliminated as a matter of policy by current or future administrations.

Additionally, the GAO and the former director of the State Department’s arms export licensing office, among others, have expressed concerns that loosening export controls would create loopholes that might make it easier for arms dealers, terrorist organizations, and proliferators of nuclear technology to obtain goods that are militarily useful.¹⁶

The potential increase in flows of military-related items to these groups might come in one of three ways.

First, as indicated above, many items with military applications will be de-controlled altogether, thereby making it more likely that they will reach dangerous buyers, either directly or indirectly.

Second, the movement of large numbers of items from the USML to the CCL will diminish the resources the State Department has at its disposal to carry out oversight of sales of items on the USML. This will create the possibility that questionable licenses might be granted due to lack of adequate scrutiny.¹⁷ Currently, the State Department’s Directorate of Defense Trade Controls is required by presidential directive to be 75

percent self-funded, from registration fees charged to companies under the department's jurisdiction.¹⁸ When the reform kicks in, there will be fewer items and fewer fee-paying companies under the State Department's process; this will create a funding shortfall that will presumably have to be made up with tax dollars. It is far from certain that adequate funding can be provided in the current budgetary environment. This, in turn, could lead to a shortfall in licensing officers and will bear watching as the reform process moves forward.

Third, an even broader range of sensitive items could reach irresponsible recipients via third parties.

A key part of the export reform is to create "strategic licenses," known as License Exception Strategic Trade Authorizations (STA's), for 36 allied nations. They include: Argentina, Australia, Austria, Belgium, Bulgaria, Canada, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Latvia, Lithuania, Luxembourg, Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, South Korea, Spain, Sweden, Switzerland, Turkey and the United Kingdom.

The STA's allow for the export of a wide range of dual use items from the U.S. without requiring a specific license for each transaction.¹⁹ All that will be needed is some paper work pledging that the items received will not be forwarded to prohibited destinations.²⁰

Even Canada, which has had a country-specific exemption to receive a wide array of defense articles since 1985, had its privileges reined in based on a GAO analysis that demonstrated that "exports were being re-exported from Canada to countries of concern without U.S. government approval," suggesting that "controls over defense and ammunition transfers needed strengthening."²¹ The analysis cited 19 cases of improper re-export of items from Canada, including improper transfers of armored personnel carriers that ended up in Iran and improper transfers of communications equipment and training to Pakistan.²² The STA system will involve many more countries and cover a broad range of items, including spare parts for weapons and possibly ammunition, which are particularly hard to track.

A review of the most recent Department of Justice tally of export enforcement cases underscores the central role of third party transfers in efforts to evade United States government export restrictions. Of 252 cases since 2007, 78 involved attempts to retransfer United States equipment to prohibited destinations via third parties. Of these, 31 of the successful or attempted retransfers involved United States allies that are now on the list to receive a wide variety of items without a license as part of the STA program.²³ This suggests that under ECRI it may become easier for smugglers to achieve the first step in any scheme to export military-related United States goods to prohibited destinations: shipping the goods to United States allies whose export control systems may be easier to evade.

Specific examples of transfers of United States technology include a case in which United Technologies pleaded guilty and paid penalties of over \$75 million after a Canadian subsidiary of its engine division, Pratt and Whitney Canada, supplied helicopter engines to China that had been adapted for military use. Although the Canadian authorities told Pratt and Whitney that they would need a license to sell military-useful engine software to China, the company managed to evade Canadian government controls. The company's rationale was summed up succinctly by the *Wall Street Journal*:

Lured by the promise of being the exclusive engine supplier to China's civilian helicopter program with the potential to generate \$2 billion in sales and service, executives at Pratt Canada dodged concerns that the sale of the engine software violated U.S. export laws.²⁴

Economic Assumptions

The administration is normally careful to maintain that the primary reason for the arms export reform is grounded in national security concerns. But it often touts ECRI's potential economic benefits as well.

The administration unveiled its policy at a White House meeting with the President's Export Council (PEC), a body consisting of business consultants and executives from Fortune 500 companies alongside appointed and elected officials. Boeing's CEO, W. James McNerney, is the Council's chairman.²⁵

This event solely focused on boosting exports. At the meeting, President Obama set a goal of doubling U.S. exports over the next five years to support millions of new American jobs. Announcing its export control initiative in this setting underscores the administration's goal of cloaking its export control reforms in the language of economic benefits.

A former Assistant Secretary of State for Political-Military affairs, Andrew Shapiro, has been more explicit than President Obama in touting ECRI's possible benefits. Shapiro has argued that the administration's export control reform would "have a real impact on our economy at a time when competition is even more fierce and at a time when our manufacturing base could really use a boost."²⁶

The administration has said that the current export control system is "bad for business."²⁷ Except for a few anecdotal examples, however, the administration has failed to demonstrate that inconveniences posed by the current licensing system cannot be addressed in a more targeted fashion, without undertaking a large-scale overhaul of current export control procedures that involves undertaking the risks outlined above.

As Will Lowell, a former head of the State Department's Office of Defense Trade Controls, put it in a comment on one of the proposed regulatory changes related to the ECRI, "it has been assumed (wrongly) that a policy of careful controls over arms exports is inconsistent with the success of U.S. industry in the international marketplace."²⁸

Tom Kelly, the Deputy Assistant Secretary of the State Department's Bureau of Political-Military Affairs, underscored this point at an April 2013 Congressional hearing. Asked whether the administration was doing enough to advocate for U.S. arms exports, Kelly said:

It is an issue that has the attention of every top-level official who's working on foreign policy throughout the government, including the top officials at the State Department ... in advocating on behalf of our companies and doing everything we can to make sure that these sales go through, again, taking into consideration all the other factors that we're required to consider in the conventional arms transfer policy ... And that is something that we're doing every day, basically

[on] every continent in the world, and we take it very, very seriously and we're constantly thinking of how we can do better. But some of the issues that are critically important to our competitiveness relate to structural issues like the export control regime, and that's why we spent thousands of man-hours and lots of consultations with this committee and with others in trying to enhance our system so that our defense industry is going to become even more competitive than they are already.²⁹

Major business networks like the Coalition for Security and Competitiveness have welcomed the administration's pro-industry stance. The nineteen members of the group, which lobbied hard for the arms export control reform, include the Aerospace Industries Association, the Business Roundtable, the United States Chamber of Commerce, the National Association of Manufacturers (NAM) and the National Defense Industrial Association.

NAM has been particularly vocal. In the midst of praising the administration's steps toward export reform, the group asserted that "continuing to work to reform export controls is absolutely critical to achieving the President's goal of doubling exports and achieving economic growth."³⁰

To bolster its advocacy campaign, NAM financed a 2010 analysis by the Milken Institute that asserts that arms export reform could substantially increase U.S. market share in key countries and generate 340,000 new jobs in the United States by 2019.³¹

The report's methodology doesn't hold up to scrutiny. It examines an unspecified group of commercially available high technology products and assumes that easing export controls on them would greatly increase U.S. sales of these products in a group of key countries that includes China, India, Pakistan, Russia, and Israel.³² In particular, the report suggests that "a modernization of export controls [to the above-mentioned states] would narrow the gap between U.S. market share in these nations and its share in the total world market by 50 percent."³³

Assume that the United States' share of the world market in a given item is 50 percent but that its share of the market for that same item in China is only 10

percent. Under the Milken report's assumptions, the United States' share of the Chinese market would triple to 30 percent as a result of export control "modernization" alone. This would indeed be an impressive result, but the Milken report offers no justification for its assumption that the United States' share of any technology product's market would increase so dramatically merely due to an easing of munitions-related export controls. There are many other factors that determine market share in a given country, from quality and price to political relationships.

The administration acknowledges that several other government policies may play a greater role in boosting U.S. exports, including the availability of export financing and the role of United States government representatives in promoting arms and related technology sales overseas.

As the State Department's Tom Kelly said at the Congressional hearing cited above, the U.S. government has already been pulling out all the stops on these fronts. As a result, United States exports of manufactured goods have been increasing at record rates in recent years, *before* major changes in the export control system have taken hold. The administration's 2012 export strategy report notes that exports of goods and services each hit all-time highs in 2011, and total exports topped \$2 trillion for the first time in history.³⁴

Arms Trade

Beyond the question of the relationship or lack thereof between export controls and export growth generally, there is strong evidence to suggest that export reform is unlikely to significantly increase U.S. sales of military-related technology. The United States already accounts for nearly 80 percent of the global market for items currently covered by the USML.

In 2011, the most recent year for which full statistics are available, the United States concluded arms sales agreements worth over \$66.3 billion, the largest figure in the history of United States arms transfers. This commerce represented an astounding 78.7 percent of the global market; the closest competitor was Russia, with 5.6% of the world arms market for the same year. Although 2011 was a record year for United States exports, the country's share of global arms exports for the four-year period from 2008 to 2011 was impres-

sive as well, with \$145 billion in total sales agreements accounting for 56 percent of the global market. By comparison, the second largest supplier for the 2008 to 2011 period was Russia, which controlled just 12.8 percent of the market.³⁵

These data, from the Congressional Research Service, focus on the dollar value of export agreements and therefore tend to be dominated by the impact of a relatively small number of large deals involving fighter planes, tanks, and attack helicopters. But United States firms are also exporting smaller items in substantial quantities. In 2011, for example, the State Department approved export licenses worth \$44.2 billion for items in all 20 categories of the USML. The largest categories by dollar value were aircraft and associated equipment, \$17.2 billion; military electronics including radar, sonar and surveillance equipment, \$15.2 billion; fire control, range finder, optical and guidance control equipment, \$2.4 billion; tanks and military vehicles, \$1.7 billion; spacecraft systems and associated equipment, \$1.4 billion; and ammunition and ordnance, \$1.1 billion.³⁶ The dollar value of export licenses approved for items on the USML has more than doubled in recent years, from \$19.8 billion in FY 2006 to \$44.2 billion in FY 2011.³⁷ For a variety of reasons, not all items licensed translate into sales, but the value of licenses granted indicates that in general, producers of smaller items of equipment and components are not suffering from an inability to acquire export licenses under the current export control system.³⁸

While the administration and industry have cited a number of anecdotes about small and medium-sized companies losing business due to allegedly onerous export restrictions, only 0.3 percent of total United States trade is subject to licensing by the Commerce Department because it is "dual use" technology with potential military applications.³⁹

Items licensed by the State Department account for just 2.9 percent of U.S. exports.⁴⁰ This estimate is high, since a relatively small proportion of the State Department-licensed items result in actual sales.⁴¹ If roughly 97 percent of all U.S. trade is not licensed in the first place, how big an economic impact could be achieved by making adjustments in how the remaining three percent is handled? Export control reform may help particular firms, but its larger economic effects

are marginal. One analyst associated with a business trade association has suggested that given this reality, any increases in United States exports due to licensing issues would be “infinitesimal.”⁴²

Jobs

To the extent that easing export controls does increase exports, it is important to note that not all exports are created equal. For example, if a United States-based firm uses foreign components in an exported item, the Commerce Department treats it as if the entire exported item was produced in the United States. This anomaly may not matter much in gauging the impact of the export on the revenues and profits of the exporting firm, but it makes a huge difference in terms of the potential impact on jobs in the United States. More foreign components mean fewer jobs in the United States. Although this issue has been raised with the Commerce Department, there has been no study done to determine the impact of outsourcing of component production on the number of jobs generated by United States exports.

The International Association of Machinists and Aerospace Workers (IAM), the union that represents the majority of arms industry workers, has questioned whether export control reform would result in a net increase in jobs in the United States.

The IAM’s president, Thomas Buffenbarger, warned in a letter to the House Foreign Affairs Committee sent in March 2013 that

In some cases, the less stringent controls provided under the CCL could lead to further transfers of technology or production from the U.S. to another country. The transfer of technology and production can have long-term consequences as other countries utilize that transferred technology and production to develop their own commercial and defense industries at our expense. These transfers have already decimated the shipbuilding, machine tool and electronics industries. They are also having a significant impact on both the commercial and defense aerospace and related industries.⁴³

The IAM has expressed particular concern that “shifting aircraft, aircraft engines, and aerospace related parts and components to the CCL without proper analysis could facilitate further outsourcing of tech-

nology and production to other countries, threatening U.S. jobs and national security.”⁴⁴

Offsets

In today’s hypercompetitive arms market, the big weapons contractors frequently outsource component production as part of an “offset” package. Offsets are side deals intended to sweeten the pot and entice a buyer to preference one seller over another. For example, Lockheed Martin will build components of its new F-35 combat aircraft in at least eight nations in exchange for their purchase of the plane.⁴⁵

Since the United States government first started tracking offset agreements in the defense sector in 1993, 61 United States-based firms have reported 11,353 offset transactions with 50 countries. The total value of offsets provided under these arrangements was more than \$56 billion.⁴⁶

Over the longer-term, equipment and know-how transferred via offset agreements – including machine tools, other production equipment and software – can strengthen competitors by enhancing the purchasing nation’s ability to build its own version of all or part of the imported item. As the Commerce Department’s Bureau of Industry and Security noted in its most recent annual report on offsets in the defense trade, “offset agreements and associated offset transactions can negate some of the potential economic and industrial base benefits accrued through defense exports if the offset activity displaces work that would otherwise have been conducted in the United States.”⁴⁷

As the department further notes, offsets can have significant, negative long-term effects on United States suppliers:

[A]t times, U.S. prime contractors develop long-term supplier relationships with foreign subcontractors based on short-term offset requirements. These new relationships ... can limit future business opportunities for U.S. subcontractors and suppliers, with negative consequences for the domestic industrial base. Other kinds of offsets, such as technology transfers, may increase research and development spending in foreign countries for defense or non-defense industries, thereby helping to create or enhance current and future competitors to U.S. industry.⁴⁸

A number of major industrial sectors show a net loss as a result of offsets – more jobs exported via offsets than created via export revenues created by offset-related sales. Industries that are net losers due to offsets include “other aircraft parts and auxiliary equipment manufacturing”; “military armored vehicle, tank, and tank component manufacturing”; “aircraft engine and engine parts manufacturing”; and “search, detection, and navigation system and instrument manufacturing.”⁴⁹ Military aircraft manufacturing is the only sector with a significant net positive – more jobs created via exports than lost via offsets. And even this is a relatively small number – 22,470 jobs.⁵⁰

The role of offset agreements in outsourcing American jobs has been of particular concern in the aircraft industry. Rivals of the United States, including China, have used offsets and technology transfers from United States-based firms to help build their own civilian aerospace production capacity. An analysis by the IAM notes that employment in the aerospace industry in the United States has decreased by 40 percent during the past 20 years, in large part due to offshoring of production linked to offset agreements.⁵¹

Boeing is a case in point. The company has bought more than \$1 billion worth of aircraft components from China, and 4,500 current Boeing aircraft include parts made in China.⁵²



C-130 Transport Plane

The Machinists union has suggested a number of measures to address the outsourcing of aerospace production and jobs to China, including doing detailed assessments of the impacts of outsourcing and technology transfers on U.S. jobs. These “employment impact statements” would be completed before deciding whether to provide government assistance for a given export deal.⁵³

As noted by Thomas Buffenbarger, the president of the IAM, aerospace is not the only industrial sector in the United States for which outsourcing of jobs is a concern. In 2010, the United States exported over \$91 billion in goods and services to China. A large percentage of these items are either production or high technology equipment.⁵⁴ And, as the Commerce Department notes, “as a result of several revisions to the EAR [Export Administration Regulations] in recent years, an increasing number of items for turnkey plants and facilities have become eligible for export to controlled destinations [e.g., China] without a license or under a license exception.”⁵⁵

Creating Competition

Will further relaxation of export controls contribute to the kind of offshoring of jobs and production capabilities described above?

The former head of the State Department’s Office of Defense Trade Controls says yes, describing the Obama administration’s export control reform as “a recipe for outsourcing”: “Unless underlying market distorting measures imposed by foreign countries [i.e., offset arrangements] are corrected, significant decontrol of the U.S. Munitions List is more likely than not to lead to more outsourcing of U.S. industry jobs, less U.S. manufacturing, and a continued decline of the U.S. defense industrial base.”⁵⁶

There are a number of reasons why this might be the case.

First, in some instances, taking an item off of the munitions list will

ARMS EXPORT REFORM AND OFFSHORING: AN UNEXAMINED ISSUE

The following exchange at a recent House Foreign Affairs Committee hearing between Rep. Brad Sherman (D-Calif.) and Assistant Secretary of Commerce Kevin Wolf suggests that the Obama administration has no plans to do a rigorous assessment of the economic impacts of the arms export control reform initiative.

REP. SHERMAN: If I were, at random, to identify an item that's been moved from one list to the other, would you be able to assure me that that liberalization has the effect of making it easier to export goods and not – and will not result or is not likely to result in the export of technology and the offshoring of production?

MR. KELLY: Well, sir, our – the basis for transferring from USML to CCL was asking the following question: Is this item going to – does this item contribute to preserving U.S. military advantage?

And that was the basis of our decision. And, for items that are important to preserving U.S. military advantage, we've kept them on the USML.

REP. SHERMAN: I would hope you would add something else to your criteria, and that is: Is the action you're about to take likely to move – to lead to offshoring of production, the decline of the U.S. industrial base, the decline of U.S. jobs and an increase in the industrial technology base of other countries?

If you leave that out of the decision-making process, what looks like an effort to enhance America's position will actually hurt it.

make it easier to get permission to produce it overseas. For exports to the 36 countries with strategic license exceptions, moving an item from the USML to the CCL may mean that it no longer needs a license at all before being produced in a foreign country. With respect to China, the initial plan is to maintain current restrictions for items that move from the USML to the CCL's "Series 600" list, but this could be changed relatively easily at any time by a simple policy shift. And to the extent that the export control reform process moves production technology off of both control lists, it will be easier to export that equipment to potential competitors.

Second, the proposed lifting of the "see-through" rule, a regulation that requires items with components on the USML to receive a license every time they are exported or re-exported, will make it easier to inte-

grate United States components with foreign produced content into a finished product.

There is some debate about this point. Proponents of the current export control reform initiative have suggested that small- and medium-sized United States firms will benefit from the elimination of the see-through rule. This, they claim, is because foreign producers are "designing around" United States components so that their products are not subject to the see-through rule and therefore not subject to United States licensing procedures each time they export or re-export a product that includes a component that is on the USML. Absent the see-through rule, they assert, foreign companies might no longer "design around" United States components, thus creating more business opportunities for smaller United States-based suppliers.

But when House Foreign Affairs Committee chairman Rep. Ed Royce (R-CA) asked Kevin Wolf, the Assistant Secretary of Commerce for Export Administration, if a study had been done to quantify the economic benefits of arms export control reform, he responded that “we don’t have an estimate for that particular economic benefit.”⁵⁷

Since neither the United States government nor any industry organization has done a study to determine how frequently the process of “designing around” U.S. produced components occurs, there is no way of knowing what impact this process might have on United States exports and jobs. Anecdotes exist, but it is unclear whether the current system has had a significant, measurable impact on total exports. The economic damage done by offsets, by contrast, is well documented.

Given this lack of basic economic analysis, the IAM urges the Commerce Department to “carefully review each item slated to be transferred to the Commerce Department control list to determine if the exporters of these goods can guarantee that they will not be utilizing this shift in U.S. export policy to further erode the domestic content of U.S. exports by further eroding U.S. manufacturing and its supplier base.”⁵⁸ This currently is not being done.

CONCLUSIONS

With very little public debate, the Obama administration has embarked on a course that could undermine U.S. national security and do further harm to the United States industrial base. Munitions export controls were put into place for a reason: Past Congresses and presidents did not want United States technology to end up in the hands of human rights abusers, dictators, and others who would harm the country. Today, under pressure from corporate leaders during an economic slump, the Obama administration has begun a sweeping liberalization of U.S. arms export controls. At the very least, Congress should ask some tough questions and demand study of what these changes portend for the country and its industrial base.

In its understandable efforts to simplify the arms export control process, the Obama administration has erred on the side of decontrol. Any economic benefits

or gains in bureaucratic efficiencies that might result from moving large numbers of items off of the USML are outweighed by the risks that loosened controls pose in the areas of human rights, anti-terrorism, and nuclear proliferation. Particular firms may benefit from loosened controls, but increases in export-related jobs in the United States will be minimal. If decontrol makes it easier to export production equipment and to produce components of weapons systems overseas, a net long-term loss in employment may well be the result for the United States.

These findings suggest three policy changes.

First, to get a clearer picture of the economic effects of export control reform, the Department of Commerce should undertake a detailed analysis of the employment impacts that may result from transferring items from the munitions list to the Commerce control list – or decontrolling them altogether. These economic effects should then be an additional factor utilized in determining whether to ease controls on a given item.

Second, Congress and the administration should take a second look at the impacts of the Export Control Reform Initiative in preventing sales to dictatorships and human rights abusers. They should strengthen those restrictions to ensure that items moved from the USML to the CCL receive the same level of human rights screening that currently applies to items on the USML. These changes should be embedded in law, not just left to the discretion of a given administration.

Finally, there should be a moratorium on moving additional items from the USML to the CCL until strict safeguards have been developed that will prevent the transfer or re-transfer of U.S. arms and arms technology to terrorists, human rights abusers, or countries seeking to develop nuclear weapons.

These changes should be transparent, and the resulting policy improvements should be documented in an annual report to Congress.⁵⁹

NOTES

¹Department of Justice, “Summary of Major U.S. Export Enforcement, Economic Espionage, Trade Secret and Embargo-Related Criminal Cases (January 2007 to the Present),”

February 2013, available at <http://www.justice.gov/nsd/docs/export-case-fact-sheet.pdf>

²Federal Register, April 16, 2013, pp. 22660-22740.

³White House, Office of the Press Secretary, “President Obama Lays the Foundation for a New Export Control System to Strengthen National Security and the Competitiveness of Key U.S. Manufacturing and Technology Sectors,” August 30, 2010. The president first announced his intention to seek an overhaul of the export control system in August 2009.

⁴Government Accountability Office, “Export Controls: U.S. Agencies Need to Assess Control List Reforms’ Impact on Compliance Activities,” GAO-12-613, April 2012; and Brittany Benowitz and Barry Kellman, “Rethink Plans to Loosen U.S. Controls on Arms Exports,” *Arms Control Today*, April 2013.

⁵For details on industry positions, see Aerospace Industries Association, “Export Controls: The Need for a Modernized System,” available at http://www.aia-aerospace.org/issues_policies/international/; and Coalition for Security and Competitiveness, “Recommendations for Modernizing Controls on Munitions List Items,” available at <http://www.securityandcompetitiveness.org/proposals/show/2241.html>. Coalition member groups include the National Association of Manufacturers, the United States Chamber of Commerce, the Business Roundtable, and the National Defense Industrial Association.

⁶“America’s ability to engage effectively with the rest of the world and keep our most sensitive technology away from those who would do us harm depend critically on our ability to get this right. I look forward to working with the Congress and my interagency colleagues to achieve the kind of systematic reform that will benefit both the security and prosperity of the American people.” – Secretary of Defense Robert Gates, “Export Control Reform,” Address to Business Executives For National Security, Washington, DC, April 20, 2010, available at http://www.aia-aerospace.org/assets/4-20-10_SecDefGatesSpeechonExportControlReform.pdf

⁷For a description of the process that applies to approving export licenses for items regulated under the International Traffic in Arms Regulations and the implications for human rights, see American Bar Association, Center for Human Rights, White Paper, “Proposals to Relax Controls for Significant Military Equipment,” January 14, 2013.

⁸White House, Office of the Press Secretary, “President Obama Announces First Steps Toward Implementation of New U.S. Export Control System,” December 9, 2010.

⁹The CCL also includes some military end items that are viewed as less sensitive on national security grounds, like High Mobility Multi-purpose Wheeled Vehicles (Humvees).

¹⁰American Bar Association, Center for Human Rights, op. cit., p. 2.

¹¹Export Control Reform Initiative Fact Sheet #2, “Myths and Facts.” January 1, 2013, p. 2.

¹²American Bar Association, Center for Human Rights, op. cit., p.3.

¹³See Richard F. Grimmert, “Arms Sales: Congressional Review Process,” *Congressional Research Service*, February 1, 2012.

¹⁴White House, Office of the Press Secretary, “Executive Order – Export Control Reform,” March 8, 2013 states the following: “The Secretary of Commerce shall, to the extent required as a matter of statute or regulation, establish appropriate procedures for when Congress is to be notified of the export of firearms that are subject to the jurisdiction of the Department of Commerce under the Export Administration Regulations and that are controlled for purposes of permanent import by the Attorney General under section 38(a) of the Arms Export Control Act (22 U.S.C. 2778(a)) and appropriate procedures for when Congress is to be notified of the export of Major Defense Equipment controlled for purposes of permanent export under the jurisdiction of the Department of Commerce.”

¹⁵Major Defense Equipment is a category of military equipment involving \$50 million in non-recurring research and development costs or a total production cost of more than \$200 million. The export reform initiative creates a new category, “Series 600 Major Defense Equipment,” which uses the same definition with respect to research and development or production costs, but applies it to a narrower range of categories of significant military equipment. See “Revisions to the Export Administration Regulations: Initial Implementation of Export Control Reform,” *Federal Register*, April 16, 2013, pp. 22659 to 22740, part 743, “Special Reporting.”

¹⁶Government Accountability Office, op. cit.; and Letter from William J. Lowell, Managing Director, Lowell Defense Trade LLC, to Charles B. Shotwell, Director, Office of Defense Trade Controls Policy, Directorate of Defense Trade Controls, Bureau of Political-Military Affairs, U.S. Department of State, regarding “Category VII Revision” and “USML – Positive List,” February 7, 2011, pp. 4-6.

¹⁷Brittany Benowitz and Barry Kellman, op. cit.

¹⁸U.S. Department of State, Directorate of Defense Trade Controls, “Frequently Asked Questions (FAQ’s), Registration Fee Change,” available at http://www.pmddtc.state.gov/faqs/registration_fees.html. The relevant section of the FAQ reads as follows: “On January 22, 2008, the President signed National Security Presidential Directive (NSPD) 56. The directive mandated a series of reforms in the way defense trade is executed by the executive branch to enhance transparency, timeliness and predictability for industry. These reforms included process and management improvements, as well as a requirement that DDTC be fully resourced to perform its mission. It also mandated that DDTC’s mission be 75 percent self-funded.”

¹⁹Department of Commerce, “Export Control Reform Initiative: Strategic Trade Authorization License Exception,” *Federal Register* Vol. 76, No. 116, June 16, 2011, pp. 35276 to 35294. The countries covered under the STA exception are listed in the text of this report.

²⁰Federal Register, op. cit., p. 35285 gives a full accounting of the paper work involved, built around a “consignee statement” that includes an agreement “not to export, reexport, or transfer these items to any destination, end use, or end user prohibited by the EAR [Export Administration Regulations].”

²¹Government Accountability Office, *Export Controls: Compliance and Enforcement Activities and Congressional Notification Requirements under Country-Based License Exemptions*, p. 7. The analysis referred to is Government Accountability Office, *Defense Trade: Lessons to Be Learned from the Country Export Exemption*, Washington, DC, March 29, 2002.

²²Ibid., pp. 21-22.

²³STA-eligible countries involved in attempted or successful retransfer attempts have included Australia, Austria, Belgium, Bulgaria, Germany, Hungary, Romania, Slovenia, the Netherlands, and the United Kingdom. Data gathered from U.S. Department of Justice, “Summary of Major U.S. Export Enforcement, Economic Espionage, Trade Secret and Embargo-Related Criminal Cases (January 2007 to the present: updated February 14, 2013),” February 2013. The tally included only export enforcement and embargo-related cases, not those dealing with trade secrets or economic espionage.

²⁴Kate Linebaugh, “UTC Helped Build China’s First Military Attack Helicopter,” *Wall Street Journal*, June 28, 2012.

²⁵The makeup of the President’s Export Council (PEC), whose non-governmental members consist entirely of corporate representatives, is of a piece with the administration’s larger approach to the development of the new export control policy. In addition to the PEC, the ECRI was largely the product of intensive consultation with the State Department’s Defense Trade Advisory Group (DTAG). Although DTAG is supposed to be drawn from “a representative cross-section of U.S. defense industry, association, academic, and foundation personnel, including appropriate technical and military experts,” the bulk of DTAG’s members represent defense-related corporations. See DTAG membership list at <http://www.pmdt.state.gov/DTAG/documents/Membership2012-2014.pdf>.

²⁶Remarks, Andrew J. Shapiro, Assistant Secretary, Bureau of Political-Military Affairs, U.S. Department of State, at the Council on Foreign Relations, Washington, DC, April 12, 2013.

²⁷“Export Control Reform Initiative Executive Summary,” administration fact sheet series, available at www.export.gov/ecr/

²⁸William J. Lowell, Managing Director, Lowell Defense

Trade LLC, letter to Charles B. Shotwell, director, Office of Defense Trade Controls, re “Category VII Revision” and “USML – Positive List,” February 7, 2011, p. 6.

²⁹Hearing of the House Foreign Affairs Committee, “Export Control Reform: The Agenda Ahead,” April 24, 2013.

³⁰National Association of Manufacturers, “Manufacturers: Changes to Export Control System Will Boost Economic Growth and Jobs,” press release, December 9, 2010.

³¹Ross DeVol and Perry Wong, *Jobs for America: Investments and Policies for Economic Growth and Competitiveness*, Milken Institute, January 2010, pp. 32-38. The report was funded by the National Association of Manufacturers.

³²Ibid., note 99, p. 60.

³³Ibid., p. 36.

³⁴Trade Promotion Coordinating Committee, *2012 National Export Strategy: Powering the National Export Initiative*, Year 3, Washington, DC, December 2012, p. 4.

³⁵Richard F. Grimm and Paul K. Kerr, *Conventional Arms Transfers to Developing Nations, 2004 – 2011*, Congressional Research Service, August 24, 2012. Although the bulk of this report focuses on transfers to the developing world, it includes data on worldwide sales as well. Data cited in this paragraph comes from the summary, Table 1, p. 27, and Table 34, p. 75.

³⁶United States Department of State, Directorate of Defense Trade Controls, *Section 655 Annual Military Assistance Report, 2011*.

³⁷The largest part of the increase came between FY2006 and FY2008, after which the dollar value of licenses approved leveled off for three years until it jumped by 29% from FY2010 to FY2011. The numbers by fiscal year are as follows: FY2006, \$19.8 billion; FY2007, \$24.5 billion; FY2008, \$34.2 billion; FY2009, \$35.9 billion; FY2010, \$34.0 billion; and FY2011, \$44.2 billion. Data are from State Department Section 655 reports for fiscal years 2006 through 2011.

³⁸The gap between the value of arms sales licensed for export and the reported value of items actually shipped in any given year can result from several factors or scenarios: a company gets a license for a deal that it loses to another firm; a government backs out of a deal for lack of funds or some other reason; licenses are approved at the maximum potential value and the deal is finalized at a lower level; licenses are valid for four years, and not all shipments related to a given license happen in the year the license is granted. Even allowing for all of these factors, the gap between licenses granted and the reported value of items shipped is enormous, seemingly too large to be accounted for by the above-mentioned factors alone. In FY2011, for example, there were \$44.2 billion in USML licenses granted but a report of only \$6.3 billion worth of items shipped. This vast disparity suggests the need for the State Department find a way to track deliveries of items licensed as commercial arms exports more accurately, as a

tool for oversight and public accountability.

³⁹U.S. Department of Commerce, Bureau of Industry and Security, *Annual Report to Congress, Fiscal Year 2011*, p. 7.

⁴⁰The 2.9% figure is derived by dividing the \$44.2 billion in licenses granted, as documented in the most recent Section 655 report, by total U.S. trade in goods of \$1.5 trillion. For source for \$1.5 trillion figure see note 34.

⁴¹See note 39 for discussion of the gap between licenses granted by State versus the reported value of goods actually shipped.

⁴²Interview with Alan Tonelson, February 11, 2013.

⁴³Letter from R. Thomas Buffenbarger, International President, International Association of Machinists, to Rep. Ed Royce, Chairman, the House Committee on Foreign Affairs, and Rep. Eliot Engel, ranking member, March 19, 2013.

⁴⁴Letter from R. Thomas Buffenbarger, International President, International Association of Machinists and Aerospace Workers, to Eric Hirschhorn, Under Secretary for Industry and Security, U.S. Department of Commerce, August 3, 2012.

⁴⁵Countries purchasing F-35s that are receiving a piece of the plane's production to offset their spending on the plane include Australia, Canada, the Netherlands, Turkey, the United Kingdom, Italy, Denmark and Norway.

⁴⁶U.S. Department of Commerce, Bureau of Industry and Security, *Offsets in Defense Trade, Sixteenth Study, Conducted Pursuant to Section 723 of the Defense Production Act of 1950, as Amended*, January 2012, p. 4.

⁴⁷*Ibid.*, Executive Summary, p. i.

⁴⁸*Ibid.*, p. 6.

⁴⁹*Ibid.*, p. 13.

⁵⁰*Ibid.*

⁵¹Testimony of Owen E. Herrnsstadt, Director of Trade and Globalization, International Association of Machinists and Aerospace Workers, Before the U.S.-China Economic and Review Commission's Hearing on "China's Emergent Military Aerospace and Commercial Aviation Capabilities," Washington, DC, May 20, 2010. p. 2.

⁵²*Ibid.*, p. 6.

⁵³*Ibid.*, p. 8.

⁵⁴U.S. Department of Commerce, Bureau of Industry and Security, *Annual Report to Congress, Fiscal Year 2011*, pp.

62-63.

⁵⁵*Ibid.*, p. 64.

⁵⁶Letter from William J. Lowell, Managing Director, Lowell Defense Trade LLC, to Charles B. Shotwell, Director, Office of Defense Trade Controls Policy, Directorate of Defense Trade Controls, Bureau of Political-Military Affairs, U.S. Department of State, regarding "Category VII Revision" and "USML – Positive List," February 7, 2011, p. 7.

⁵⁷Hearing of the House Foreign Affairs Committee on "Export Reform: The Agenda Ahead," April 24, 2013. A March 2013 administration fact sheet makes reference to a Commerce Department survey that allegedly received responses from industry indicating over \$2 billion in lost sales due to arms export controls. Repeated requests to the department for a copy of the survey did not yield one, or even an acknowledgment that such a survey exists. Given the testimony cited here in which a Commerce official states that there has been no study of the economic benefits of export control reform, it can only be assumed that the survey mentioned was not rigorous enough to be considered a legitimate study of the issue.

⁵⁸*Ibid.*

⁵⁹To be of use, these reports must be subject to rigorous Congressional oversight. Otherwise they may be observed in words rather than deeds. For example, the annual report of the Commerce Department's Bureau of Industry and Security is supposed to provide a detailed analysis of the economic impacts of exports of turnkey plants and/or components for building such plants to controlled destinations such as China. Instead, the bureau has basically thrown up its hands and said that it cannot do such an analysis for lack of readily available data: "U.S. export data that are available from the Bureau of the Census do not provide the level of specificity needed to identify exports of turnkey plants or items for turnkey plants and facilities. This precludes a thorough assessment of the impact of U.S. exports of items for turnkey plants and facilities to controlled countries. However, the small number of such exports in the past, coupled with the low percentage of U.S. exports destined for controlled countries and items subject to a license requirement, make it reasonable to conclude that the ultimate impact on U.S. production is not significant." (U.S. Department of Commerce, Bureau of Industry and Security, *Annual Report to Congress*, p. 64). In short, instead of developing a way to do a detailed assessment, the bureau decided that things would essentially remain the same as they had been in the past, despite the rapidly growing imbalance of U.S.-China trade.

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