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MILITARY EXPORTS

Analysis of an Interagency Study on Trade Offsets

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NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

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April 4, 1986

The Honorable John D. Dingell
Chairman, Subcommittee on Oversight
and Investigations
Committee on Energy and Commerce
House of Representatives

Dear Mr. Chairman:

In response to your October 23, 1985, letter and subsequent discussions with your office, we examined the scope and methodology of the administration's report, Impact of Offsets in Defense-Related Exports, issued to the Congress in February 1986. The report, mandated by the Defense Production Act Amendments of 1984 (Public Law 98-265), was prepared by an interagency committee chaired by the Office of Management and Budget (OMB).

Appendix I provides information on the data collection effort and the development of the interagency report. In developing the report, there was considerable interagency disagreement--with two principal agencies (Treasury and Commerce) openly critical of some findings.

We found a number of limitations in the study. For example, the study acknowledges that subcontractors--a group many sources believe is most likely to be hurt by offsets--were underrepresented in the data collection survey. Furthermore, information from nondefense industries was not gathered, even though nondefense firms can be affected when defense contractors agree to offsets involving unrelated products.

We recognize that obtaining comprehensive information on how offsets impact on subcontractors and nondefense industries would be very difficult. However, given these and other limitations, we believe the study's findings need to be qualified. The study's executive summary draws definitive conclusions about offset effects without recognizing important qualifications and caveats that are in the body of the report.

In evaluating the data base developed for the study, we examined the design of the questionnaire administered by the International Trade Commission (ITC) on behalf of the interagency group. We also examined the accuracy of data transferred from completed questionnaires to the computer for tabulation and analysis. We did not attempt to verify the accuracy or completeness of respondents' replies other than to test selectively for conflicting data that might be indicated by cross-checking answers to related questions.

We discussed the development of the questionnaire and the interagency report with officials at ITC, OMB, the Departments of Commerce, Defense, Labor, State, and Treasury, and with officials in the Office of the U.S. Trade Representative and the Council of Economic Advisors. We also held limited discussions with selected industry representatives. Our work was performed from January to April 1986 in accordance with generally accepted government auditing standards. The views of directly responsible officials were sought during the course of our work and are incorporated in the report where appropriate. In accordance with your wishes, we did not request OMB or other involved agencies to review and comment officially on a draft of this report. Unless you announce its contents earlier, we plan no further distribution of the report until 15 days after its issue date. If you have any questions, please call me on (202) 275-4128.

Sincerely yours,

Joan M. McCabe

Joan M. McCabe
Associate Director

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ANALYSIS OF AN INTERAGENCY STUDY ON TRADE OFFSETS

INTRODUCTION

Military sales between U.S. corporations and foreign countries continue to be negotiated not only on the basis of cost and military effectiveness, but also on the acceptance of corollary agreements designed to offset the purchase price. Foreign countries have increasingly required "offsets" when buying U.S. military equipment to enhance their own employment, technical knowledge, and production capacity. (See app. II for a definition of the various types of offset agreements.)

In April 1984, an amendment to the Defense Production Act of 1950 mandated that the administration study and report annually on the effect of offsets associated with military export sales. Specifically, it required the administration to assess the impact of offsets on defense preparedness, industrial competitiveness, employment, and trade of the United States. Additionally, administration reports were to include information on the types, terms, and magnitude of offsets. Implicit in the legislation and in the conference report was the need for a data base to facilitate analysis and reporting.

The Office of Management and Budget (OMB), on behalf of an interagency committee, submitted the first report to the Congress in February 1986, 4 months after its due date.[1] The report noted that for the study period 1980 to 1984 military export sales totaled over $22 billion and offsets were approximately $12.3 billion. An OMB official told us the drafters of the report considered that their mandate was to provide a macroeconomic assessment of the impact of offsets on the U.S. economy--and not an analysis of specific impacts on individual industries or sectors. Among the report's major findings were the following:

--The overall magnitude of offset obligations does not appear to be large in the context of either total exports by the companies reporting, or in the context of the value of total military production by these companies.

--The positive effects of sales on employment exceed by far the adverse effects of offsets.

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[1]The second executive branch study on offsets is due to the Congress in October 1986. Reports beyond that depend on extending the Defense Production Act, which is due to expire later this year.

--Available evidence suggests the profitability of defense-related industries has not been damaged by offsets.

--Effects of military trade on the total U.S. economy are likely to be close to zero.

The interagency study covered sales agreements involving offsets entered into from 1980 to 1984. The study did not assess the long-term impacts of offsets. However, the report does contain several statements regarding potential long-term effects. For instance, it notes that certain types of offsets, such as those involving technology transfer, may generate employment effects that will last long past the period of initial contract. It also notes that direct offsets, in the form of coproduction, licensed production, direct subcontracting and technology transfers, contribute to the production base of foreign producing nations and may have a potential long-run negative effect on some sectors of the U.S. defense industrial base.

Study participants and responsibilities

An interagency coordinating committee, chaired by OMB, was established to design the data collection instrument (questionnaire), analyze the data obtained, and develop a report. The OMB was chosen to coordinate this study because no executive branch agency has lead responsibility for military trade offsets. The interagency committee's principal members were the Departments of Commerce, Defense, Labor, and Treasury. The Department of State, the Office of the U.S. Trade Representative, and the Federal Emergency Management Agency had minor roles in writing the study. The National Security Council and the Council of Economic Advisors reviewed the final draft of the report. The International Trade Commission (ITC), although not a member of the coordinating committee, played a major role in the data collection effort.

The coordinating committee began designing its questionnaire during the summer of 1984. At the same time, ITC was starting a barter and countertrade study and submitted a questionnaire to OMB for clearance under requirements of the Paperwork Reduction Act. To avoid duplication and reduce the burden on the firms surveyed, OMB decided to add the coordinating committee's questionnaire to ITC's since both were aimed at obtaining similar information. ITC agreed to conduct the combined data collection effort.

In designing its questionnaire, the coordinating committee obtained the views of industry representatives, who commented that the questionnaire was too detailed and that information requested was not readily available. The questionnaire was modified based on these comments; nonetheless, some industry officials told us that the time required to complete the final questionnaire still ranged from 175 to 400 hours. This contrasts with the 35 hours originally projected by the questionnaire designers.

The questionnaire was divided into four parts as follows:

Section I	Aggregate Sales Data on Military and Nonmilitary Domestic and Foreign Sales
Section II	Contracts Involving Countertrade Not Associated With Military Related Export Sales
Section III	Overseas Military Related Export Sales Involving An Offset Agreement.
Section IV	Comments on Questionnaire

Section III of the questionnaire was further divided into (1) offset agreements with a face value of less than $2 million where only general information was requested and (2) offset agreements over $2 million where more detailed responses were required. Both were to be addressed by prime defense contractors. Several questions were also grouped together and directed at subcontractors, but the questionnaire did not make clear whether they were to be answered according to the above criteria.

Survey coverage

The questionnaire went principally to defense prime contractors and to some subcontractors, but was not sent to nondefense industry sectors also affected by offsets. Comments cited throughout the body of the interagency report recognize an underrepresentation of subcontractors and other industry sectors affected by offsets and the consequences thereof. For example, the report notes that subcontractors were underrepresented to such a point that the survey data collected is likely to underestimate employment effects by a significant amount. It also notes that the offsets are likely to have a large impact on subcontractors. The report further indicates that a survey question asked respondents to describe the domestic employment impact only on their firms. As a result, data on the employment effects on lower tier subcontractors, which supply the defense firms surveyed, was not obtained.

Basis for analyzing interagency report

The interagency report suggests a higher number of firms in the offset data base than is actually the case based on the number of companies that responded to the offset questions in section III of the questionnaire.

Because no complete listing of companies involved in offsets was available, the interagency committee judgmentally compiled a mailing list of over 200 companies from various publications which listed defense contractors, trade associations and other organizations involved with military export sales. When asked whether all major companies dealing in offsets were sampled, officials at Commerce, Treasury, and ITC indicated it was largely a "shot in the dark."

The interagency committee reported that 212 corporate entities (parent companies and subsidiaries) were surveyed. After consolidating subsidiaries' responses with those from parent companies, the committee received data representing 139 consolidated companies. However, only 63 of those 139 companies[2] surveyed actually reported any activities involving offsets.

The interagency report does not clearly distinguish among the total companies sampled, the lesser number of companies who reported military sales dollar values, and the even smaller grouping who responded to the specific offset questions. For example, the report's executive summary shows that 212 corporate entities were surveyed and also states that "nearly 90 percent of the respondents to the survey stated that offsets were a necessary condition for the sale." No mention is made of the response rate or the number of companies that did not report any offset activities. Other information presented narratively, and in the tables cited in the report, often does not indicate the nonresponse rate to individual questions.

QUESTIONNAIRE DESIGN LIMITS DATA COLLECTED

The questionnaire's defense trade offset section was not properly designed. It included nonstandardized (open-ended) response formats and undefined terms. These design problems can lead to imprecise tabulations, nonresponses, and/or a lack of uniform responses. For example, one question asked respondents to describe the domestic employment impact on their firms of the sales agreement and offset-related obligations under consideration. The term "domestic employment impact" was not defined; and the question did not specify the time period to be considered, the type of response desired--i.e., quantitative or qualitative--or whether both positive and negative impacts were to be disclosed. Also, the response format for this question tended to discourage companies from giving a detailed response since only two blank lines were provided for an answer.

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[2]These included 42 prime contractors and 21 subcontractors. Prime contractors also reported on offsets for transactions where they performed in a subcontractor capacity.

Without the necessary specificity in the questionnaire, respondents are likely to base their answers on different considerations and report them in a nonuniform manner; our examination of selected responses showed this to be the case. Nonuniform responses make it difficult to aggregate data and raise questions about the validity of the aggregation as presented in the interagency report.

Several questions solicited multiple answers, but the format did not provide for separate responses. In other cases, information sought seemed to be limited. For example, one question asked for the name of competing firms for individual sales contracts; it did not ask whether those firms were known to be offering offsets, or whether offsets were being offered by both U.S. and foreign competitors.

In addition, other data collection limitations included the following:

--The questionnaire collected detailed information on offsets valued over $2 million. It collected considerably less detail for offset agreements under $2 million. As it turned out, the total number of sales with offsets reported in this category was almost twice that of sales with offset arrangements over $2 million. Thus, specific information on plant and equipment capacity, employment impact, and the goods and services requested was not collected for many offset agreements.

--Companies were not specifically asked to identify what goods and/or services would be imported as a result of their offset arrangements. The report, as a result, assumed all offsets involving countertrade are imported into the United States and not disposed of overseas.

--The questionnaire did not collect data that would give a complete picture of individual offset transactions for sales agreements concluded during the study period. Excluded were details on goods and services involved in satisfying those offset agreements beyond the study period. The interagency study found that implementation of offset agreements was spread over an average of 12 years. Also excluded were details concerning some offsets negotiated separately by subcontractors.

Accuracy of offset values collected

We reviewed a small number of completed questionnaires to verify the accuracy in ITC's processing of responses and to determine whether the data base included all pertinent information from prime contractors and subcontractors. Our review indicated some errors in processing questionnaire responses, resulting in both overreporting of sales and underreporting of offset values.

In one instance, about $700 million of a subcontractor's sales during the 1980-84 period was entered into the data base twice; once separately and again as part of the parent company's sales amount. In another instance, an offset of about $96 million reported by a prime contractor was never entered into the data base because the company reported the value in the wrong column on the questionnaire grid.

Our review also indicated that some offsets may not have been reported. The questionnaire was designed so that all offsets associated with a military export would be reported by the prime contractor. However, in a small judgement sample of subcontractor questionnaires we found several instances where it appeared from their narrative responses that offsets totaling $313.7 million may not have been reported by their prime contractors. In these instances offset values cited by subcontractors were larger than the total values reported by the prime contractors. This raises the question as to whether prime contractors were reporting all offsets passed on to their subcontractors. We did not attempt to verify the accuracy or completeness of reporting by respondents other than to test for discrepancies evidenced by conflicting data.

We also found over $110 million in offsets which were not included in the total value of offsets reported because they were reported by U.S. companies serving as subcontractors to foreign prime contractors; the latter were not included in the survey.

According to an OMB official, another factor which could also affect the reporting of offset amounts is that offset arrangements are not always tied directly to a specific military sale. Some firms are able to build up offset credits in advance of sales against which they are applied. The questionnaire was not designed to gather information regarding this type of arrangement.

INTERAGENCY DISAGREEMENTS AFFECT STUDY COMPLETION

Disagreements existed concerning access to survey data, how the study would be done, and what would be reported. Two agencies have expressed disagreement with the report issued by the interagency committee.

Access to data collected was a problem

A controversy developed over what information was to be made available for the interagency study from the completed data collection effort even as the questionnaire was being finalized and sent out. OMB had assured the coordinating committee members that they would have access to all information collected by ITC in order to do their analysis of the offset issue. ITC, to protect sensitive business interests, declined to provide specific data and indicated it would provide information only in the aggregate. ITC also insisted on withholding response data involving the names of companies and competitors for a sale, product descriptions, and other identifying data, stating that this type of information was business sensitive and should be protected. ITC promised respondents such protection in a statement added to the questionnaire.

Commerce, Labor, and Treasury opposed this approach stating they would not be able to provide a thorough and meaningful analysis of offsets. Their comments reflect the desire to begin with a microanalysis of individual sectors and firms versus the macroanalysis OMB told us was their mandate. They noted that aggregated data would not disclose important differences and possible impacts of offset requirements among products and industries. Further, deleting firm names and competitors would obscure instances where U.S. firms were engaging in offsets to compete against each other as opposed to foreign competition. In addition, it would preclude any opportunity to identify all the parties to a sale, including subcontractors, and would prevent any efforts to obtain follow-up information and/or verify the accuracy of data reported.

After months of negotiations, and after OMB had formally demanded the data, ITC agreed that it would provide individual response data as reported by industry but with all reference to company name, product name, and competitor name deleted from the data base. Commerce and Treasury continued to voice concern over the limitations. According to a Treasury official involved in the study, the only way that a meaningful analysis of offsets could be done was for the agencies to have unlimited access to the individual company responses sent to ITC.

Coordinating committee told to begin drafting report without survey data

The coordinating committee initially designed a report outline which focused on specific congressional concerns and assigned lead agency responsibilities as follows:

Summary	OMB
Chapter, Defense Preparedness	Defense
Chapter, Industrial Competitiveness	Commerce
Chapter, Employment	Labor
Chapter, International Trade Position	Treasury
Appendices:	
Glossary of Terms	OMB
Types, Terms and Magnitude	Commerce
Bilateral and Multilateral Negotiations	U.S. Trade Representative
Memoranda of Understanding	Defense

An OMB internal memorandum dated January 17, 1985, indicated that the participating agencies had been directed to begin drafting their report sections based on existing data. OMB said that the survey data, once obtained, could be used primarily as support for the information drafted or to fill in gaps wherever possible to strengthen the analysis. OMB officials told us that their intent was to begin writing the report as early as possible because of tight deadlines and dispersion of responsibilities among several agencies. They also pointed out that sources other than the questionnaire provided data for the report.

Treasury officials insisted on first having the survey results, expressing the view that this new data was needed. Also, Treasury had planned to use analyses performed by the other agencies as a basis for its assessment on the effect of offsets on international trade. Treasury believed this, along with short time frames, would not permit it to do a thorough and meaningful analysis; as a result, Treasury withdrew from participation in drafting the report. OMB and Labor then assumed responsibility for drafting the trade section.

Two agencies disagree with issued report

In December 1985 letters to OMB, Treasury and Commerce expressed disagreement with the report the interagency committee planned to submit to the Congress. Treasury objected to the report noting that it added no new information on offsets and that it contained numerous unsubstantiated assertions, erroneous conclusions, and contradictory statements. In reviewing the issued report, a Treasury official stated that the same problems existed.

Commerce did not concur with the report stating that its segment on industrial competitiveness no longer contained the substance or perspective of the draft that it had submitted. Examples of statements in Commerce's draft which were deleted include the following:

--"...offsets are increasing foreign competition through transfer of technology and production capability, and are contributing to the erosion of the U.S. subcontractor base. As offsets increase, U.S. systems costs rise, further adding to U.S. government defense procurement costs. The cycle is further perpetuated."

--"To the extent that offsets have and will continue to reduce the USG capability to purchase adequate numbers of domestically produced defense systems, they will contribute to the erosion of the U.S. defense base."

--"There is a need for more detailed analysis of the impacts of offsets on the U.S. defense industrial base, particularly at the subsectoral level."

When asked why the deletions were made, an OMB official told us it was because the Commerce draft made numerous unsubstantiated assertions, and that a consensus for the deletions existed among the coordinating committee members. While we did not independently assess the validity of deleted Commerce data, we noted that the essence of some of the information deleted is contained at various points in the OMB report, though perhaps not quite as explicitly or with the implications presented by Commerce.

Both Commerce and Treasury also disagreed with the report on the grounds that it did not objectively present the available data. Officials of both agencies told us during our review they still disagreed with the issued report.

FINDINGS AND CONCLUSIONS NOT APPROPRIATELY QUALIFIED

Although the study recognizes that certain industrial sectors may be disproportionately affected by offsets and that long-term effects were not measured, its findings are not qualified to reflect this. According to OMB officials, findings are presented on a macroeconomic basis because that was how they viewed the intent of the study.

Even so, the caveats and qualifications contained in the body of the report concerning data and analysis limitations are sometimes lacking in the executive summary so that some findings read like firmly substantiated conclusions. Some examples follow:

--One finding states that "the employment effects of the sales exceed by far the adverse effects of offsets. Even when one considers the upper-bound estimates, the study finds that the positive effects of sales exceed the adverse effects by about 62,000 job opportunities." The body of the report points out that 62,000 is an upper limit; it includes a corresponding lower limit of 30,000 job opportunities. The body of the report points out that both survey data and an economic technique used in developing the employment estimate have important limitations. The approach is used for deriving "ballpark" estimates. However, in the absence of better data or methodologies, the finding should not be worded in such definitive terms. Also, this finding is not qualified to indicate that adequate information was not obtained from some important industry sectors which may be disproportionately affected by offsets. Nor does the finding specify that the examination of long-term effects was beyond the study's scope.

Also, the interagency report uses numerous tables in examining the employment impact created by offset arrangements. These tables should be viewed in relation to the qualifications and caveats cited in the text describing them. For example, one table showing domestic production for direct and total employment effects is generated using the survey data for offset type and industry description and applies an economic model, involving many assumptions, along with the survey data, to generate the number of job opportunities. The report narrative states that these estimates are "fictitious" (hypothetical) in that there is no basis for assuming that the estimates represent the adverse employment effects of indirect offsets. The narrative also states that the effect of offsets such as indirect foreign investment and technology transfer on near-term domestic production and employment are impossible to measure.

--Another finding dealing with the impact of offsets on the U.S. trade position states that "the effects of military trade on the U.S. economy as a whole are likely to be close to zero, because any imbalances in such trade are likely to be counterbalanced by capital flows that effect both interest rates and exchange rates, thereby generating changes in domestic production and flows of goods and services." The finding does not discuss specific sectors that can be disproportionately affected by offsets.

--An additional finding states that "available evidence suggests that the profitability of defense-related industries has not been damaged by offsets." This finding is not qualified to reflect the limited coverage, particularly underrepresentation of subcontractors, provided by the data collected for this study and the adverse effects that potentially could be felt by industry sectors providing inputs to defense industries.

--Another finding states that "to the extent that arms sales would not take place in the absence of offsets, sales with offsets have net economic benefits for the U.S. as compared with no sale at all." This statement assumes that any adverse effects on other parts of the U.S. economy will be outweighed by the positive effects of winning the sale, but the body of the report notes that possible negative impacts are the loss of subcontractor work and the creation of foreign competitors. The impact on subcontractors and the potential for future competitors are areas the report was least able to deal with.

We recognize that the interagency study dealt with a difficult subject for which there are no easy answers. However, given the extent of data limitations and study coverage, the findings reported should be appropriately qualified.

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

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 below).

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.

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