Export Control Reform:
Economic Illogic and Overlooked Consequences

Supporters of the Obama Administration's arms export control reform initiative frequently cite economic benefits – namely an increase in exports of U.S. defense products and resulting job creation – as a rationale for shifting thousands of items from the State Department's U.S. Munitions List to the Commerce Department's Control List, where they will be more easily exported.[1] Former Assistant Secretary of State for Political Military Affairs Andrew Shapiro defended the initiative as having "a real impact on our economy at a time when competition is even fiercer and at a time when our manufacturing base could really use a boost."[2]

A close look, however, raises questions about the purported economic benefits, finding that they are far from guaranteed and that the reform could, just as easily, undermine domestic manufacturing and lead to a net job loss.

Proponents of the reform effort describe the negative effects of the bureaucratic "nightmare" of exporting items that are tightly controlled, but U.S. exports of manufactured goods have been increasing at record rates in the past few years, even without a massive reorganization of export controls. Industries exporting items on the U.S. Munitions List are flourishing; the dollar value of export licenses approved for items on the USML has more than doubled in recent years, from $19.8 billion in 2006 to a staggering $44.2 billion in 2011. Not all items licensed translate into actual sales, but the value of licenses granted indicates that in general producers of equipment and components are not suffering from an inability to acquire export licenses under the current export control system governing items on the USML.[3]

Marginal Gains: At What Cost?

In 2011 the United States cornered 78.7% of the global arms market, with the closest peer competitor being Russia, with 5.6%.[4] This overwhelming dominance of the global arms market calls into questions both the need for, and the ability of, arms export reform to significantly increase U.S. sales of military-related technology.

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[1] For example, according to a White House factsheet on the ECRI, "In response to a Department of Commerce industry survey, U.S. firms estimated that U.S. firms lost in excess of $2.1 billion annually in sales due to export controls and billions more in lost opportunities to even compete for a sale." Repeated efforts to obtain a copy of the survey and a more detailed summary of the results have been rebuffed. http://export.gov/static/ECR%20Factsheet%201%20-%20The%20Basics%20v%203_Latest_eg_main_047472.pdf, page 3

[2] Remarks, Andrew J. Shapiro, Assistant Secretary, Bureau of Political-Military Affairs, Council on Foreign Relations, Washington, DC, April 12, 2013.

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

[4] Richard F. Grimmett 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.

Moreover, only an extremely small portion of total U.S. trade requires an export license today: about 3% of U.S. trade is subject to licensing from the Department of State. If roughly 97% of U.S. trade is not licensed in the first place, how big of an economic impact could be achieved by making adjustment in how the remaining 3% is handled – particularly given the pre-existing U.S. dominance of that sector? One business trade analyst has suggested that given this reality, any increases in U.S. exports due to arms licensing issues would be "infinitesimal."[5]

The Administration has undertaken a massive bureaucratic effort to reform export controls based, apparently, on a survey of U.S. industry that claims a loss of more than $2 billion in sales annually due to export controls.[6] This survey is not publicly available.

When House Foreign Affairs Committee chairman Rep. Ed Royce (R-CA) asked whether the Obama Administration had quantified the economic benefits of export control reform, the Assistant Secretary of Commerce for Export Administration responded that "we don't have an estimate for that particular economic benefit."

What is available is a 2010 analysis by the Milken Institute, financed by the National Association of Manufactures.[7] This study concluded that the ECRI could substantially increase U.S. market share in key countries – such as China, India, Pakistan, Russia, and Israel – and generate 340,000 new jobs by 2019. Not surprisingly, this impressive conclusion has been frequently touted by supporters of the initiative, but the report's methodology is seriously mysterious.

The study assumes that the ECRI will result in a 50% increase in U.S. market share in crucial countries where it is currently underperforming relative to its global marketshare. For example, assume that the U.S. share of the world market in a given item is 50%, but its share of the market for that same item in China is only 10%. Under the Milken report's logic, the U.S. share of the Chinese market would jump to 30% – triple its current levels – if U.S. export controls are "modernized." But the report offers no justification for its assumption that the U.S. share of any product would increase so dramatically merely due to an easing of export controls. There are many other factors at play (price, quality, relationships) and many other government policies that may play a much greater role in boosting U.S. exports, such as export financing and the role of U.S. government in promoting sales of U.S. technology.

How the Reform Could Undermine the Industrial Base

Critics of the reform effort believe that several implications of loosening controls on USML items could, in the words of a former head of the State Department's Office of Defense Trade Controls, constitute a "recipe for outsourcing" production. Under this scenario, the ECRI would, in fact, harm domestic industry and result in the export of jobs.

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[5] Interview with Alan Tonelson, Research Fellow, U.S. Business and Industry Council Educational Foundation, February 11, 2013.

[6] 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.

[7] Ross 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.

Calculating the economic costs or benefits of looser restrictions on exports of certain items is complicated by the fact that that not all exports are created equal. If a U.S.-based firm uses foreign components in an exported item, the Commerce Department treats the entire item as if it was produced in the United States. This 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 U.S. jobs. More foreign components mean fewer U.S. jobs. Changes made through the reform initiative will make it more likely that subcomponents of U.S. weapons systems will be produced abroad. Although the largest labor union representing workers in this industry have repeatedly raised the issue with the Commerce Department, the Administration has apparently undertaken no study to determine the impact of outsourcing of component production on the number of jobs generated by U.S. exports.

In the complex world of international trade, most countries demand economic "offsets" – arrangements that reduce the economic cost of an imported item – when they purchase a product from the United States. Offsets may be *direct*, such as placing production of components or final assembly of the item in the purchasing country; or *indirect*, such as steering production on an unrelated item to the purchasing country, making unrelated investments there, or even helping the purchasing country sell its own products in the world market. Since the U.S. government first started tracking offset agreements in the defense sector in 1993, 61 U.S. firms have reported 11,353 offset transactions with 50 countries. The total value of offsets provided under these arrangements was over $56 billion.[8] Obviously, this phenomenon convolutes the benefits to domestic industry and workers by moving production of key components overseas.[9]

Even by a narrow definition of the offset phenomenon that focuses only on defense trade, a number of major industrial sectors show a net loss – 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."[10] Military aircraft manufacturing is the only sector with a significant net positive – that is, more jobs created via exports than lost via offsets. Even in this case, however, some of the 22,470 jobs cited might actually be overseas.[11]

In fact, the role of offset agreements in outsourcing American jobs has been of particular concern in the aircraft industry, where rivals such as China have used offsets and technology transfers from U.S. firms to help build up their own civilian aerospace production capacity. Boeing is a case in point: the company has bought over $1 billion worth of aircraft components from China, and 4,500 current Boeing aircraft include parts made in China.[12]

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[8] U.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.

[9] The Commerce Department has admitted that "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." Ibid., p. i.

[10] Ibid., p. 13.

[11] Ibid.

[12] Testimony of Owen E. Herrnstadt, 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. 6

Decontrolling items on the Munitions List will likely exacerbate this trend of outsourcing in two ways. First, in some instances taking an item off of the U.S. Munitions List will make it easier to get permission to produce it overseas. And for exports to 36 countries[13] that will be granted a strategic license exemption, 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. Increases in overseas production could occur either to take advantage of lower labor costs or to use production of the item as part of the quid pro quo entailed in an offset agreement. And to the extent that the reforms move items off of both control lists, they will make it easier to export production technology or to produce U.S.-designed parts in China.

Second, the reform's proposed lifting of the "see-through" rule – a regulation that requires whole items with components on the U.S. Munitions List to receive a license every time they are exported or re-exported – will make it easier to integrate U.S. components with foreign produced content into a whole, finished product.

Actions Needed

To continue a massive reorganization of the U.S. export control system without actually examining the potential costs and benefits, particularly to workers, is a costly solution to a problem that appears limited to begin with. Congress needs to take the following steps to help ensure that the arms export reform does not further erode the U.S. industrial base:

- Get a clearer picture of the economic effects of export control reform. Require the Commerce Department to undertake a specific, 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.

- Require that the economic effects then be an additional factor utilized in determining whether to ease controls on a given item.

[13] *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.*