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BY THE COMPTROLLER GENERAL

Report To The Chairman, Subcommittee On Economic Stabilization, Committee On Banking, Finance, And Urban Affairs House Of Representatives

OF THE UNITED STATES

Trade Offsets In Foreign Military Sales

Trade offsets involve shared manufacturing by a foreign government or other arrangements aimed at "offsetting" part of the cost of a weapon system purchased from the United States Various government and private industry officials have expressed concern about the increased use and possible consequences of offsets in foreign military sales GAO was asked to review the policies, responsibilities, and data bases of federal agencies regarding these offset arrangements

This report contains information on each of these areas It also suggests that the Congress may wish to direct the administration to institute a policy to resist offset demands by foreign governments purchasing military goods from the United States when U.S assistance is provided. GAO believes that foreign military sales credits or grants should not be used directly or indirectly to expand the industrial base of a foreign country at the expense of the U S industrial base and U S jobs. Exceptions to this general rule might be made for foreign policy reasons

UNITED STATES GENERAL ACCOUNTING OFFICE

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C 20548

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The Honorable John J. LaFalce
Chairman, Subcommittee on Economic
  Stabilization
Committee on Banking, Finance and
  Urban Affairs
House of Representatives

Dear Mr. Chairman:

Your letter of July 15, 1983, requested that we review how "offsets" in foreign military sales (FMS) affect the defense industrial base. Specifically, you asked us to

--determine what the U.S. national policy is on offsets,

--ascertain which federal agency has responsibility for monitoring offset activities and determine how agencies coordinate the administration of offsets,

--determine to what extent offsets are used in FMS and commercial transactions, and

--identify what type of data base exists to track offset activities in order to determine their effect.

As used in this report, the term "offset" includes any arrangement wherein U.S. industry shares production of a system procurement or purchases items from sources within a foreign country to offset an established percentage of the cost of that procurement.[1]

We reviewed the policies, responsibilities, and data bases of federal agencies regarding trade offset arrangements. We found that at the federal level:

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[1]Offsets include coproduction, licensed production, subcontractor production, overseas investment, technology transfer, and countertrade. (See app. II for a definition of each element of offsets.)

--No comprehensive national policy exists to guide federal officials or industry representatives in offset transactions. DOD has instituted its own policy to rely on industry market forces to regulate offsets except when industry is unable to satisfy any particular government's demands.

--There is little coordination among the agencies studying offsets, and no single federal agency has taken the lead to ensure that the various U.S. interests are served when a U.S. firm makes an offset commitment with a foreign government.

--No central data base exists on offset commitments and complete and accurate data on offsets are not otherwise readily available.

The following presents the highlights of our review. Additional details on our observations, as well as our objectives, scope, and methodology, are included in appendix I.

The United States has no comprehensive national policy on the administration of offsets that incorporates the views of the various affected U.S. government agencies and private industry. Although officials at the Departments of Commerce and the Treasury and the Office of the U.S. Trade Representative generally agree that such a policy is needed, they have not agreed on how it should be administered and which agency should have the lead role. At present, the nearest statement of policy is DOD's directive stating that (1) DOD will stay at arm's length in guaranteeing offsets unless industry is unable to satisfy a foreign government's demands and (2) FMS credits will not be used to directly finance coproduction or licensed production abroad.

The United States takes no active role in administering offset transactions, and therefore no agency comprehensively monitors offset activity. Likewise, no agency is responsible for ensuring that all national interests are served when a U.S. firm makes an offset commitment to a foreign government as a condition for the sale of U.S. defense items. Coordination of the administration of offsets, to the limited extent it exists, does not involve departments such as Treasury and Commerce, which have major trade policy interests in these transactions.

Although limited, existing information indicates that offsets are a substantial element in the sale of U.S. weapons systems. Moreover, developing countries are now joining the increasing number of industralized countries demanding such concessions. Available data also suggest the number of offset demands is increasing and will continue to increase in the future. For example, in an August 1983 report on coproduction, DOD estimated that in the next 5 years, about $30 billion in potential arms sales are expected to involve offsets.

Because increased demands for offsets have raised sufficient questions as to whether the practice is detrimental to the United States, several agencies have decided to further examine the issue. The Departments of State, Commerce, Defense, the Treasury and the Office of the United States Trade Representative have reviewed or are reviewing and defining their positions on the use of offsets. These activities include policy reviews, analytical studies, and obtaining advice and views from industry leaders. However, these reviews are being conducted individually by each department with little joint coordination. We believe it is essential that these agencies collaborate with each other and industry on the use of offsets in foreign military sales.

MATTER FOR CONSIDERATION BY THE COMMITTEE

In addition to the issues discussed above, there is a related issue which we believe warrants the Committee's particular attention--allowing offsets in FMS transactions which are financed by FMS assistance. Some of the countries now requesting offsets are also receiving FMS credit or grant assistance. Although Defense has a policy that FMS credits will not be used directly to finance coproduction or licensed production abroad, there is no policy to prevent a country which has received FMS assistance, in the form of a grant or FMS credit, from requiring an offset commitment from a U.S. firm as a condition of sale. This offset could then be used by the FMS-recipient country to expand its own industrial base at the expense of the U.S. industrial base and U.S. jobs. We believe that FMS credits should not be used directly or indirectly to expand the industrial base of an FMS recipient at the expense of the U.S. industrial base and U.S. jobs, especially when countries' FMS credits have a significant grant element, are forgiven, or might not be repaid. Exceptions to this general rule might be made for foreign policy considerations. We recognize that to the extent that certain countries build their industrial military bases, they may require less economic and military assistance from the United States.

If this practice becomes widespread, in our opinion, it could run counter to U.S. interests because it diminishes the beneficial effects that advocates of FMS programs often speak of; that is, FMS assistance does not result in a substantial outflow of U.S. resources since these funds return to the United States in the form of increased demands for goods. Accordingly, the Committee may wish to consider the need for the Congress to direct that the administration institute a policy to resist offset demands by foreign governments when FMS credits or grants are involved in the sale.

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As requested by your office, we did not obtain agency comments on this report. We did, however, discuss the report's contents with program officials at the Departments of Commerce, Defense, State, the Treasury and the Office of the United States Trade Representative, and their comments have been incorporated where appropriate.

Also, as agreed with your office, we are sending copies of this report to the Director, Office of Management and Budget; the Secretaries of Commerce, Defense, State, and the Treasury; the Office of the United States Trade Representative; the cognizant congressional appropriations and authorizations committees; other interested congressional committees; and others upon request.

Sincerely yours,

Milton J. Socolar

Acting Comptroller General
of the United States

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ABBREVIATIONS

AWACS	Airborne Warning and Control System
DOD	Department of Defense
DPACT	Defense Policy Advisory Committee on Trade
FMS	Foreign Military Sales
GAO	General Accounting Office
GATT	General Agreement on Tariffs and Trade
NATO	North Atlantic Treaty Organization
OMB	Office of Management and Budget

TRADE OFFSETS IN FOREIGN MILITARY SALES

BACKGROUND

Various officials of the Departments of Commerce, Defense (DOD), State, and the Treasury; the Office of the U.S. Trade Representative; and U.S. defense contractors are concerned about foreign military sales which incorporate offsets--defined as coproduction, licensed production, countertrade, subcontracting, and technology transfer--mandated by foreign governments as a condition of sale. The terms of the offset on individual contracts may vary substantially, and a contract may call for more than one kind of offset.

DOD examines the security implications of making sophisticated military equipment and technology available to other countries. Prior to 1978, DOD negotiated equipment acquisitions which included offset arrangements between U.S. defense equipment manufacturers and other countries. However, present DOD policy on guaranteeing offsets is not to become involved in negotiating such arrangements unless they cannot be resolved otherwise. As a result, offsets are now negotiated directly between the U.S. defense contractor and the procuring government, usually without DOD commitments and involvement.

Reasons for adopting the existing policy included (1) the management complexities and resource drain on DOD in negotiating and implementing compensatory coproduction/offset agreements, (2) such agreements had the effect, or created the impression, of obligating the U.S. government to place orders for systems or components in foreign countries or of requiring DOD to force U.S. contractors to do so, (3) a conviction that offset commitments were business judgments which should not involve DOD, and (4) once commitments were made by industry, the U.S. defense contractors, not DOD, should assume responsibility to the foreign government for fulfilling the promised offset.

A more recent restatement of this policy is outlined in DOD Directive 2010.6, dated March 1980. The directive, which pertains only to NATO, relies on industry to arrange for efficient means of arms collaboration on each sale. If industry is unable to satisfy any particular government's demands, then government-to-government agreements, which may include offsets, can be considered. However, according to Defense officials, there is involvement concerning technology transfer, third country transfers, impacts on U.S. programs, impact on the U.S. industrial base, and other political, economic, and military aspects relating to foreign policies and national security interests.

Offset demands by foreign governments may be increasing because the purchase of military equipment represents a major and highly visible outflow of the purchasing country's foreign exchange. In past years, countries tried to reduce this outflow and to create employment by demanding licensed production of procured products. This experience proved to be very expensive and, for some countries, technically unsatisfactory. Consequently, to adjust for this outflow, countries have turned to other forms of offsets, such as coproduction, countertrade, and technology transfer. In this way, they can create jobs, correct national technological deficiencies, force investments to be made in the country which under normal commercial circumstances might not be made, and assist export sales of indigenous goods and services.

In recent years, more and more industrialized countries have required offsets, or some type of industrial participation, as a prerequisite for purchasing major defense equipment from other countries. This has been particularly prevalent in aircraft acquisitions; for example, offsets associated with the Airborne Warning and Control System (AWACS) to the North Atlantic Treaty Organization (NATO) countries, the F-5E sale to Switzerland, F-16 sales to four northern European participating governments, Israel, and Turkey, and the F-18 sales to Australia, Canada, and Spain. France is also seeking offsets relating to a possible Airborne Early Warning (AEW) aircraft purchase.

OFFSETS ARE A SUBSTANTIAL ELEMENT IN U.S. CONTRACTS

The limited data and information currently available indicate that offsets are substantial elements in the sale of U.S. weapon systems. For example, a Department of the Treasury report, dated May 24, 1983, was prepared in cooperation with the Aerospace Industries Association and the Electronics Industries Association, which conducted a survey of offset arrangements signed between 1975 and 1981 involving responses from 26 major U.S. aerospace and electronic equipment manufacturers. The survey results showed that these corporations entered into 143 contracts involving offsets with 23 countries totaling $15.2 billion, of which $14.2 billion was for military sales. A specific offset value associated with 130 contracts was $9.55 billion, of which $8.94 billion involved offsets associated with the sale of aircraft and related equipment. Canada had the largest share of offset arrangements, both in number of contracts (28) and dollar value ($4.6 billion). Other significant offset contracts were with NATO countries, Israel, Japan, and Australia.

The use of offsets, specifically coproduction, began in the late 1950s and early 1960s in Europe and Japan. Originally, the Europeans' desire to coproduce portions of weapons systems was based on needs similar to those of the United States now, such as

--maintaining domestic employment,

--creating a national defense industrial base,

--acquiring modern technology, and

--assisting its balance of payments position.

It is in the U.S. interest to meet some of these allies' needs; that is, bolstering mutual defense capabilities, improving their defense industrial capability, and strengthening their overall economies. However according to the DOD August 1983 report, International Coproduction/Industrial Participation Agreements, with increased competition from foreign countries, these programs are often a challenge to U.S. interests.

Currently, many foreign purchasers now expect to receive offsets as a matter of course, and some have policies or legislation requiring offsets on military purchases. For example, Norway has a strong national policy requiring 100 percent offsets in the purchase of military hardware. To promote self-sufficiency in defense requirements, Spain has a law requiring offsets in procuring foreign military equipment. The purpose of the law is to ensure that military purchases will be used to secure commercial and industrial reciprocal arrangements and to acquire new technology which will enable Spain to take part in joint projects to supply third countries. Australia has an offset policy of 30 percent and is considering increasing the policy to 40 percent. Also being considered is the idea that companies which have not fulfilled previous offset agreements will not be eligible for new contracts. Additionally, the Israeli government has a policy of requesting U.S. suppliers to offset or "buy back" from Israel goods or services equal to 25 percent of Israeli purchases of $1 million or more. Israel was permitted offsets of 15 percent using FMS credits in fiscal year 1984.

Recently, the Israeli government signed an agreement with General Dynamics to purchase 75 F-16 fighters for $2.7 billion. An accompanying agreement requires General Dynamics to subcontract goods and services in Israel for $300 million in the next 5 years. If the subcontract goals are not met, there is a penalty clause requiring the contractor to pay 1 percent or $3 million to the Israeli government.

Additionally, DOD indicated in its report on the International Coproduction Participation Agreements that within the next 5 years about $30 billion in potential U.S. arms sales are expected to involve offsets to improve the economic and industrial position of the recipient.

OPINION IS DIVIDED ON OFFSET EFFECTS

Supporters of offsets claim that such arrangements can benefit U.S. national defense through commonality of weapon systems, create closer ties with friendly countries, lower unit costs, and generate new U.S. jobs. Offsets are becoming an increasingly common business practice in all areas of international trade. According to some respondents in the aerospace and electronics industries survey, the sales they identified would have been lost without offsets. In summary, this group believes that U.S. firms obtain contracts which would be placed elsewhere if offsets were not granted. They also maintain that technology transfer is not a problem since such transfers rarely involve state-of-the-art technology.

Some DOD officials indicate that military sales help our defense posture by

--providing orders for larger production runs thus reducing unit costs to our own forces,

--improving the defense industrial mobilization base, and

--providing jobs for American workers.

The Secretary of Defense, in testimony before the House Committee on Foreign Affairs on February 22, 1983, emphasized the role military sales play in creating jobs in the United States and increasing revenue when he said that:

"A recent Bureau of Labor statistics study concluded that annual foreign defense deliveries at levels ranging between $5 billion and $10 billion require between two and three hundred thousand jobs in the U.S. private sector. As the value of U.S. defense deliveries increase, as they have in the past few years, the number of private sector jobs also increase. These jobs cut across the economic spectrum, although they are largely concentrated in manufacturing.

"Foreign military exports, because they are sales to foreign customers, generate some tax revenues to the U.S. Treasury. We estimate, for example, that FMS credit monies which are virtually all spent in the U.S., return modest amounts to the Treasury."

There is some agreement that offsets, in the form of coproduction, are beneficial for security reasons to standardize military hardware, rationalization, standardization, and interoperability (RSI) and for economic reasons to make military trade a "two-way street" within NATO, rather than have the United States as the seller and other nations as buyers. However, the Department of Commerce indicated on June 8, 1983, that:

> "In complying with the rationalization-standardization-interoperability (RSI) and two-way alliance trade directives and with foreign policy objectives, the long-term domestic commercial effect is sometimes overlooked. These agreements may adversely affect the U.S. defense industrial base at the secondary and tertiary levels of subcontractors and suppliers, and therefore the readiness posture of U.S. industry.
>
> We should work with industry to ensure that short-term profits do not lead to long-term industrial decline. We should bring industry officials into the negotiation process early-on to avoid placing them in a position of meeting government-imposed requirements to which they were not an informed nor a negotiating party."

Critics in and out of government complain that foreign government-mandated offset agreements can erode the industrial and mobilization base, result in technology transfers coming back to the United States in the form of commercial competition, create an unfavorable U.S. balance of payments position, reduce tax revenues, take jobs from U.S. workers, increase costs, distort trade--both current and future plans--adversely affect U.S. trade interests, and subsidize foreign industry.

The U.S. Trade Representative indicated that competitive business opportunities are denied U.S. firms--either the prime contractors or may be passed on to second or third tier subcontractors--when foreign governments, directly or indirectly through the purchasing firm, require as a condition of sale that some portion of a major purchase be produced in-country or that the seller contract for some amount of goods or services to be procured in the purchasing country. Offsets are a growing element of international trade, and it is neither practical nor desirable to eliminate offsets totally. However, according to the U.S. Trade Representative, offsets in military trade have grown to unreasonable proportions and should be moderated because

--excessive offsets raise the cost of international defense procurements,

--offsets can result in the selection of weapon systems on bases other than military and cost effectiveness, and

--offsets in the form of technology transfer can be damaging to both national security and the industrial base of the seller country.

The State Department in April 1983, commenting on defense related offsets indicated that:

"At this point, State is only prepared to support a careful economic study of whether in fact a problem exists. We believe it is premature to undertake any new multilateral negotiations or to issue any statement condemning offsets since there is clearly no agreement between State, Treasury, DOD, OMB or Commerce (or industry) on what the facts are, the nature of the problem, and appropriate remedial steps."

U.S. AGENCIES DO NOT HAVE DATA ON OFFSETS

While both critics and supporters make a case for the use/non-use of offsets, the information needed to determine the long-term effects--both good and bad--on the U.S. economy, as well as potential security implications, is not readily available.

No single agency has a complete or accurate data base showing the extent to which offsets have been provided. While each of the agencies has some data and information in its special area of interest, aggregated information in usable form is not currently available. Some agencies have had to rely on private industry reports, trade publications, and newspapers.

USING FMS CREDITS AND ALLOWING OFFSETS

In the past, most offsets were requested by industrialized countries. Now, however, developing countries are beginning to request more offsets. Some of the countries now requesting offsets, such as Egypt, Greece, Israel, Korea, Spain, and Turkey, are also FMS credit or grant recipients under the security assistance program.

Even if one were to take the position that government agencies should not become involved in commercial offsets, we believe the use of offsets in conjunction with the security assistance program is a different matter. Although security assistance is provided through repayable loans, some of these loans differ from regular commercial transactions because of their subsidy element. A substantial amount of the FMS program for both Egypt and Israel is in forgiven loans. For example, Egypt and Israel have been forgiven (allowed to write off) $425 million of $1.3 billion and $750 million of $1.7 billion FMS loans, respectively, for fiscal year 1983. This means that to this extent, the program is grant aid. Secondly, U.S. Economic Support Funds (ESF) are provided as cash grants to Israel and Turkey for budget support. These grants can be used to help pay their foreign debts, including FMS loans.

Moreover, as we reported in January 1983,[1] the FMS credit or loan program is unrealistic. Some FMS credit recipients are experiencing difficulties in making their required interest payments and have been granted relief through debt rescheduling. Turkey, for example, has already had to reschedule loan payments, and other recipient countries appear to be vulnerable as their loans expand with the increasing purchases of sophisticated weapons systems.

A major concern of allowing FMS assistance to recipients who request offsets is the impact this may have on the U.S. industrial base and employment. In our June 1983 report on security and related assistance to Israel,[2] we discussed Israel's trade offset arrangements with U.S. firms in connection with its FMS program. For example, as a direct offset in providing it with F-16 aircraft, an Israeli firm is producing the aircraft's composite rudder. In another case, Israel decided in February 1982 to go forward with the Lavi, an indigenous aircraft fighter development program, and subsequently requested authorization to obligate nearly $200 million in FMS credits for expenditure in Israel for the project. In April 1983, the administration decided to approve license requests for Phase I of the program and release production technology licenses for other components.

In November 1983, the Congress allowed Israel to spend "not less" than $250 million of U.S. military assistance loans and grants to buy defense goods and services for the Lavi within Israel from Israeli firms. However, the precedent set by allowing a country to use FMS credits could be a problem if other recipient countries ask for similar concessions.

Although Turkey is having financial difficulties, the United States is providing FMS credits to assist in purchases of defense equipment which include coproduction offsets. In 1983, Turkey signed an agreement to procure and coproduce about 160 F-16s over a 10-year period at a cost of approximately $3.5 billion to $5 billion. It is projected that this sale will require FMS assistance. Turkey has wanted to set up its own military aircraft industry since the U.S. Congress, for a

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[1] Unrealistic Use of Loans To Support Foreign Military Sales, Jan. 19, 1983 (GAO/ID-83/5).

[2] U.S. Assistance to the State of Israel, June 24, 1983 (GAO/ID-83-51)

period, banned all military sales to Turkey following the invasion of Cyprus in 1974. This sale will assist the development of Turkey's aircraft industry. At present Turkey has no aircraft plant to manufacture F-16s. It is estimated that Turkey will commit $1.8 billion of its own funds over the 10-year period, and the rest of the project is expected to be financed through bank credits, loans, and U.S. assistance. Additionally, the aircraft manufacturer has offered to help find markets for Turkish products to earn foreign exchange to offset the cost of its proposed aircraft industry. In connection with this, the United States plans to substantially increase its assistance to Turkey during fiscal year 1984--to $755 million in military aid and $175 million in ESF.

Defense officials point out that this sale to Turkey does not include the direct use of FMS credits to finance the coproduction since this is against their policy, (see page 10) except for the Israeli situation which is congressionally mandated. However, it is not likely that Turkey would have been able to negotiate the purchase of the F-16s including the use of a coproduction offset arrangement without the use of FMS credits.

Four respondents in the aerospace and electronics equipment survey believed that FMS contracts or other contracts financed through the U.S. government should be free of offset requirements or, if offsets are allowed, the U.S. government should provide assistance in meeting the offset or pay the extra costs. Other companies believe that foreign governments should pay the premium involved, regardless of whether or not the equipment is sold directly through the government. Finally, one firm suggested that no more than half of U.S.-developed systems should be produced outside the United States.

The Defense Policy Advisory Committee on Trade (DPACT), a high level advisory panel which is made up of about 35 chief executive officers in U.S. defense industries, studies and comments on defense trade issues, including offsets. The DPACT, which meets twice a year, has been given an opportunity to discuss the conclusions of the DOD task force on International Coproduction/Industrial Participation Agreements. The DPACT has been addressing offsets since its first meeting in April 1982. The committee has met on four occasions and issued its first report on December 15, 1983, which recommended that:

> "Where possible, the government should preclude offsets where U.S. grants, aids, or foreign military sales credits are used and should obtain offset recognition for military support, economic development and other economic contributions made by the United States to the procuring government

> but not directly linked to the specific procurement. Otherwise offsets should be an industry responsibility to negotiate and fulfill on a case-by-case rather than a participant in the process."

Defense agrees with the DPACT that the U.S. government should not normally permit offset demands against that part of a sale financed by FMS credits or grants and stated:

> "The argument for this position becomes more cogent as the grant or concessional component increases in U.S. assistance. It is relevant that U.S. financing for arms sales is basically intended, by the Arms Export Control Act for the purchase of U.S. products which implies concomitant economic benefits for the U.S. To the extent that the foreign buyer extracts any sort of offsets against these sales, economic benefits to the U.S. are lost. If the buyer insists that offsets must be a certain percentage of a USG-financed sale, it should normally pay for that percentage of the program as well as any additional program costs covered by the offsets."

Traditionally, military loans and grants have been spent only on the purchase of U.S. arms from U.S. companies, although there have been some exceptions. Some of these exceptions have been made pursuant to national security foreign policy and economic interests. We recognize that to the extent that countries such as Egypt, Greece, Israel, Korea, Spain, and Turkey build industrial military bases, they may require less economic and military assistance from the United States.

We believe that FMS credits, as a general rule, should not be used directly or indirectly to expand the industrial base of an FMS recipient at the expense of the U.S. industrial base and U.S. jobs, especially when countries' FMS credits have a significant grant element, are forgiven, or might not be repaid.

U.S HAS NO NATIONAL POLICY ON OFFSETS

The U.S. government has no comprehensive national policy on offset agreements for the sale of military equipment to foreign governments. As discussed, DOD has taken a formal position of noninvolvement; other agencies believe more active participation is needed. Since 1978, offset commitments for such equipment sales have been worked out directly between the U.S. prime contractor(s) and the purchasing foreign government.

The Defense Security Assistance Management Manual states the DOD policy on offset procurement as follows:

> "DOD Policy. It is DOD policy not to enter into government-to-government offset arrangements because of the inherent difficulties in negotiating and implementing such arrangements. Any foreign government requesting offset should be informed that the responsibility for negotiating any offset arrangements resides with the U.S. contractor involved. The U.S. Government will not commit a U.S. contractor to an offset commitment without having its prior concurrence."
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> "Coproduction Programs Financed by FMS Credits. The AECA, Section 42(b) requires the Secretary of State to provide advice to the Congress prior to the approval of the use of any credit or guarantied loan proceeds involving coproduction or licensed production abroad. Such advice must include a description of the particular defense article or articles which would be produced under license or coproduction and the probable impact of the proposed transaction on employment and production within the U.S."

Some industry and agency officials believe that offset demands are accelerating primarily because no U.S. policy exists to help the defense industry limit increasing foreign government demands. In the aerospace and electronics equipment survey, half of the firms which responded believed that the government should negotiate multilateral or bilateral agreements to "clearly define" or "limit" offset practices in order to assure competition and guard against restraint of trade. Some industry representatives suggested that the U.S. government, through multilateral negotiations, attempt to remove offset requirements as a standard way of doing business in military sales.

Some industry spokesmen believe that in some cases, DOD continues to make offset commitments for them because foreign military sales are normally formalized by DOD and the procuring government through memorandums of understanding. They contend these memorandums tend to create obligations on industry with resulting implications on jobs and technology transfer which result in other longer range competitive effects. Some industry representatives also believe that DOD is unilaterally entering into understandings, agreements, and/or arrangements with foreign governments without consulting industry.

Agency officials agree that a comprehensive national policy on offsets is needed. The Assistant Secretary of the Treasury, International Affairs, in a March 1983 letter to the Interagency

Group on International Economic Policy,[3] indicated that the economic dimensions of arms production and trade have received no systematic attention within the U.S. government. He recommended that a U.S. policy and objectives for negotiations with other principal arms-exporting countries be established in the near term. The goal of such negotiations would be agreement on guidelines limiting offset/coproduction practices as an element of competition in arms sales.

In our March 1982[4] report on military coproduction with Japan, we recommended that

> "the Secretary of State take the lead and in cooperation with the United States Trade Representative and the Secretaries of Defense, Commerce, the Treasury, Labor and other relevant agencies, form a clear and more comprehensive military coproduction policy."

In the past, in the absence of a national policy, multinational negotiations have been used regarding the use of offsets in U.S. trade. For example, the United States was successful in the Multilateral Trade Negotiations in inserting clauses into both the Agreement on Government Procurement and the Agreement on Civil Aircraft to limit the use of offsets in commercial trade. An official in the Office of the U.S. Trade Representative suggested the possible development of a policy similar to the current General Agreement on Tariffs and Trade (GATT) which discourages signatory nations from requiring or demanding offsets and could be used to protect U.S. national security, the industrial base, and the overall domestic economy. Foreign military sales are not covered by present GATT provisions which are limited to trade in civil goods.

The August 1983 DOD report on International Coproduction/Industrial Participation Agreements stated the need to establish a policy on offsets. The DOD report also indicated that guidelines for limiting the extent of offsets would be considered and an initiative by the U.S. Trade Representative to conduct international negotiations to limit offsets would be supported.

The DPACT in its December 15, 1983, report recommended that

> "The U.S. government, principally through the Office of the U.S. Trade Representative, should

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[3]An interagency group comprised of members from 12 agencies established to maintain oversight of economic issues relating to foreign policy.

[4]U.S. Military Coproduction Programs Assist Japan In Developing Its Civil Aircraft Industry, Mar. 18, 1982 (ID-82-23)

> promote the negotiation of multinational agreements to eliminate or set limits on the level of offsets that are acceptable in an international agreement--with the participation and concurrance of the industries involved."

The U.S. Trade Representative is presently pursuing this, has obtained concurrence from Defense, and is awaiting clearance from the Departments of Commerce, State, and the Treasury to proceed.

NO FEDERAL AGENCY HAS A LEAD ROLE IN ADMINISTERING OFFSETS

No agency has the lead role for ensuring that comprehensive national interests are served when a U.S. firm makes an offset commitment with a foreign government as a condition for the sale of U.S. defense items. Instead, this role is shared and coordinated to a limited extent among the federal agencies.

DOD has a critical role in the sale of weapon systems to NATO and allied countries and interacts mainly with the Department of State and, to a lesser extent, with the U.S. Trade Representative and the Departments of Commerce and the Treasury. The Departments of Commerce and the Treasury have interests in these transactions since they administer credit and licensing arrangements but are rarely consulted during DOD's review of U.S. defense contractor compensation agreements. Agencies usually find out about such transactions only after arrangements are finalized. For example, according to the Director of Commerce's Bureau of Industrial Economics, the State Department approves and DOD negotiates and implements military coproduction programs with little or no input from other agencies.

The Director of Treasury's Office of Trade Finance stated that DOD and State declined to cooperate in an examination of offset effects because their positions on national security superseded any economic proposals that another agency might advance and that could help alleviate possible negative impacts of offsets on the U.S. domestic economy. The Treasury Assistant Secretary, International Affairs, in a March 1983 memorandum to the Interagency Group on International Economic Policy, stated that:

> "The economic dimensions of arms production and trade have received no systematic attention within the U.S. Government. While the Defense Department has negotiated arms production and trade agreements with allied governments, its focus has been military and technical. Policy oversight from an economic perspective should still permit fruitful cooperation with friendly governments while safeguarding U.S. economic interests..."

This memorandum also stated that military equipment trade is treated as a unique economic sector that is considered exempt from the general trade and investment policies and separate from other U.S. merchandising transactions. He said that such treatment may be inappropriate.

FEDERAL AGENCIES ROLES AND RESPONSIBILITIES UNDER STUDY

Each federal agency involved in the transfer of goods and services to a foreign country has an interest in offsets. Recognizing increased congressional and private sector concern and increased demands from U.S. allies for offsets, the Departments of State, Commerce, and the Treasury and the U.S. Trade Representative are currently reviewing their roles and redefining positions on the use of offsets. These activities include making policy reviews and analytical studies and obtaining advice and views of industry leaders. However, these reviews are being conducted individually by each department with little joint coordination.

Department of State

The Arms Export Control Act makes the Secretary of State responsible for "continuous supervision and general direction" of foreign military sales, leases, and exports to see that they are integrated with other U.S. activities and best serve U.S. foreign policy.

State also provides executive guidance for operation of approved military assistance/sales programs to determine a country's capabilities to accommodate the programs and to provide direct high-level contact with foreign government executives or indirect contact through the in-country diplomatic staff.

State's day-to-day involvement in military sales cases is conducted through its Bureau of Politico-Military Affairs and its Office of Munitions Control. The bureau reviews sales requests to determine if a foreign military sale is consistent with U.S. security and foreign policy and the Office issues licenses to U.S. firms that want to export "munition list" items. These items include firearms, military aircraft, ships, tanks, vehicles, fire control equipment, and technical data related to the listed items.

Department of Defense

The Arms Export Control Act charges the Secretary of Defense with certain responsibilities in foreign military sales. DOD has primary responsibility for determining military equipment requirements and procurement, delivery, and allocation of military equipment.

DOD undertook two actions to better manage and administer U.S. arms transfers involving offset arrangments: (1) A task force studied the DOD policy involving offsets and (2) DOD and the U.S. Trade Representative established the DPACT. The DPACT was created as an advisory committee to address defense trade subjects such as technology transfer, international trade legislation, the defense industrial base, foreign military sales, and other defense trade issues.

The DOD task force report, International Coproduction/ Industrial Participation Agreements, issued on August 15, 1983, concluded that while many military equipment transfers are accomplished on a purely sales or grant basis, a significant portion is accompanied by side conditions intended to improve the economic and industrial position of the recipient country. The study estimated that within the next 5 years, about $30 billion dollars in potential U.S. arms sales are expected to involve offsets. The report recommended that:

1. The DOD should not establish a general policy which limits offsets to a particular percentage of the value of programs. However, DOD should support an initiative by the U.S. Trade Representative to conduct international negotiations to limit offsets.

2. Upon request, if all involved U.S. prime contractors agree, DOD should consider establishing guidelines for limiting the extent of industrial participation or offset.

3. Pending an international agreement for limiting offsets, the U.S. government should not hesitate to review the impact of offsets on DOD programs and to discuss offset packages. However, that portion of the 1979 memorandum precluding U.S. government guarantees of offset commitments or tracking of offset fulfillment is reaffirmed.

The Under Secretaries of Defense for Policy and for Research and Engineering indicated that they will coordinate with the U.S. Trade Representative and other interested agencies regarding the negotiation of international agreements on offset limitations. Additionally, they will develop policies to review offsets and advise U.S. contractors. The thrust of the policy will be whether U.S. industry will lose the sale or whether the military/political benefits to DOD can be achieved without coproduction or other offsets.

Department of Commerce

The Commerce Department has cognizance over non-military U.S. international trade, including sales of goods which have dual use, that is, commercial items which can also have military applications such as electronics items or computers. It supports DOD by providing foreign industrial information and basic marketing data and by informing U.S. industry of NATO business intentions.

Commerce believes it should be the lead agency in monitoring offsets. Commerce manages export administration and related activities, including federal policy and programs affecting industry and commercial segments of the economy. In support of its position, Commerce, under the auspices of the Emergency Mobilization Preparedness Board, Industrial Mobilization Group, is conducting a study to assess the impact on the industrial base from coproduction of defense material, related offset arrangements, and other trade agreements. Commerce officials indicate that this study will lead to a recommendation for the establishment of a U.S. government policy calling for Commerce to be the leader and focal point in all military coproduction, offsets, and other foreign trade agreements affecting the U.S. industrial base. Commerce officials believe the information obtained from the study will assist the U.S. Trade Representative with multilateral negotiations on offsets.

Department of the Treasury

The Treasury Department has the major responsibility for formulating and executing policies and programs dealing with international finances and currencies. Credit arrangements are frequently worked out between the Treasury and DOD when a foreign government desires credit to purchase U.S. military equipment.

Treasury completed an economic survey of offsets in May 1983. This study used inputs from the Aerospace Industrial Association and the Electronics Industry Association survey regarding existing offset commitments. Treasury officials said this was a first attempt to generate data on the subject and anticipated that the results will assist an interagency group on International Economic Policy chaired by Treasury's Assistant Secretary, International Affairs, in determining what policy actions might be appropriate.

Office of the United States Trade Representative

The United States Trade Representative is responsible for the direction of all trade negotiations and for the formulation of trade policy for the United States. Eliminating unfair trade practices is a major concern of the U.S. Trade Representative. In this regard, the U.S. Trade Representative is working with the other agencies and foreign governments to develop common offset policy objectives which preclude offset demands by foreign purchases that are detriments to one or more of the supplier countries.

CONCLUSIONS AND MATTERS FOR CONSIDERATION BY THE COMMITTEE

The United States has no national policy on the administration of offsets that incorporates the views of the various affected U.S. government agencies and private industry. Although agency officials at the Departments of Commerce and the Treasury and the Office of the U.S. Trade Representative generally agree that such a policy is needed, at present the nearest statement of policy is DOD's directive stating that (1) DOD will stay at arm's length in guaranteeing offsets unless industry is unable to satisfy a foreign government's demands and (2) FMS credits will not be used directly to finance coproduction or licensed production abroad.

Since the United States takes no active role in administering offset transactions, no agency comprehensively monitors offset activity. Likewise, no agency is responsible for ensuring that the various national interests are served when a U.S. firm makes an offset commitment to a foreign government as a condition for the sale of U.S. defense items. Coordination of the administration of offsets, to the limited extent it exists, does not involve other departments such as Treasury and Commerce, which have major interests in these transactions.

Although limited, existing information indicates that offsets are substantial elements in the sale of U.S.weapons systems, that the trend of offset demands is increasing, and that developing countries are joining the increasing number of industrialized countries demanding such concessions.

Although Defense has a policy that FMS credits will not be used to finance coproduction or licensed production abroad, there is no policy to prevent a country which has received FMS assistance, in the form of a grant or FMS credit, from requiring an offset commitment from a U.S. firm as a condition of sale. This offset could then be used by the FMS-recipient country to expand its own industrial base, possibly at the expense of the U.S. industrial base and U.S. jobs.

If this practice becomes widespread, in our opinion, it could run counter to U.S. interests because it diminishes the beneficial effects that advocates of FMS programs often speak of; that is, the FMS program does not result in a substantial outflow of U.S. resources since these funds return to the United States in the form of increased demands for goods. Accordingly, the Committee may wish to consider the need for the Congress to direct that the administration institute a policy to resist offset demands by foreign governments when FMS credits or grants are involved in the sale. Exceptions to this general rule might be made for foreign policy considerations.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives were to (1) determine what the national policy is on this issue, (2) ascertain what federal agency has responsibility for monitoring offset activities, (3) determine how agencies coordinate the administration of offsets, (4) determine to what extent offsets are used in FMS and commercial transactions, and (5) identify what type of data base exists to track offset activities in order to determine their effect.

Our review was performed primarily in Washington, D.C., at Departments of Commerce, Defense, the Treasury, and State and the Office of the U.S. Trade Representative. We also visited the U.S. Air Force Aeronautical Systems Division, Foreign Disclosure Policy Office, F-5, F-15, and F-16 program offices, at Wright-Patterson Air Force Base, Ohio. At these locations we interviewed agency officials and representatives to obtain an understanding of procedures and practices associated with offset agreements. In most cases, these contacts provided pertinent supplemental documentation, such as policy reviews, studies, plans, and letters from members of the DPACT concerning the problems of offsets in foreign trade.

Our review was performed in accordance with generally accepted government audit standards.

DEFINITION OF OFFSET ELEMENTS

Although the terms of the offset on individual contracts may vary substantially and a contract may call for more than one kind of offset, offsets can generally be grouped into the following types:

COPRODUCTION

Overseas production based upon government-to-government agreement that permits a foreign government or producer to acquire the technical information and know-how to manufacture all or part of an item of U.S. equipment. It includes government-to-government licensed production. It excludes licensed production based upon direct commercial arrangements by U.S. manufacturers.

LICENSED PRODUCTION

Overseas production of all or part of an item of U.S. equipment based upon transfer of technical information and know-how under direct commercial arrangements between a U.S. manufacturer and a foreign government or producer.

SUBCONTRACTOR PRODUCTION

Overseas production of a part or an item of U.S. equipment. The subcontract does not involve license of technical information or know-how and is usually a direct commercial arrangement between the U.S. manufacturer and a foreign producer.

OVERSEAS INVESTMENT

Investment arising from the offset agreement, taking the form of capital invested to establish or expand a subsidiary or joint venture in the foreign country.

TECHNOLOGY TRANSFER (other than licensed production and coproduction)

Transfer of technology occurring as a result of an offset agreement that may take the form of:

1. Research and development conducted abroad.

2. Technical assistance provided to the subsidiary or joint venture of overseas investment (see above).

3. Other activities under direct commercial arrangement between the U.S. manufacturer and a foreign entity.

COUNTERTRADE

Purchase of goods and services from the buyer country as a condition of the offset agreement, excluding purchases under coproduction or licensed or subcontractor production. These purchases may be made by the U.S. government, the U.S. contractor, the contractor's suppliers, or by third parties with whom the contractor acts as a middleman. The purchase may involve products for defense or civil use.

Source: Department of the Treasury and the Aerospace and Electronic Industries Associations Survey, dated May 24, 1983.

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON ECONOMIC STABILIZATION
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July 15, 1983

Mr. Charles A. Bowsher
Comptroller General
of the United States
General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Bowsher:

The Subcommittee on Economic Stabilization has been conducting extensive hearings on revitalization of the U.S. defense industrial base. Thorough examination of this issue has revealed very serious problems.

One serious question which the Subcommittee wants to pursue is how "offsets" in foreign military sales (FMS) affect our defense industrial base. In overseeing these offsets and to stay abreast of their effect, I am requesting the GAO's assistance. I would like the you to:

1. Determine what our national policy is on this issue;

2. Ascertain what Federal agency has responsibility for monitoring offset activities;

3. Determine how agencies coordinate the administration of offsets;

4. Determine to what extent offsets are used in FMS and commercial transactions; and

5. Identify what type of data base exists to track offset activities in order to determine their effect.

I understand that GAO is already doing work in this area, and this request has been discussed with the staff of the National Security and International Affairs Division. I appreciate their assistance and look forward to the results of these efforts. I would appreciate it if you could have a report issued to me as soon as possible, but not later than October 28, 1983.

Sincerely,

JOHN J. LaFALCE
Chairman

(463698)

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