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“Rebuilding the Arsenal of Democracy:
The Imperative to Strengthen America’s Defense Industrial Base and Workforce”
House Select Committee on the
Strategic Competition between the United States and the Chinese Communist Party
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Introduction

Chairman Moolenaar, Ranking Member Krishnamoorthi, and members of the committee, thank you for the opportunity to provide testimony for today’s hearing. My name is Eric Fanning, and I serve as the President and CEO of the Aerospace Industries Association (AIA). For over 100 years, AIA has advocated for America’s aerospace and defense (A&D) companies and the more than two million men and women who are the backbone of our industry. AIA serves as a bipartisan convener, bringing people together to find consensus on important topics, like effective federal investments and adaptation of policies empowering our defense industrial base (DIB) and country for the 21st century and beyond.

As this Committee, Congress, and consecutive administrations smartly recognize, China is our “pacing challenge.” From the industry perspective, we see two central pillars to address this challenge: encouraging the government and industry to work together to innovate faster than our adversaries and working with government to identify key investments needed to build capacity and properly equip the warfighter. These two pillars underscore a key asymmetric advantage the United States has over China: a healthy and resilient Defense Industrial Base (DIB).

The DIB is the Department of Defense’s (DOD) most important partner in equipping and protecting our warfighters and defending our country. The DIB also plays a central role in providing capabilities that enable strategic deterrence and allow us to support our allies. To fulfill this vital role, the companies that make up the DIB rely on clear demand signals from Congress, sufficient federal investment, a regulatory environment that allows us to innovate and move at the speed of relevance, and a healthy and resilient supply chain. Recently, a confluence of challenges –record inflation; workforce challenges, including rising labor costs that have grown at a much higher rate for our industry and the persistent struggle to recruit and retain qualified workers; supply chain disruptions; a conflict in Europe and the Middle East; and the geopolitical threat posed by China, to name a few – have put significant pressure on our industry.

To best address these challenges, it is crucial to understand our industry and the drivers of its overall health. The defense industrial base – and its ability to respond to these challenges – is largely shaped by a single customer: the federal government. This is what differentiates the DIB from the commercial

marketplace – which has more customers and growth opportunities – and has an outsized impact on its products, people, and performance. The DIB depends on federal investment to help ensure the overall health and resilience of the industry. This means that the number of programs prescribed by the Pentagon has a direct correlation to the contours of the industry. For advanced fighters, bombers, and aircraft carriers, there simply aren't enough opportunities in the marketplace to support the scope of competition that existed when DOD budgets were 5 to 8.5 percent of GDP.

The DIB itself has changed in size and scope since the “Peace Dividend” era following the collapse of the Soviet Union. But the DIB is not monolithic; the DIB today is a diverse ecosystem, with companies of all sizes, each with its own role to play – to the great benefit of the national security enterprise. While small companies can be innovation incubators by virtue of their size and ability to speed decisions, prime contractors bring scalability, advanced capability, and cash flow, as well as a large talent pool with extensive experience. Primes can also afford to maintain a workforce in ready state to meet evolving or sudden needs. Large companies need these skills to integrate the myriad of subsystems in today's programs of record into a single, properly functioning platform.

While federal investment is critical to the health of the DIB, DIB companies also leverage outside investment to drive innovation, recruit the best talent, and reinvest in our national defense. Obtaining outside investment requires a business model that demonstrates some profitability. However, profit margins for most aerospace and defense companies are significantly lower than other industries, like technology, which operate at profit margins multiple times that of the A&D industry. These margins put our industry on a similar level to staple industries like food and health care, a situation that causes challenges when competing for talent in other sectors of our economy or when trying to attract commercial suppliers.

While these challenges have come to a head within the last several years, the contours of the DIB and its ability to respond to these challenges are rooted in policy and funding decisions made years ago. The levels of appropriated federal funding, the annual reliance on short-term funding measures, and the constant specter of government shutdowns have created deep-seated and disruptive instability and uncertainty. Furthermore, well-meaning but burdensome statutes and government policies drive up the cost and complexities of doing business with the federal government.

As a result, some companies within the DIB are choosing to no longer do business with the DOD in favor of other commercial industries, reducing the competition needed for the DIB to thrive and for DOD to consider the broadest range of technological solutions. Even companies committed to defense often choose to invest more capital in their commercial businesses where there are clearer demand signals and returns. Those companies committed to remaining in the DIB, particularly small and medium-sized businesses, are often hamstrung by regulations and requirements, inhibiting innovation and modernization. In the absence of new entrants and small businesses, our military can no longer access the full range of innovative solutions to meet the growing, geographically diverse, and evolving mission set positioned against a backdrop of competition with China, a war in Ukraine, conflict in the Middle East, and the possibility of conflict in Taiwan, as well as a range of other threats.

Our current industrial base is maximized to perform in an environment of irregular warfare – a product of over 20 years of fighting the war on terror in Iraq and Afghanistan. That means excess capacity for surging is not always built into the system. We are optimized for efficiency, both from an infrastructure and workforce standpoint. What our acquisition system is not optimized for, however, is promoting innovation and supply chain resilience. With the possibility of conflict on the horizon, we need to consider how we resource and support the capacity and resilience of the defense industrial base. Both Congress and the executive branch have a role to play.

Who We Are

Today, AIA represents more than 300 American A&D companies ranging from family-run businesses to multinational corporations, operating up and down the supply chain. Our membership includes aircraft and engine manufacturers and companies that design and build cutting-edge military and dual-use technology second to none. Our members have a worldwide reputation of global technological leadership, and the A&D industry represents a dynamic workforce composed of many types of workers.

Our industry is not only integral to national security but is also a significant driver of the American economy. Despite the inflationary pressure, the industry's workforce generated \$955 billion in sales in 2023, a 7.1 percent increase from the prior year.

Even when facing challenges, the 2023 A&D workforce stood at more than 2.2 million strong. The industry supports jobs representing approximately 1.4 percent of the nation's total employment base. More than 58.7 percent of employment comes from the shared A&D supply chain and an extensive network of suppliers composed of thousands of small and medium-sized businesses located in every state in the United States. Importantly, because of the nature of our work, the average salary in our industry is 50 percent above the comparable national average, providing well-paying jobs to millions of Americans.

While the defense industrial base continues to innovate at an unprecedented rate, it must also continue to produce older technologies that remain relevant but have only a single supplier for some of their key parts. We must ensure that these companies are healthy enough to do both, which is clearly a financial challenge.

The Challenges We Face and Opportunities to Address Them

China is investing in its military and innovation more than ever. DOD's 2023 China Military Report indicated China's military budget nearly doubled from 2013 to 2023, and Beijing stated earlier this year that its defense budget will increase by 7.2 percent. By comparison, President Biden's proposed FY25 defense budget is a 3.3 percent year-over-year increase.

China's historic military modernization is being buffeted by equally aggressive investments in innovation. Between 2000 and 2020, China's share of global research and development (R&D) rose from 4.9 percent to 24.8 percent. At the same time, China extended its super deduction for R&D

expenses for manufacturing companies to an extra 100 percent of eligible R&D expenses in addition to actual expenses incurred— while a recent U.S. tax change reduced that deduction for American companies. That means for every \$100 spent on innovation, Chinese companies can deduct \$200, 10 times more than American companies in a similar situation.

The United States has clear opportunities to right the ship. Congress must restore competitive R&D tax amortization rules to strengthen our global R&D posture relative to China. The tax code is imperative to incentivizing the private sector, and particularly the A&D industry to develop the next generation of technologies to keep the warfighter safe and maintain our global economic competitiveness.

On the international stage, our democratic industrial bases need the equivalent policy and regulatory runway to excel so that overall integrated deterrence is achieved. To this end, it is important the U.S. ease regulatory burdens that both inhibit closer cooperation with allies and trusted partners and strengthen domestic manufacturing and supply chains. Easing technology transfer requirements and promoting the seamless integration of U.S. and allied industrial bases and establishing resilient domestic supply chains are key to a U.S. posture that effectively deters and out-innovates our adversaries. We've seen great progress so far in this domain from the U.S. and our partner governments, but more can be done.

Next, federal investment in national defense must keep pace with the threats we face. As our military faces a growing, geographically diverse, and evolving mission set, the DIB, which is an essential element of troop readiness, is confronted with these tests as well. Effectively addressing these threats will require focused changes in federal policy and investment, which continue to be unpredictable and inconsistent. Even as China continues its unprecedented investment in its military, the U.S. Congress continues to debate cutting federal investment in defense, budget caps, supply chain disruptions and related material shortages.

Returning to regular order and providing on-time, predictable, and sufficient funding for the departments and agencies that work with the DIB is the first and most important step. At all costs, we must avoid a return to multiyear, arbitrary budget caps, insufficient defense funding or defaulting to the use of stopgap funding legislation, which relies on two-year-old funding levels to meet the challenges of today, wastes money on programs no longer needed, and prevents new programs from getting off the ground. Aside from the very real harm this inflicts on the wellbeing and morale of our military, continuing resolutions (CRs) muddy the demand signals Congress sends the DIB, slow or even halt the development of cutting-edge technologies, and force businesses into stop-and-start cycles that are hugely inefficient.

The Ukraine conflict has been a test case for our country's ability to maintain a high state of military readiness while also surging to assist our allies and partners in their response to conflict. The sense of urgency for increased production extends beyond Ukraine to our allies and partners, as well as to addressing China, and must be matched with an equal sense of urgency when it comes to building our budget.

Furthering our challenge is the substantial decline in the number of companies in the DIB over the past decade. Companies seeking to enter the DIB must contend with a multitude of laws and regulations that are cost- and time-prohibitive, disrupt established supply chains, and require implementation of costly new systems, processes, and procedures. Congress and DOD have correctly recognized the need to expand the DIB and reduce the barriers to entry. Deputy Secretary of Defense Kathleen Hicks stated, "...over the past decade, small businesses in the defense industrial base shrunk over 40 percent. The data shows that if we continue along the same trend, we could lose an additional 15,000 suppliers over the next 10 years." This recognition, while important, is not translating into action, as Congress and DOD continue to add new laws and regulations every year before properly assessing current policies and the cumulative impact on the health of the DIB. Instead, Congress should focus on right-sizing the regulatory regime to encourage new entrants and support companies of all sizes within the DIB.

Another barrier to participation in the DIB is the length of time between release of a final solicitation to award of a contract, which continues to rise. Prime contracts with estimated sales of more than \$100 million now average over 300 days. For commercial companies used to working quickly, the delays in awarding contracts and executing agreements is a strong disincentive to contract with the DOD. For small businesses, they simply can't maintain the cash flow over such a long horizon. Such delays also increase costs to contracts and delay capabilities from getting to warfighters. To deter, and if necessary, defeat our adversaries, we must be able to get capability into the warfighter's hands as quickly as possible. Emerging technology from commercial or non-traditional defense contractors can't – or won't – wait on convoluted, outdated contracting processes.

Mergers and acquisitions (M&A) should be viewed as a tool to strengthen the industrial base and provide stability to the workforce and business operations. Too often, these opportunities are reflexively dismissed rather than reviewed on the individual merits. M&A is a tool for companies to grow and to stabilize the workforce, unleash innovation, bolster performance, and strengthen capability and capacity. Some companies need to access the tools and resources of a larger company to continue development, while some investors view M&A as a faster path than becoming a program of record. Given the potential opportunity to bolster the health and resiliency of the DIB through these strategies, an effective government policy would fairly review the benefits and costs on a case-by-case basis considering the long-term health of the DIB.

Building and strengthening the resiliency of the global supply chain while reducing our reliance on sole sources of supply is another strategic imperative for the A&D industry and our government partners. This is essential to the health of the civil aviation sector, the DIB, and our overall deterrence. We are a long-lead supply chain industry. Our companies order strategic minerals, materials, parts, and components months in advance and are generally able to manage short- and medium-term disruptions. They also work on mitigation strategies in the event of long-term disruptions. For example, critical minerals have become a focus for our industry as our companies seek to reduce dependencies on adversarial sources, build both resiliency and redundancy into their supply chains, and manage cost as the strategic landscape demands the need for alternative sources of supply. Expanding the DIB with a balance of international and domestic suppliers in addition to commercial entities is vital to improving this resiliency, while also spurring innovation and competition.

Supply chain perturbations can take some time to become apparent. Russia's invasion of Ukraine and conflict in the Middle East have heightened supply chain challenges as they place increased pressures on industry to bolster production, as evident in the titanium market. That is why we must set the right policy conditions when it comes to investment, and a framework to support the long-term health of the DIB and the effectiveness of our security partnerships. To manage growing supply chain hurdles and inflation uncertainty, we need on-time, stable, sufficient funds, and long-term policy that is both clear and flexible to enable surge capacity and to target material shortages and other supply chain gaps.

To meet the growing demands on both delivery and innovation within the DIB, there is a systemic need to address today's workforce needs by meeting a demand for a skilled and diverse talent pipeline. Investing in STEM education, reskilling current industry employees for new technologies, and enhancing our country's training efforts, including apprenticeship programs, on-the-job training, and certification and credentialing programs, are vital to expanding talent pools and ensuring a highly skilled, dynamic future workforce.

Conclusion

The A&D companies within the DIB share Congress' enduring commitment to national security, our global economic competitiveness, and our nation's continued leadership in innovation. The government has a willing partner in the DIB to address the challenges presented by China's unprecedented growth, to accelerate innovation and acquisition, and set the United States on a stronger course for a more secure future.

On behalf of AIA and our members, I thank you for your time and consideration of these matters. As always, AIA is available to address any questions or concerns the Committee may have.