To retain its vitality, the aerospace industry must be able to attract private investment in the highly competitive global capital markets. The investment community values companies with predictable revenue flows, sustainable growth in sales and earnings, strong positive cash flows, healthy profitability, innovative capabilities, and a vibrant workforce.

For the past half-century, the U.S. aerospace and defense industry has been inextricably linked to a defense budget characterized by a “10 years up, 10 years down” cycle. A vibrant, productive, enduring enterprise is not consistent with this “boom-and-bust” cycle, and aerospace companies must be vibrant, productive, and enduring. Our armed forces rely on advanced technology for awareness, protection, and instruments of action. Our government must provide for the many needs of our society, so value for money efficiently spent on security must be demonstrated. Our aerospace systems are designed to perform for decades, with some extending through a

**RECOMMENDATION #7:** The Commission recommends a new business model designed to promote a healthy and growing U.S. aerospace industry. This model is driven by increased and sustained government investment and the adoption of innovative government and industry policies that stimulate the flow of capital into new and established public and private companies.
half century of service, and companies must be in a position to support customers through their evolving and demanding missions.

Historically, investors have characterized the aerospace industry, including the commercial business, as a low-growth sector, chronically hampered by high cyclicality, low margins, revenue instability, and inadequate returns on investment, amplified by the uncertainty in the government budgeting and acquisition process.

As a result, the relative importance of the aerospace sector in the global marketplace for capital has significantly diminished over the last two decades as evidenced by the decline in sector market capitalization. In 1980, the aerospace sector had a market capitalization of $13 billion, equivalent to 2.4 percent of the total Standard and Poors (S&P) 500. In 1990, the sector dropped to 1.8 percent of the market, and declined further to 0.9 percent in 2000. Today, even with the largest proposed defense budget in history and the longest bear market since World War II, aerospace comprises 1.4 percent of the S&P 500—well below the sector’s comparative value just prior to the Reagan defense buildup. See Figure 7-2.

The most compelling determinant in an investors’ decision-making process is their expected risk-adjusted return on investment. By this standard, the aerospace sector is unattractive. From 1997-2002, the returns on investors’ capital from aerospace investment lagged behind even the risk-free rate of return on Treasury securities. See Figure 7-3.

During the last “bust” cycle that impacted the industry during the 1990s, more than 50 companies were compelled to consolidate into today’s “Big 5”: Boeing, General Dynamics, Lockheed Martin, Northrop Grumman, and Raytheon. See Figure 7-4. While successful efforts to consolidate capacity within the framework of current government regulations are clearly evident, significant over-capacity remains. To fuel the consolidation process, the use of debt was significantly expanded across the sector, reducing financial flexibility, increasing leverage, straining coverage and liquidity, lowering credit quality, and increasing capital costs. Furthermore, the industry lost more than 600,000 scientific and technical jobs in the past 13 years significantly depleting intellectual capital and experience and increasing the average age of today’s workforce (see Chapter 8). In important and enduring aspects, the industry has been weakened.

Some observers of the current equity markets note that selected aerospace firms with little commercial market exposure appear to be doing comparatively well with regard to other stocks given the renewed interest in defense spending. The Commission notes that this perceived strength in the sector is transient, as the industry is for the moment enjoying the improved funds flow of the “boom” portion of the defense cycle while the rest of the economy is in
recession. History suggests that the sector will decline as the broader economy recovers. Where history will fail, however, is in support of the assumption that a call to action may be unnecessary—that industry will endure and recover as it has through past cyclical declines without immediate and substantial attention—because history does not accurately reflect the current weakened state of the industry throughout its entire supply chain.

Without significant change to the business model upon which the sector relies, the industry will be unable to survive the next downturn in either the commercial or military aerospace cycle. The Commission has identified several elements of U.S. government policy as well as industry practice that, if implemented, would significantly improve the industry’s position in the capital markets.

Objective: Aerospace Industry Attractive to Investors

Innovative industry-government initiatives are required now to sustain the preeminence of the American aerospace industry, ensuring industry health and producing sustained contributions to both the economic performance and national security of the United States. The U.S. government must initiate measures to establish and maintain a stable and predictable budget for aerospace investment and remove government constraints to reasonable profitability, thereby reducing risk and improving returns such that the industry can better attract capital. A government focus on essential core competencies will stimulate long-term investment in both facilities and the best and the brightest talent, ultimately spawning new cycles of exciting technology development.

Innovative partnerships among global suppliers of advanced technology are needed to assure the interoperability of systems while fostering the pursuit of new opportunities through assured open market access. Efficiency within the industry can be stimulated by a further revolution in business affairs that transforms all processes and practices to a single, integrated industry-government model that employs the maximum use of commercial business practices and innovations. A solid framework of balanced export and tax policies will safeguard vital national security information and protect intellectual property while allowing successful industry competition in the global economy.

The future economic vitality and national security of the United States depends on a strong, vibrant, and flexible aerospace industry. The Commission views these initiatives as essential steps necessary to establish a successful and enduring government-industry partnership.
Figure 7-4  20 Years of Industry Consolidation

* Merger Pending Approval
Issues
The U.S. government budgeting and procurement system is extraordinarily complex and inefficient, driving up the cost of needed national security systems while delaying the introduction of new capabilities. This observation is hardly new. Since shortly after the end of World War II, about a dozen major studies and literally thousands of lesser assessments have cited this finding. Furthermore, sound government acquisition reform initiatives have been proposed and debated for more than 40 years, but only marginally implemented. Because we have failed to sustain the will necessary to secure lasting change, we are today spending more for national security and getting less.

To the casual observer, this proposition may seem dramatically counterintuitive—do we not have the finest, best equipped military on earth? The direct answer is “yes”, but it was purchased decades ago under conditions that do not exist today. Many of the systems in use now are a result of the Reagan defense build up of the 1980’s when defense spending was approximately 5 percent to 8 percent of Gross Domestic Product (GDP). Today that spending is about 3 percent.1

A greater proportion of total spending then was devoted to “investment funds”, i.e., Research and Development and Procurement, which expanded scientific frontiers, engineered leading edge solutions, attracted talent to the industry, stimulated interest by the capital markets, and fielded capabilities that won the Cold War and performed superbly well in Operation Desert Storm. Today more funds flow to Operations and Maintenance, the fastest growing segment of the defense budget, the bulk of which pays for health care, military training, support of aging systems, equipment maintenance, and other support activities.

The overall budget, therefore, remains insufficient to maintain existing capabilities, meet operational tempo needs, fulfill our commitments to military personnel, protect our homeland, and assure transformational capabilities are fielded in a timely manner to meet 21st century threats across a broadening and increasingly complex spectrum. Funding sources must be adequate, reliable, and stable. Acquisition and program management practices require simplification and reform. Trade and tax policies need to be streamlined and harmonized.

The Commission has strong and unanimous conviction that without immediate initiatives to address the long-term health of this indispensable industry, the U.S. aerospace sector will lag in the capital markets, lose global market share, provide a reduced contribution to the U.S. balance of trade and the U.S. economy, atrophy its essential core competencies, and lose high-tech and high-paying jobs to overseas competition. The Commission believes this downward drift and dissipation of potential, no matter how difficult to discern on a day-to-day basis, is nonetheless occurring and constitutes an unacceptable risk to the U.S. economy and national security.
Budgeting and Funding: Unpredictable and Unstable

The overall defense budget has two broad provisions: one for near-term personnel, operations maintenance costs, and one for investments to fulfill our long-term need for technological advancement through research and development (R&D) and procurement. Despite budget increases over the last decade, growth in investment funding remains relatively small, especially as a share of the federal budget.

In the past, the Department of Defense’s (DoD) promised growth in investment funding has not materialized adding to the complexity of capacity planning and labor force management while diminishing overall efficiency. At the same time, system costs continue to be underestimated by both the government and industry due to the pressure to adopt the optimistic scenarios necessary to accommodate limited funding, the progressively aggressive bidding behavior that results as companies with excess capacity resist being marginalized in the competition for a diminishing number of new program opportunities, and the desire to incorporate ever increasing program capability requirements. Within this unpredictable framework, many programs are also changed annually through the Congressional authorization and appropriation process or reprogrammings. See Figure 7-5.

Government-unique acquisition processes and procedures are cumbersome and unnecessarily complex, adding time and expense to systems development, and are not complementary to healthy commercial practices. Finally, any failure to perform on contract, at times induced by program and budget instability, exacerbates the tensions between government and industry and heightens the tendency to impose even more oversight and financial penalties on contractors. These factors create a cycle that contributes to the diminished return on the government’s investment in national security capabilities and serves as an impediment to long-term industry excellence.

Figure 7-5  Actual Procurement Spending has Consistently Fallen Below Projections
Source: Morgan Stanley
The government must stabilize program requirements and protect adequate long-term investment funding, enact reforms that increase the financial flexibility of companies and the government, and improve program management stability and continuity. Industry must focus on performance and execution and deliver on contract commitments. These changes will help provide the resources necessary to drive competition, incentivize research and development, and enhance industry’s performance on contract and in the investment markets.

**Protect Investment Funding.** As discussed in Interim Report #2, a stable long-term investment budget is critical to the modernization and transformation goals of the Armed Services. However, the bulk of recent DoD funding increases has been consumed by costs associated with operations, fuel, pay raises, and health-care. To protect investment funding, the Commission reiterates its recommendations contained in the interim report, that government establish and maintain a stable investment budget in the Future Years Defense Program (FYDP), protected from reductions to cover unbudgeted operations and support (O&S) and other support and personnel costs. In addition, the Commission suggests that DoD study the management of O&S costs, with the goal of better estimating and annually budgeting for these costs, rather than continuing to tap the investment accounts to pay unanticipated, unbudgeted “must pay” O&S bills.

The Commission also reiterates its recommendation in the interim report that DoD require industry and the military Services to develop realistic cost estimates and fully budget for those program costs in the FYDP. The Commission believes this action is necessary to reduce the current tendency to understate program costs in order to include unaffordable programs within the FYDP, and will also preclude contractor and DoD investment in programs that cannot be realistically completed.

**Increase Financial Flexibility.** The Commission believes that both the government and contractors must do a better job of realistically estimating program costs. The Commission also believes the current financial system is overly restrictive in that it allows only very limited financial flexibility, once the budget is formalized, to address unanticipated costs or requirements as individual programs progress through execution. The “color of money” and inadequacy of program reserves preclude program managers from making common-sense adjustments within a program, and decades-old reprogramming limitations preclude the government from effectively managing its budget to reflect changes in program priorities or performance.

Reprogramming thresholds for all accounts should, as a minimum, be doubled to account for 20 years of inflation since their last adjustment.

The Commission advocates increasing the government’s financial flexibility to make funding adjustments among and within programs. Program managers should have the authority to move funds from procurement to R&D to cover unanticipated development and sustainment costs, or to apply unused R&D funds to procuring the weapon system. Reprogramming thresholds for all accounts should, as a minimum, be doubled to account for 20 years of inflation since their last adjustment. Such action will provide government with the needed flexibility to meet higher priority requirements as they arise, make the best use of cost savings in any program phase, and resolve problems earlier.

Streamlining cost principles, the elimination of statutory cost principles, and the use of Generally Accepted Accounting Principles will benefit the sector by eliminating unnecessary and duplicative requirements and allow government contractors who also have significant commercial business to use a single accounting system across the enterprise. The Commission concludes that the government should develop a proposal to implement cost principles and accounting standards that are more commercially oriented.
Realignment of the Defense Working Capital Fund (DWCF) will provide DoD managers with accurate and reliable cost information to manage their operations, while improving weapon system readiness and the total cost of ownership. The fund was designed to provide an effective mechanism for financing, budgeting, accounting for, and controlling the costs of goods and services. In practice, the DWCF is structured to support and maintain logistics stovepipes in terms of supply management, maintenance, and transportation, thus limiting the ability to meet DoD customers’ new product support challenges. The Commission urges ongoing General Accounting Office (GAO) management review of the DWCF, as well as an allowance for restructured costs and a shift to performance or price-based acquisition structures.

Revise Program Management. As discussed in the Commission’s Third Interim Report, the Commission believes the use of multi-year funding and contracting for both procurement and R&D programs will not only improve program stability and performance, but produce needed cost savings. The Commission reiterates its recommendations from Interim Report #3 for expanded use of multi-year procurement contracts and milestone-to-milestone budgeting for development programs, including the incorporation of spiral development and evolutionary acquisition principles into these long-term contracts.

In addition, the Commission supports the immediate repeal of the June 2002 DoD Financial Management Regulation that establishes an artificial and unnecessary ceiling on unfunded cancellation costs in multi-year contracts. The Commission believes the prudent use of multi-year contracting, applied to stable programs that are performing well, makes unnecessary the establishment of financing limitations that will stifle innovative acquisition strategies.

The ability of the government to become a “world class” buyer of research, products and services is an essential element of acquisition excellence. A Commission-sponsored study on the application of Smart Price-Based Acquisition reviews the current cost-based and price-based approaches to government procurement and recommends a progressive and evolutionary roadmap for implementing changes to more fully capitalize on the price-based acquisition of goods and services.

The report cites the wide variance in federal department and agency contracting that is in need of review, and recommends moving to price-based, rather than cost-based acquisition under certain conditions. First, the government must be able to clearly and adequately define its requirements for the product or service. Second, there must be a commercial market for the product or service, or the government through past or ongoing government unique efforts must have a sufficient basis of price comparison.

The report correctly states that, while the utility of price-based acquisition for government procurements is evident, it is not meant to be viewed as an across the board solution for all government procurements. For example, research and development initiatives where requirements cannot be clearly and adequately defined due to dynamic situational analysis and/or there is high risk in the potential utilization of technologies, must remain cost-based. The report also cites the reluctance of the DoD to leverage its buying power and the power of electronic commerce by utilizing the General Services Administration’s (GSA) Federal Supply Schedule and Federal Technology Services for certain procurements, as permitted by current law. While some agencies are required to purchase items through GSA schedules, the DoD—through the Defense Federal Acquisition Regulations—does not mandate the use of GSA schedules and continues to issue their own contracts for GSA-available items.

The report cautions that, if the requirements of smart price-based acquisition are to be met, the government must have a procurement workforce that understands market prices and the capabilities of the market. In order to create an appropriately trained procurement workforce, the organizational structure...
for federal procurement must be redesigned to focus on development and maintenance of market knowledge. The ability of the government to leverage its buying power and centralize “smart buying” functions will enable better performance management of its many providers.

The Commission views the recommendations in this report as one of many possible approaches to streamlined acquisition of products and services, especially when procured as part of a stable program involving low-risk technology and clear requirements. As a general rule, the Commission does not endorse greater use of fixed-price contracting for programs that do not meet these criteria. The Commission further believes that the report supports the existing Federal Acquisition Regulations (FAR), concerning price-based acquisitions. Neither does the Commission view the report as advocating such an approach across-the-board. Instead, the Commission reads the report as recommending an option for a streamlined acquisition process that could produce not only a more efficient and less burdensome contracting process, but could also produce savings in personnel costs and time that could be allocated to higher-priority national security requirements.

Other reforms to be considered include:

- Implementation of a requirements process that is supportive of evolutionary acquisition and spiral development.
- Development of an acquisition approach for system-of-systems efforts, rather than a component-based approach.
- Provide adequate profit on R&D contracts so contractors do not wait until production contracts to recoup lost profits.
- Separately funding R&D on key components and sub-systems that are not integral parts of major systems.
- Facilitating incorporation of commercial technology in current weapons systems by expanding use of the FAR (Part 12, commercial buying) for R&D.
- Expanding the potential for contractors to earn higher profit margins and providing other incentives to drive and reward positive performance.

The following table summarizes recommended reforms, the specific participants responsible for each reform, and the near and long-term actions necessary to achieve the objectives earlier described.

<table>
<thead>
<tr>
<th>Reforms</th>
<th>Actors</th>
<th>18-month Enabling Actions</th>
<th>Long-term Actions</th>
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<tbody>
<tr>
<td>Budget Reform</td>
<td>OMB, DoD, NASA,</td>
<td>• Establish/maintain stable top-line for DoD investment in the FYDP (see June 26, 2002 interim report)</td>
<td>• Study and develop methods for centralized management of non-program specific O&amp;S costs.</td>
</tr>
<tr>
<td>Financial Reform</td>
<td>OMB, DoD, Congress</td>
<td>• Enact proposals to increase DoD financial flexibility (see June 26, 2002 interim report)</td>
<td>• Streamline cost principles, and eliminate statutory cost principles.</td>
</tr>
<tr>
<td>Program Strategy</td>
<td>DoD, NASA, Congress</td>
<td>• Expand the use of multiyear procurement contracting, and implement multiyear milestone budgeting for development programs.</td>
<td>• Develop and implement an evolutionary/spiral requirements process.</td>
</tr>
<tr>
<td>Reform</td>
<td></td>
<td>• Repeal the June 2002 Financial Management Regulation establishing a 20% ceiling on unfunded liability costs in multiyear contracts.</td>
<td>• Expand FAR Part 12 commercial buying for R&amp;D.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Allow contractors to earn higher profit</td>
<td>• Separate R&amp;D funding for components that are not integral parts of major systems.</td>
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<tr>
<td></td>
<td></td>
<td>• Develop and implement a new system-of-systems acquisition approach</td>
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<td></td>
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<td>• Provide adequate profits on R&amp;D contracts</td>
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High-Tech Partners and Suppliers: Difficult to Attract and Retain

While it is sometimes convenient to refer to the aerospace industry through the short hand of the “Big 5” referring to the five largest aerospace systems companies, it is important to note that the government and commercial “industry” for aerospace products and services in fact extends through a network of purchasers, subcontractors, suppliers, and partners, sometimes referred to as the supply chain. Each of the participants in the sector is intrinsically tied to the factors affecting the industry. Encouraging a climate that is attractive to new entrants while stable enough for current players will promote competition and innovation, add to efficiencies, and lower costs. In addition, steps must be taken to establish a stable and predictable business climate (see section entitled “Long-term Growth and Financial Health: In Jeopardy” for additional information).

Contract Reform Must Focus on Simplification and Innovation. Successful implementation of acquisition reform is a profound challenge that involves two distinct and interdependent elements. The first, culture change, involves evolving the behavior of acquisition personnel from the traditional “buying of resources under a design specification” to the “buying of results under a performance specification”. Today, an extraordinary amount of government talent, time, and resources are devoted to the process of refining and detailing comprehensive design specifications. Despite good intentions and considerable effort, this practice yields questionable value added and should be discontinued. Contemporary acquisition management practice demands a shift away from the emphasis on purchasing assets to a focus on the delivery of capabilities. Second, the implementation of new contracting rules will foster understanding of the conceptual and pragmatic nature governing the buyer-seller relationship.

Building on the Commission’s earlier findings concerning expanded use of multi-year contracting, the Commission calls for the consideration of multi-year leasing arrangements as well as multi-year contracts for the procurement of goods and services. Developing stable baselines and establishing and protecting current and future year funding for programs not only provides cost savings, but allows for the use of innovative procurement strategies such as buy-to-budget in which quantities procured are limited only by available funding. Long-term excellence in this area is further enabled by near-term reforms, such as utilization of “other transaction authority” and implementation of efficiency savings and share-in-saving strategies that recognizes the benefits of productivity improvements and rightsizing of workforce and facilities, that can improve, streamline and strengthen technology access, encourage open-market competition and implement technology-driven prototyping.

The Commission notes that certain changes to DoD’s “shared savings” initiative since the Commission’s endorsement of that effort in its March 20, 2002 interim report have caused the Commission to reconsider its recommendations. The Commission is concerned that these changes to the efficiency savings initiative will so limit its applicability and utility as to make the effort almost negligible and ineffective in incentivizing contractor investment in rightsizing and productivity improvements. The Commission urges DoD to reevaluate this initiative and consider once again including program-specific initiatives to provide the greatest possible incentives and broadest application of the policy.

Finally, a vital element of effective contract reform is directly related to reforming regulations regarding returns on government contracts. The Commission asks that DoD strongly consider proposing and implementing changes to permit: increased award fees, carryover of unearned award fees into the next rating period, elimination of fixed price development contracts, elimination of profit take backs and withholds on Cost Plus Fixed Fee (CPFF) contracts far in excess of requirements to protect the government, and revised profit guidelines for fee bearing Independent Research & Development (IR&D).
Other reforms that should be considered include:

- Create a liability limitation for sales to all government agencies, as well as state, local, and commercial entities, to facilitate incorporation of homeland security technologies across America.

- Repeal/reform Civil False Claims Act to increase the number of high technology suppliers to government.

- Allow prime contractors to waive flow-down to lower-tier suppliers of unnecessary and costly terms and conditions.

- Minimize reliance on cost data.

- Facilitate the use of common subcontracting processes.

- Investigate leasing as an acquisition tool.

Privatization, Competitive Sourcing, and Public-Private Partnerships. Widespread business practice overwhelmingly supports the economic and performance benefits that result when enterprises focus on the essential core competencies through which it fulfills its mission and creates value. Indeed the goal of every contemporary organization includes an intense focus on defining and cultivating the core while realigning roles and responsibilities accordingly. The Commission believes that there are many opportunities for redefinition and prioritization of routine non-core governmental activities currently performed by government agencies. Private sector providers specializing in military base maintenance, facility firefighting services, payroll and accounting, and human resources management can perform such services. The Commission calls for a government-wide review of functions and services to identify those functions that are not “core” to the effective execution of the mission and which could best be performed by the private sector.

The Commission has significant philosophical reservations regarding public-private competition, and believes such competitions under current regulations disadvantage all parties.

Office of Management and Budget (OMB) Circular No. A-76, “Performance of Commercial Activities,” establishes federal policy for the performance of recurring commercial activities, and provides guidance and procedures for determining whether recurring commercial activities should be operated under contract with commercial sources, in-house using government facilities and personnel, or through inter-service support agreements (ISSAs). In principle, Circular A-76 is not designed to simply contract out. Rather, it is designed to: (1) balance the interests of the parties to a make or buy cost comparison, (2) provide a level playing field between public and private offerors to a competition, and (3) encourage competition and choice in the management and performance of commercial activities.

The A-76 process was established in an era where cost was the principal award determinant for all competitions. Reliable cost and past performance information is crucial to the effective management of government operations and to the conduct of competitions between public or private sector offerors. Unfortunately, this information has not been generally available and/or has often been found to be unreliable. In today’s era of best value procurements, which recognize that cost is but one of many important factors that assure taxpayer interests are most appropriately served, the old “cost-based” decision tree is no longer valid.

The Commission believes that it is vital for government agency competition with private offerors of goods or services to be conducted on the basis of truly comparable cost accounting practices, past performance and best value. In addition, the process...
should be kept as high-level and streamlined as possible, avoiding the excessively detailed, overly mechanistic, aspects of the current A-76 procedure. The Commission supports reform of A-76 procedures to achieve these goals.

As changes to outsourcing competitions are developed and implemented, the Commission believes that defense and aerospace industry must work with government organizations to develop effective partnering relationships. To the maximum extent possible, these public-private partnerships should be founded on best business practices and should focus on enabling both government and industry to provide the products and services best suited to their organizational characteristics. Public-private partnerships will be required to integrate best provider government organizations, satisfy statutory requirements, and provide access to unique facilities, infrastructure and technical expertise. These partnerships will also foster a more business-like relationship, reduce administrative and life-cycle costs and reallocate risks, and assist in the evolution of government and industry roles and responsibilities. Recent changes to Title 10 U.S. Code regarding “hold harmless” will facilitate the use of conventional contractual arrangements and partnerships between industry and government. The Commission recommends that both industry and government vigorously pursue such partnerships, and supports changes in law or regulation that would facilitate increased use of public-private partnerships.

Commercial Acquisition Practices. One of the goals of acquisition reform is streamlining and simplifying the procurement process in order to reduce development and production cycle times and life cycle program costs, and to strengthen the technology and industrial base through increased access to, and use of, advanced commercial items. The FAR developed a broad range of “unique” controls and requirements for its contractors and subcontractors over the past 50 years. The government is now attempting to realign these purchasing processes to lower costs and gain access to new technology by eliminating, or at least lowering, barriers that make government business inefficient and unattractive to commercial firms and inhibit greater integration of commercial and military production lines. The Commission supports these efforts, but recognizes that the government must make this transformation while maintaining good faith and stewardship of the public dollar.

The Commission supports these enabling actions:

- Eliminate government unique contract requirements.
- Expand use of commercial like terms and conditions.
- Establish a presumption that products and services purchased from predominantly commercial companies are commercial vs. government enabling commercial contracting processes.
- Eliminate FAR cost principles that are administratively burdensome and discouraging to typical non-government contractors.
- Broaden available contract types under FAR (Part 12) to include standard commercial-type contract vehicles.
- Accelerate implementation of e-business environment.
- Streamline all payments with electronic processing and payments.
Domestic and International Business Climate: Burdensome

Certain U.S. tax and trade laws and regulations that affect a wide variety of industries weigh particularly heavily on defense and aerospace, both in competition with domestic commercial entities as well as in the international markets.

The complex U.S. Tax Code does little to reward or incentivize private investment in maintaining and enhancing our nation’s technological edge, either military or commercial. The Tax Code also fails to recognize the unique nature of defense development and production. In addition, a proposed resolution to a long-standing trade dispute with the European Union threatens to place military and aerospace exporters at a distinct disadvantage in the global marketplace.

Outdated and restrictive U.S. export control laws and regulations do little to protect vital national security technologies and, at the same time, adversely affect the ability of defense firms to export military products to our allies and friends, and negatively impact the ability of the government to pursue vigorously efforts to improve the military readiness and interoperability of our allies.

Finally, high-tech companies are discouraged from doing business with the U.S. government, and current contractors are unfairly

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### Table: 18-month Enabling Actions and Long-term Actions

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<tr>
<th>Reforms</th>
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<th>Long-term Actions</th>
</tr>
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</table>
| Contract Reform          | OMB, DoD, Congress| • Develop and enact laws and regulations limiting contractor liability for homeland security sales to all government agencies, as well as state, local, and commercial entities.  
                          | Industry         | • Minimize use of certified cost or pricing data.  
                          |                  | • Facilitate use of common subcontracting processes.  
                          |                  | • Reevaluate changes in DOD Shared Savings initiative.  
                          |                  | • Revise government profit policy to permit increased award fees, unearned award fee carryover, higher profit guidelines for fee-bearing IR&D.  
                          |                  | • Eliminate fixed price development contracts, profit takebacks, and withholds on CPFF contracts in excess of requirements to protect the government.  
                          |                  | • Formulate effective share-in-savings policies; reevaluate changes in efficiency savings initiative.  |
| Competitive Sourcing     | OMB, DoD, Congress| • Conduct a government-wide study of activities and services performed by government civilian and military personnel, and develop recommendations for privatization of non-core functions and services.  
                          | Industry         | • Reform OMB Circular A-76 to provide for more equitable and effective public-private competitions.  
                          |                  | • Incentivize and expand the use of public-private partnerships.  |
| Commercial Acquisition Practices | OMB, DoD, Congress | • Eliminate government unique contract requirements.  
                          | Industry         | • Continue the implementation of e-business environment.  
                          |                  | • Implement electronic processing and payments for all transactions.  
                          |                  | • Expand use of commercial practices.  
                          |                  | • Revise FAR part 12 to include standard commercial-type contract vehicles.  
                          |                  | • Eliminate burdensome FAR cost-based principles.  
                          |                  | • Expand commercial item definition to include all products and services purchased from commercial companies.  |

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The complex U.S. Tax Code does little to reward or incentivize private investment in maintaining and enhancing our nation’s technological edge.
penalized, by the laws and regulations governing rights to inventions and technology developed under government contract.

The Commission believes the government should act promptly to replace these burdensome tax laws and outdated trade laws, as necessary, with laws and regulations that remove unnecessary administrative burdens from industry and recognize the unique contribution of defense and aerospace companies to our nation's defense and economic security. Enacting or implementing the proposals outlined below would remove some of the clearest impediments to defense/aerospace industry health.

**Ensure FSC/ETI Resolution Maintains Industry Benefit.** As discussed in the Commission’s Second Interim report, U.S exporters face possible sanctions totaling up to $4 billion per year in tariffs on the sale of U.S. goods if the Foreign Sales Corporation (FSC) Repeal and Extra Territorial Income (ETI) Exclusion Act of 2000 (FSC/ETI), which was ruled an illegal export subsidy by the World Trade Organization (WTO), is not repealed.

In Interim Report #2, the Commission recommended that the U.S. Trade Representative seek a delay in imposition of any sanctions on U.S. exports to allow government and industry the time to develop a resolution of the FSC/ETI issue. The Commission is concerned that, while sanctions may not be imposed in the near term, the threat of significant sanctions will negatively impact the U.S. economy and other trade issues with our European allies. The Commission also reaffirms its belief that loss of the FSC/ETI benefit would have a serious adverse impact on the ability of U.S. defense and aerospace companies to compete in the global marketplace.

The Commission therefore strongly concludes that the Administration, Congress, and industry engage in serious discussions to develop an equitable resolution of this issue that maintains the current level of benefits for defense and aerospace companies. The Commission considered several proposals that could benefit defense and aerospace companies, while meeting the test of WTO compliance. The proposals favored by the Commission are an enhanced National Security R&D credit, the National Foreign Trade Council (NFTC) wage credit proposal, and the NFTC Footnote 59 changes.

**Enhance the Effectiveness of the Research and Experimentation (R&E) Credit.** The Commission emphasizes the recommendations contained in its Second Interim report for improving the utility of the current research and experimentation tax credit for defense and aerospace companies. Expanding on its earlier recommendations to make the R&E credit permanent and increase the rates for the current Alternative Incremental Research Credit, the Commission sees value in an additional alternative credit that would allow defense and aerospace companies to enjoy the same level of benefit as other industries—currently a 6 percent average credit. The Commission believes there should be a new alternative tax credit of 12 percent of the excess of current-year qualified research expenditures (QRE) over 50 percent of the average QRE for the prior three years, or 6 percent of current-year QRE for start-up taxpayers.

**Repeal Percent of Completion (POC) Tax Accounting Method.** One area of particular complexity in the U.S. Tax Code is the Percentage-of-Completion method under Section 460 of the Internal Revenue Code (the “POC method”) that was enacted in 1986 when the “Competed Contract method” was repealed. Under the POC method, taxpayers are required to perform a complicated set of calculations involving estimated costs, price, and revenues to derive a percentage that is used to determine the amount of annual tax due on each contract. Many defense and aerospace contracts must be handled under the POC method, either because they are long-term contracts (requiring more than 12 months to complete) or because the items being produced are “unique” items not normally carried in inventory.

Section 460 imposes an unfair burden on defense and aerospace companies, as well as certain other industries, by requiring them to pay tax before profit is earned. In addition, complicated look-back and
other requirements impose a compliance burden on taxpayers and a correspondingly large administrative burden on the Internal Revenue Service to monitor and enforce compliance, for relatively little revenue gain.

The Commission welcomes the Administration’s expression of interest in reviewing Section 460 of the Tax Code. The Commission concludes that the POC method should be repealed, allowing defense contractors to be treated similarly to all other businesses. At the very least, the method should apply only to contracts involving items that take a very long time to manufacture, i.e., three years versus the current one-year limit in law.

Export Control Reform. Export controls have a real and direct impact on the defense and aerospace industry’s ability to establish and maintain international partnerships, meet market demand and stay competitive, and address the requirements of existing overseas partners and customers. Current export licensing policies and procedures are complicated and inefficient, and erode the competitive position of U.S. companies in the global marketplace.

The Commission believes that protection of our national security and technological edge in key capabilities must continue to be the principal focus of our export control laws. However, without a fundamental restructuring of the current system, American companies will lose out to foreign competition and our nation’s own industrial and high technology base will be significantly undermined. Refer to Chapter 6, Global Markets for a detailed consideration of the Commission’s recommendations on this critical topic.

Airline Industry Bankruptcy and User Fees. The Commission also considered the plight of the U.S. airline industry, which is in the midst of a financial crisis. If left unchecked, this crisis will have a serious negative impact on the entire American economy. The impact could become more serious very quickly if more airlines are forced to declare bankruptcy leading to payment delays or defaults on debts owed to labor, manufacturers, and service providers. U.S. airlines lost $7.1 billion in 2001, and according to the Air Transport Association, will lose an estimated $9.0 billion in 2002. The airline loss of revenue has been exacerbated by the combined effects of the terrorist

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<th>Tax/Fee</th>
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<th>1992</th>
<th>2002</th>
<th>R/T***</th>
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*Tax Applies Only to Domestic Transportation **Legislative Maximum ***Single-Connection Roundtrip With $4.50 Passenger Facility Charge

Source: U.S. Tax Code via www.airlines.org
attacks of September 2001, the current economic
slump and chronically high internal cost structure.
On the manufacturing side, the surplus of commer-
cial aircraft is at a record level and worldwide pro-
duction continues to exceed demand. The
Commission has been told by experts that they
expect demand to pick up with an eventual rebound
in the economy. Most believe evolving market forces
will eventually lead to a major restructuring of the
airline and aviation servicing industries.

Today’s aerospace industry
demands a dynamic, results
oriented workforce with the
talents, multidisciplinary
knowledge, and up-to-date
skills to enhance an
organization’s value.

The Commission finds that one cause of the current
financial condition of the industry relates to the fed-
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Commission indicated that for a
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the result of government imposed fees. See Figure 7-7.
The Commission believes that
the Administration and
Congress should review and
consider reducing these user fees
on the airlines and their cus-
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problems caused by the scheduling cost and lack of
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The Commission is aware of concerns that, in future
bankruptcies, airlines may be pressured to give for-

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the technological capabilities of the aerospace industrial base. A healthy, competitive, and innovative industry meeting defense and aerospace needs must be closely integrated with the global commercial marketplace. Reduction in the uncertainty of ongoing business and future aerospace markets enables government and industry to make the necessary investments in people, technology, and facilities, to continue to ensure “world class” aerospace products today and for the future.

Major challenges to this desired climate include the need for dramatic personnel and training reform—how will we attract and retain necessary intellectual capital, sustain a robust workforce for the future, and attract highly and specifically qualified individuals to government service; and merger and acquisition policy reform—a global perspective and approach to mergers and acquisitions for a globally driven industrial base.

The Commission concludes that investors and the technology industry will continue to direct their focus toward the global commercial marketplace if specific reforms are not implemented in the near term, thus depriving the government and the aerospace industry of the best and brightest personnel, innovative ideas and technologies, and capital investments. The Commission has outlined a desired end-state within each of these areas and has provided a specific framework for long-term excellence.

**Personnel and Training—The Engine for Change.** Today’s most successful organizations are defining in very specific terms what they want to accomplish and what kind of structures are necessary for success. They are also defining a shared vision for the future, focusing on core values, goals, and strategies and communicating this shared vision clearly, constantly, and consistently. Top organizations then choose the best strategies for integrating their organizational structures, activities, core processes, and resources to support mission accomplishments.

Aerospace-oriented organizations in both the public and private sectors recognize that people are an organization’s key asset. Today’s aerospace industry demands a dynamic, results-oriented workforce with the talents, multidisciplinary knowledge, and up-to-date skills to enhance an organization’s value to its customers and to ensure that it is equipped to achieve its mission. Because mission requirements, customer demands, technologies, and other environmental influences change rapidly, a performance-based organization must continually monitor its talent needs. It must also be alert to the changing characteristics of the global (not just U.S.) labor market and identify the best strategies for filling its talent needs through recruiting and hiring, and follow up with the appropriate investments to develop and retain the best possible workforce.

The Commission believes that a primary barrier to accomplishing many of the other recommendations in this report is the lack of understanding by the government and industry workforces about the roles, responsibilities, and challenges facing their counterparts. The Commission is also concerned about reported instances of government acquisition personnel failing to recognize business realities, such as the need for adequate profit margins.

Government and industry should work together to develop and implement training and exchange programs that would educate and expose their workforces to their respective challenges and responsibilities.

Government and industry should work together to develop and implement training and exchange programs that would educate and expose their workforces to their respective challenges and responsibilities.
The Commission also concludes that government acquisition personnel should be required to be knowledgeable about the characteristics of the integrated civil contracting model, and that industry acquisition personnel be fully trained in the complexities of the government acquisition system. The Commission also believes that all government officials with budget and program acquisition, management, or review responsibilities, both appointed and elected, should have either a business or financial background or be provided access to expert advice in these areas. The Commission urges each new President to take these criteria into account when making selections for relevant positions. Both the executive and legislative branches are encouraged to create training programs so that personnel in relevant positions are fully knowledgeable about business practices and financial issues.

The Commission also believes that investments in new, contemporary learning systems should be immediately established to respond to the backlog of new policies and regulations that urgently need greater cultural understanding and further skill development. System focus should include: emphasis on the “how to” practical aspects of applying new rules and techniques, clear treatment of both culture change and new process, maximum use of technology based learning tools, mechanisms for validating learning tools and measuring the effectiveness of the learning process, and incorporation of joint buyer-seller learning scenarios in selected critical areas. Additionally, judicious use of outsourcing to access private sector education and training capability, aggressive use of government-industry exchange mechanisms to best leverage each side’s knowledge, and finally, skills and sustained management attention and accountability including requirement for business and financial backgrounds and training for all government personnel responsible for program acquisition and financial management should be implemented.

A Global Approach to Merger and Acquisition Policy. Just as the global marketplace drives our business environment, a global approach to mergers and acquisitions is fundamental. Today’s economy is comprised of multi-national corporations, operating across all time zones and financial markets. No one country or corporation has a corner on technology, innovation, or management processes. Access to global best practices and markets is an absolute necessity in today’s environment.

The Commission believes the government must develop and implement a policy regarding international cooperation in defense and aerospace that recognizes the global industrial base. The Commission urges the Administration to undertake a review of the current policy regarding both domestic and international business combinations, based on an analysis of the U.S. defense industrial base, including the supplier industrial base.
Conclusions

The Commission concludes that for our aerospace industry to be globally preeminent, now and in the future, it must be able to attract vitally needed capital at a reasonable cost. We further conclude that the defense and aerospace sector is viewed as a low growth industry with low margins, unstable revenue and a capricious major customer, the government. Without a significant change in the business model, the future of the aerospace industry, so critical to our national economic and homeland security, is uncertain and at risk.

Provide Investment Opportunities. Predictability, stability and performance are critical to the health and growth of a robust aerospace industry. The government must stabilize program requirements and protect adequate long-term investment funding, enact reforms that increase the financial flexibility of industry and the government, and improve program management stability.

Enable Industry to Attract and Retain High-Tech Partners and Suppliers. The future of the aerospace industry is intrinsically tied to the ability of the sector to attract and retain high-tech partners and suppliers throughout the supply chain. The government should pursue near-term reforms to realign purchasing processes to lower costs and gain access to new technology by eliminating, or at least lowering, barriers that make government business inefficient and unattractive to commercial firms. DoD should implement changes to permit greater profitability and financial flexibility of industry working on government efforts. A government-wide review of functions and services should be conducted to identify those functions that are not “core” to the effective operation of government and those functions that could best be performed by the private sector.

Create a favorable Domestic and International Business Climate. Certain U.S. tax and trade laws and regulations that affect a wide variety of industries weigh particularly heavily on defense and aerospace, both in competition with domestic commercial entities as well as in the international markets. The government should act promptly to replace burdensome tax laws and outdated trade laws with laws and regulations that remove unnecessary administrative burdens from industry and recognize the unique contribution of defense and aerospace companies to our nation’s defense and economic security. In addition, the Administration and Congress should review and consider reducing user fees on airlines and their customers.

Ensure Long-Term Growth and Financial Health. Government and industry must recognize that a healthy, competitive, and innovative industry meeting security and aerospace needs must be closely integrated with the global commercial marketplace. Major challenges to this desired climate include the need for dramatic personnel and training reform and recognition of the dynamic interrelated global environment. Government and industry should work together to develop and implement training and exchange programs that would educate and expose their workforces to those challenges and responsibilities. All government officials with budget and program acquisition, management, or review responsibilities, both appointed and elected, should be required to have a business or financial background or training. Finally, government must develop and implement a policy regarding international cooperation in defense and aerospace that recognizes the global industrial base. The Administration is urged to undertake a review of the current policy regarding both domestic and international business combinations, based on an analysis of the U.S. defense industrial base, including the supplier industrial base.

RECOMMENDATION #7

The Commission recommends a new business model designed to promote a healthy and growing U.S. aerospace industry. This model is driven by increased and sustained government investment and the adoption of innovative government and industry policies that stimulate the flow of capital into new and established public and private companies.