

GAO

Report to the Honorable
Alan J. Dixon, U.S. Senate

April 1990

DEFENSE PRODUCTION ACT

Offsets in Military Exports and Proposed Amendments to the Act



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National Security and
International Affairs Division

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April 19, 1990

The Honorable Alan J. Dixon
United States Senate

Dear Senator Dixon:

In response to your February 20, 1990, request and discussions with your Office, we reviewed:

- The Administration's 1988 report to the Congress, Offsets in Military Exports. Specifically, we addressed the interagency process used to prepare the report, the extent of factual analysis, the use of economic models to measure the impact of offsets, and differing agency views on assessing the impact of offsets.¹
- Certain provisions of Section 114, Annual Report on Impact of Offsets, of Senate bill 1379, entitled Defense Production Act Amendments of 1989. Specifically, we
 - (1) commented on provisions that relate to including differing agency views in the offsets report and
 - (2) provided information that might indicate the degree of burden on industry in responding to the bill's proposed reporting requirements on agreements involving offsets exceeding \$5 million.

Background

The Defense Production Act of 1950, as amended, requires an annual report on the impact of offsets on defense preparedness, industrial competitiveness, employment, and trade of the United States. Section 309(b) of the Defense Production Act requires each offsets report to be based on interagency studies designed to show the short- and long-term effects of offsets, including those resulting from technology transfer to other countries, and the direct and indirect effects of offsets on lower-tier defense subcontractors and on non-defense industry sectors that may be adversely affected by offsets. According to the Office of Management and Budget (OMB), interagency studies are those conducted by more than one agency participating in preparing the report. Further, the Defense Production Act requires the offsets report to summarize the findings

¹Offsets are a range of industrial and commercial compensation practices required by foreign governments and firms as conditions for the purchase of military exports. The various types of offsets include coproduction, licensed production, subcontractor production, overseas investment, technology transfer, and countertrade. Offsets are negotiated by prime contractors, but the Congress has expressed concern that offset obligations are passed down to subcontractors and lower tiers of production.

impact on lower-tier defense subcontractors and non-defense industry sectors. However, the results of the methodology used are of limited value because they do not identify the effect on more specific industry sectors critical to defense. Moreover, the use of differing significant assumptions in the application of that methodology makes the analyses of the two sections inconsistent and appears contradictory.

The 1988 offsets report summarizes new data on prime contractors collected during 1988 for the Interagency Coordinating Committee from U.S. firms involved in defense sales featuring offsets. However, the 1988 report does not contain any analysis of the new data, which OMB attributed mainly to delays caused by the uncertainty of statutory action on related legislation in 1988. The report basically restates analyses and findings of the three prior annual offsets reports to the Congress that were based on data collected in 1985.

The interagency process for drafting the 1988 report was mostly informal, allowing the Interagency Coordinating Committee to complete the report by the statutory deadline. However, the Defense Production Act provides a formal mechanism for reflecting differing agency views in the report. According to the OMB representative who chairs the Committee, including differing views in the report requires an interagency study, and because no such studies had been prepared, differing views have not been included in the offsets reports. We found that for the 1988 and previous reports, adopting such differing views may have significantly affected the reports' conclusions.

Senate bill 1379's proposed amendments to the Defense Production Act, as well as the Defense Production Act itself, need to be changed to better provide for disclosing in the annual report significant differing agency views. That is, an agency involved in preparing the report should not be required to perform an independent study, as Senate bill 1379 proposes, or an interagency study, as the act provides, as a precondition to be met before its significant differing views must be included in the report.

reviewed the comments and decided which revisions would be made for the final report. The Committee members did not vote in the meetings held to discuss the report. When a consensus could not be reached at the Committee meetings, differing comments were set forth in letters to OMB by senior officials in the agencies. (Significant differing agency views are discussed on page 8.)

Data and Analysis

The 1988 report summarizes new data on prime contractors collected during 1988 by the Bureau of Economic Analysis. The survey extended and expanded a 1985 International Trade Commission data base to include information on sales and offsets through 1987. However, the 1988 report does not contain any analysis of these new data. OMB officials explained that (1) they postponed the Bureau's data collection process while awaiting final congressional action on new legislation that would have added an offset reporting requirement and may have changed the data collection effort and (2) by the time the survey results were obtained from industry and the Bureau prepared preliminary summary tables of the data in late December 1988, there was insufficient time to analyze the new data and include the analysis in the report.

The 1988 report basically restates the analysis and findings of the three prior reports to the Congress on the impact of offsets using data collected in 1985 for the Coordinating Committee by the International Trade Commission. This earlier data base covered calendar years 1980-84 and contained narrative responses to selected questions, sales data, information on military export sales with related offset obligations of over \$2 million, and summary information on offsets of \$2 million or less. These restated analyses include the effect of offsets on defense preparedness, industrial competitiveness, employment, and international trade.⁵ The 1988 report also reproduces previous analyses based on case studies and contains a new case study on the offsets related to the sale of the F-16 aircraft to Greece.

The industrial competitiveness, employment, and international trade sections in the 1988 report were primarily reiterations of previous reports with some modification. However, the defense preparedness section, according to OMB, contains new analysis done by Data Resources,

⁵See our earlier report *Military Exports: Analysis of an Interagency Study on Trade Offsets* (GAO/NSIAD 86-99BR, Apr. 1986.)

imports over the period studied, which was 1980-84. Based on this analysis, the report concluded that offsets have had little effect on the levels of employment, either U.S. or foreign, although they have affected the distribution of employment across industries.

Based on the use of an input-output model to analyze the impact of offsets on defense preparedness, the offsets report provided an assessment of the overall effect of offsets on the top 30 defense industries.⁷ Such an aggregated analysis, however, does not result in identifying the impact of offsets on particular suppliers or industry segments critical to defense. For example, this model can be used to estimate the aggregate impact of offsets and their associated exports on the ball and roller bearing industry. However, it does not provide information on the impact on specific segments of that industry, such as superprecision ball bearings, which are important to DOD. Moreover, an input-output model is subject to limitations that affect its predictive accuracy. For example, it does not allow for adjustments in the demands for industry outputs to changes in prices. While showing the impact of offsets on industry segments is an inherently difficult task methodologically, there is no obviously superior alternative to the input-output model.

Although the defense preparedness and employment analyses both used input-output models, the defense preparedness analysis did not employ a balance of trade assumption such as the one used in the employment analysis. The general result of such an assumption was essentially to eliminate the estimated positive effect of offset agreements on the level of U.S. employment. If a similar assumption were applied in the input-output analysis of defense preparedness, the result would be to reduce any estimated increases in output of the overall economy due to the offset agreements. With regard to the 30 industries reported on, the result of such a balance of trade assumption would also be to reduce the estimated increases in output due to the agreements, but this effect may be small.

The assessment of the impact of offsets based on the use of economic models in the two report sections is highly dependent on strong assumptions employed in the analysis. Specifically, the implicit assumption in the defense preparedness section that the reported offsets were necessary for the reported exports and the assumption in the employment

⁷The Data Resources, Incorporated, Interindustry Model contains 432 industries. Motors and generators, ball and roller bearings, and iron and steel forgings are examples of the lowest level of detail represented by the manufacturing industries in the model.

In addition, another agency official said that OMB consulted with private industry on the amount of effort that would be required to respond to such a survey and industry objected, saying that such a survey would be burdensome, complicated, and expensive.

Conversely, the Federal Emergency Management Agency, Commerce, and Treasury officials said that surveying only prime contractors does not provide sufficient subtier visibility. These officials said such a survey would limit the precision of the analysis at all tiers. Although the survey provides an aggregated analysis, it does not identify the effect on lower-tier subcontractors, including particular types of suppliers and segments of the industrial base critically important to defense needs.

Comments on Proposed Amendments to the Defense Production Act's Offsets Reporting Requirements

Section 309 (b) of the Defense Production Act currently provides a formal mechanism for reflecting differing views. That is, the act requires the annual offsets report to contain a summary of the findings and conclusions, including differing views of the agencies involved in the requisite interagency studies that formed the basis of the offset report. However, OMB officials said that including differing views in the report requires an interagency study, and since no such studies had been prepared, differing views have not been included in the offsets reports.

Senate bill 1379 would make the Department of Commerce the new lead agency responsible for preparing the offsets report. The bill would also provide that the Secretary of Commerce may include alternative findings or recommendations in the report if the Secretary has been given, during report preparation, an independent study or analysis on which such views are based.

We believe that Senate bill 1379's proposed amendments to section 309 of the Defense Production Act should be changed to better provide for the inclusion of significant differing views in the annual offsets report. For the 1988 and previous offsets reports, differing agency views regarding such basic matters as study methodologies and assumptions that may have significantly affected the reports' conclusions were not included in the reports. We believe that an agency involved in preparing the report should not be required to perform an independent study, as Senate bill 1379 proposes, or an interagency study, as the act provides, as a required precondition to have its significant differing views included in the report.

reported such sales with offset agreements valued at more than \$2 million.

We have no basis to assess the other aspect of the reporting burden, that is, the average time required for firms to respond to the proposed requirement. OMB has estimated that the reporting burden for the 1988 collection of information varied from 5 to 60 hours per response, with an average of 20 hours. This estimate included time for reviewing instructions, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the information. If the information Senate bill 1379 and implementing regulations would require is similar to the 1988 survey, then the average response time may be similar to OMB's estimate.

Matters for Congressional Consideration

The Congress may wish to consider amending section 309(b) of the Defense Production Act to better provide for the disclosure of significant differing agency views. Specifically, the Congress may wish to provide that agencies participating or consulting in developing the offsets report will have their significant differing views included in the report without performing additional studies or analyses. The formal studies that have actually been done are not of such obvious merit as to warrant the exclusion of less formally derived views.

Objectives, Scope, and Methodology

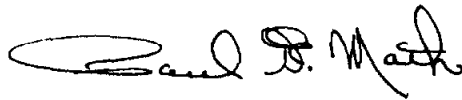
In response to your February 20, 1990, letter, and subsequent discussions with your Office, the objectives of our review were to (1) provide the results on the 1988 offsets report and (2) provide our comments and information relating to section 114 of Senate bill 1379.

Our review of the 1988 offsets report was done for the Subcommittee on Legislation and National Security, House Committee on Government Operations. On October 17, 1988, the Subcommittee requested that we evaluate a broad range of issues relating to the adequacy of information on the U.S. defense industrial base. As requested, we provided the Subcommittee a report in November 1989 on several of these issues.⁹ As agreed with the Subcommittee, we did not include the results of our review on offsets reporting, but did provide a briefing to the Subcommittee on April 12, 1989.

⁹Industrial Base: Adequacy of Information on the U.S. Defense Industrial Base (GAO/NSIAD-90-48, Nov. 15, 1989.)

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix II.

Sincerely yours,

A handwritten signature in black ink that reads "Paul F. Math". The signature is written in a cursive style with a large, stylized initial "P" and "M".

Paul F. Math
Director, Research, Development,
Acquisition, and Procurement Issues

Appendix I
Excerpts of Agency Comments on the 1988
Report on Offsets in Military Exports

"The material with which we do concur would include mainly the historical reviews of U.S. Government actions and policy statements related to offsets, the presentation of data from this year's survey, and the summary of Greek offset programs."

- DOD's January 4, 1989, letter, signed by the Assistant Secretary of Defense for International Security Affairs, stated that:

"DOD concurs with the draft fourth annual report to Congress on Offsets in Military Exports subject to the changes outlined on the attached markup."

- The Department of Labor's January 5, 1989, letter, signed by the Deputy Secretary of Labor, stated that:

"We have reviewed the draft report and find that except for some required editorial changes which will be submitted to your staff it is satisfactory and responsive to the Congress. Therefore, we have no objection to its being transmitted to the Congress."

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Excerpts of Agency Comments on the 1988 Report on Offsets in Military Exports

On December 12, 1988, OMB forwarded to all of the agencies on the Coordinating Committee the final draft of the 1988 military offsets report. The following excerpts are responses to OMB's request for comments by the agencies that drafted major segments of the report.

- Commerce's December 30, 1988, letter, signed by the Under Secretary for Export Administration, stated that:

"This Fourth Report for Congress consists mostly, but not exclusively, of information and analysis already presented in the three previous annual reports and in the three year summary report. As you are aware, the Department of Commerce was dissatisfied with these earlier reports and did not concur with their original submission to the Congress. Since we are on record as non-concurring with these previous reports, we regretfully cannot accept the submission of the same information this year.

"Moreover, I believe that resubmission of the same information will have the undesirable effect of obscuring the new data and analysis that is contained in the report, including the new survey data collected this year by the Department of Commerce/Bureau of Economic Analysis, the Case Study of the F-16 Aircraft Sale to Greece, as well as the portions of the report responding to the new Defense Authorization Act reporting requirements . . .

"In conclusion, I recommend that OMB, as editor for the DPA report, make the necessary changes to make this document acceptable to all agencies concerned."

- Treasury's January 9, 1989, letter, signed by the Deputy Assistant Secretary, Trade and Investment, stated that:

"Treasury did not concur in the earlier reports pursuant to Section 309 of the Defense Production Act, due primarily to the procedures adopted for handling the survey data and secondarily to the tone of parts of the reports, which could have been read as justifying other governments' offset practices. But with this year's change in procedures for collecting and analyzing the data, and with an eye toward the international negotiating effort required by the Defense Authorization Act, we hope such differences can be put behind us.

"Our drafting changes in the main are aimed at deleting the recapitulations of previous reports. This principally would affect Section IV and the first three case studies in Section V. Our primary concern is that these passages may be read as sympathetic to other countries' offset practices and hence may prejudice the impending U.S. negotiating effort. If specific discussions of the defense, competitiveness, employment and trade effects of offsets are considered necessary, additional preliminary analysis of the new data could be inserted. . . .

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Abbreviations

| | |
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| DOD | Department of Defense |
| OMB | Office of Management and Budget |

This review included analyzing the 1988 interagency report, Offsets in Military Exports, and the interagency procedures used to draft the report. In response to the Subcommittee's request,

- we analyzed the 1988 report to determine whether the report included an analysis of facts related to offsets and attempted to assess the effects of these offsets on the defense industrial base and
- we discussed the contents and analysis of the 1988 report, the procedures used to draft the report, and the participants' views on the assumptions and methodologies used with various interagency participants.

In response to your request for comments on section 114 of Senate bill 1379, we analyzed relevant legislation, including the reporting requirements related to military offsets and the proposed amendments to these legislative requirements. Reviews related to the 1988 report were performed from January 1989 through March 1989 and our review of the legislation was performed during February 1990 and March 1990.

The views of responsible agency officials were sought during the course of our review and are incorporated where appropriate. As requested, we did not obtain official agency comments on this report.

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

Unless you publicly announce its contents earlier, we plan no further distribution of the report until 30 days from the date of the report. At that time, we will send copies to the various agencies that participated in the interagency process and other interested parties and make copies available to others on request.

We believe Senate bill 1379 should provide for authorizing the inclusion of significant differing agency views in the report if the Secretary of Commerce has been given, during the preparation of the report, the basis for such views. Further, instead of merely giving the Secretary the discretion to include such views, as Senate bill 1379 currently provides, we believe that Senate bill 1379 should amend the Defense Production Act to require the Secretary to include such differing views in the report if an agency has provided Commerce with the basis for its views.

Offsets Reporting—the Burden

Section 114 of Senate bill 1379 would also amend section 309 of the Defense Production Act by adding an offsets reporting requirement. U.S. firms entering into a contract for the sale of a weapon system or defense-related item to a foreign country or firm, if such a contract is subject to an offset agreement exceeding \$5 million, would be required to furnish information concerning the offset agreement to the federal government.

Our analysis of the data collection efforts related to the annual 1988 offsets report tends to suggest that the reporting burden in terms of the number of corporations affected may be limited. For instance, as previously stated, the Bureau of Economic Analysis' 1988 survey questionnaire was sent to 52 corporations selected from the top 100 DOD contractors. According to the Arms Control and Disarmament Agency, the total value of U.S. military exports for the years 1980-85 amounted to \$58.7 billion. This amount appears to approximate the universe of contracts "for the sale of a weapon system or defense-related item to a foreign country or firm" referred to in Senate bill 1379. The 1988 offsets report states that almost 90 percent of this amount, or approximately \$52.4 billion, represented the value of military exports, with or without offsets, for the 52 corporations surveyed.

The Bureau's survey included military export sales contracts that were signed between January 1, 1980, and December 31, 1987, and involved offset agreements. For the sales with offsets over the 8 years covered in the survey, the report states that 36 of the 52 corporations reported approximately \$35 billion in sales exceeding \$500,000. The reported value of these offset agreements was approximately \$20 billion.

In addition, the 1985 survey done by the International Trade Commission reported that relatively few corporations accounted for a high percentage of the value of military exports and that only eight companies

section that military exports must be balanced by equivalent imports over the 5-year period considered, strongly influenced the results obtained. Further, we believe that using the balance of trade assumption in the employment section of the report and not in the defense preparedness section appears to make the two analyses inconsistent. This appears to be a significant contradiction and should have been addressed in the report.

The report's discussion of the effect of offsets on industrial competitiveness and on international trade was not based on quantitative models. The industrial competitiveness section concludes that the effect of offsets on U.S. competitiveness is mixed. The international trade section concludes that the effect of offsets is unknown due to unobservable facts about other governments' behavior.

Agency Views Differ on Methodologies Used to Assess the Impact of Offsets

The report used data collected from prime contractors as a substitute for developing subcontractor data to measure the impact of offsets on the lower level tiers of production. The views of agency officials on the Coordinating Committee differed on whether or to what extent the 1988 report assessed the effect of offsets at the subtier levels of production. However, the differing views were not discussed in the report. The Committee considered three options for obtaining information on subcontractors: sending a questionnaire to (1) prime contractors, (2) subcontractors and suppliers, and (3) prime contractors, subcontractors, and suppliers.⁸

OMB and DOD officials said that the best approach was to survey prime contractors and use the input-output model to estimate subcontractor and supplier information because this method is consistent, systematic, and provides a measure of economywide effects. The officials cited the following disadvantages to surveying subcontractors and suppliers (the alternative usually proposed):

- no master list from which to generate a representative sample of subcontractors and suppliers and
- difficulty in obtaining proprietary information and questionable responses from subcontractors and suppliers based on an estimated value of contracts lost from prime contractors due to offsets.

⁸According to OMB documents, the Bureau of Economic Analysis estimated costs ranging from \$122,000 to \$173,000, for a survey of prime contractors and \$350,000 if subcontractors were also included.

Incorporated. This analysis used an input-output model.⁶ (See next section for details.)

According to OMB, there have been no interagency studies designed to show the effects of offsets on lower-tier defense subcontractors and on non-defense industry sectors that may be adversely affected by offsets, including effects resulting from technology transfer. The OMB representative stated that these matters have eluded serious analyses because of the difficulties in developing a valid research design for measuring both technology transfer and lower-tier impacts and the probable large cost of such studies.

OMB's representative stated that the 1988 report would be a baseline for the new Administration and reiterations of previous reports were appropriate. Treasury and Commerce had previously objected to prior annual reports and, therefore, objected to these reiterations. For example, Treasury's Deputy Assistant Secretary for Trade and Investment sent a letter to OMB noting the Department's disapproval of the report's tone and the inclusion of data to which the agency had strongly objected in the past. (See app. I.)

Economic Models Used to Measure Effect of Offsets

Analyzing the effect of offsets on defense preparedness in the 1988 report was based partly on a model of the U.S. economy developed by Data Resources, Incorporated, in conjunction with data obtained from surveying prime contractors. In this input-output model, the economy is represented by a set of equations intended to describe the linkages among industries in producing goods. Such models can be used to estimate the amount of output from each industry needed to produce a given set of final products. The analysis of defense preparedness implicitly assumed that the offsets reported were necessary to make the sales with which they were linked. The analysis used the input-output model to compare the output of major defense industries with and without exports accompanied by offset agreements. Based on this analysis, the report concluded that export sales increased the top 30 U.S. defense industries' real output after factoring out the related offsets effect.

The analysis of the impact of offsets on employment was also based on an input-output model. This analysis included a balance of trade assumption; that is, military exports must be matched by equivalent

⁶An input-output model provides a conceptual framework that helps to analyze the interrelationship among the resources used and goods produced by various industries.

Offsets in Military Exports—1988 Report

Interagency Process

The process for preparing the 1988 offsets report was mostly informal because there were generally no guidelines or written procedures to follow.³ However, the informal process allowed the Coordinating Committee to proceed from discussing OMB's proposed draft report outline to completing the final report quickly enough to be responsive to the statutory deadline.

The OMB representative proposed a draft report outline and a timetable for developing the 1988 report to the Coordinating Committee. The timetable began in May 1988 with a discussion of the outline and ended in December 1988 with the distribution of the final report to the Committee members. The following Coordinating Committee members did the analyses and proposed a draft of the report segments indicated:

- Department of Defense (DOD): defense preparedness;
- Department of Labor: employment;
- Department of Commerce: industrial competitiveness; and
- OMB: trade,⁴ introduction, and summary.

Commerce's Bureau of Economic Analysis collected information on military equipment export sales and related offsets from 1980 to 1987. The Coordinating Committee developed a questionnaire for the Bureau's use in collecting such information. The questionnaire was sent to 52 U.S. corporations selected by the Committee from the top 100 defense contractors. The questionnaire provided information on military export sales contracts signed between January 1, 1980, and December 31, 1987, valued at over \$500,000, and involved offset agreements.

A first draft of the report was ready by November 1988 and the OMB representative requested written or oral comments from all the agencies represented on the Coordinating Committee. OMB's representative

³This discussion of the interagency process refers primarily to the 1988 report. The procedures for the 1989 report are similar, although the timing of the report, as well as some aspects of its organization, differ slightly.

⁴Department of Labor customarily has been responsible for drafting the trade section. The Department of Treasury wrote on parallels between trade-related investment measures and offsets but this information was not included in the report.

and conclusions, including differing views, of the agencies that participated in the requisite interagency studies that formed the report's basis.

The National Defense Authorization Act, Fiscal Year 1989, also requires reports on offsets. Section 825(d) of the Authorization Act requires reports on the progress of international negotiations related to offsets and a report relating to the appropriate actions to be taken by the United States when other countries require offsets as a condition for a military sale. Section 825 (d)(1) requires the President to submit to the Congress a comprehensive report on contractual offset arrangements required of U.S. firms for the supply of weapon systems or defense-related items to foreign countries or foreign firms.

The 1988 offsets report was submitted to the Congress by OMB to fulfill reporting requirements of the 1950 act, as amended, and section 825(d)(1) of the National Defense Authorization Act.

Senate bill 1379 was introduced on July 24, 1989. Section 114 of this bill, Annual Report on Impact of Offsets, would make amendments relating to the substance of the report and the manner in which it is prepared.

Executive Order 12521, June 24, 1985, names OMB as the coordinating agency for the Executive Branch in preparing the offsets reports. OMB completes the report in December of each year and submits it to the Congress. Accordingly, OMB chairs the Interagency Coordinating Committee,² which prepares the report.

Results in Brief

Although section 309(b) of the Defense Production Act requires each annual offsets report to be based on interagency studies, OMB states that no such studies have been done because of problems in developing a valid research design to accomplish the statutory purposes of the studies and the probable large costs of such studies.

The methodology used to prepare the defense preparedness and employment sections of the 1988 report provided an assessment of the overall impact of offsets on U.S. industries, including the overall aggregated

²The organizations represented on the Committee include OMB; the Departments of State, Treasury, Commerce, Labor, and Defense (including the Office of the Secretary of Defense, the Office of the Assistant Secretary for International Security Affairs, and Defense Security Assistance Agency); the Federal Emergency Management Agency; the Arms Control and Disarmament Agency; the Central Intelligence Agency, the U.S. Trade Representative; and the National Security Council.

