

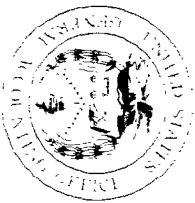
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United States General Accounting Office
Report to the Honorable
John R. Kasich, House of
Representatives

December 1990

MILITARY EXPORTS

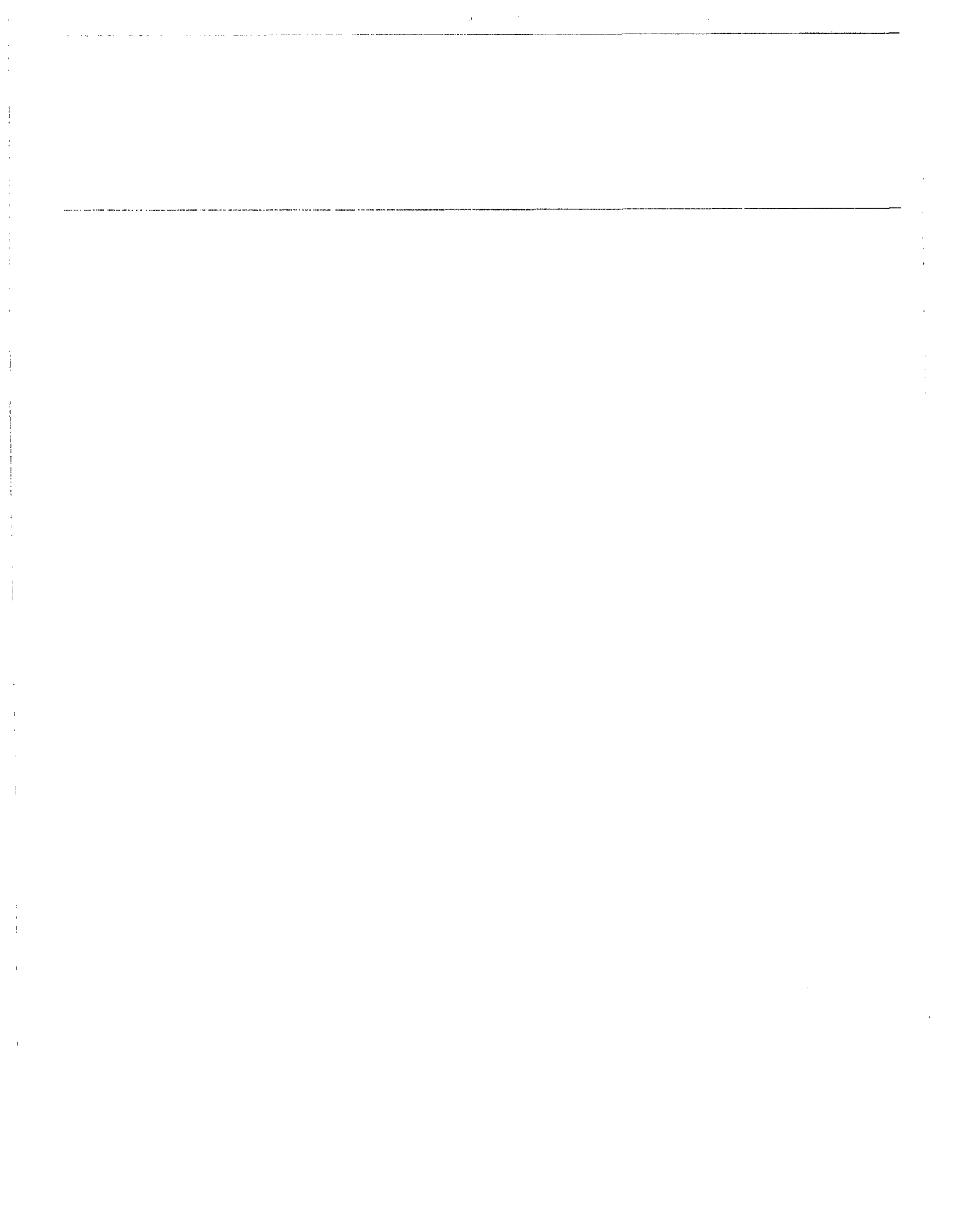
Implementation of Recent Offset Legislation



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National Security and
International Affairs Division

B-239622

December 17, 1990

The Honorable John R. Kasich
House of Representatives

Dear Mr. Kasich:

In response to your request we examined the implementation of recent congressional legislation involving offsets in military exports. Specifically, we determined what steps the executive branch has taken under the National Defense Authorization Act, Fiscal Year 1989 (P.L. 100-456), September 29, 1988, to (1) establish a comprehensive U.S. policy on offsets addressing technology transfer, U.S. financing of offset arrangements, and the effects of offsets on specific subsectors of the U.S. industrial base, (2) negotiate with foreign governments to limit the adverse effects of offsets, and (3) require U.S. industry to notify the Department of Defense (DOD) of offset arrangements exceeding \$50 million.

Background

Offsets are a range of industrial and commercial compensation practices required by foreign governments and firms as conditions for the purchase of military exports. Offset arrangements may be part of a government-to-government or commercial sale of defense articles or services. Offsets include technology transfers, licensed production, coproduction, and foreign subcontracting. Foreign governments require offsets to reduce the financial impact of foreign military sales, obtain valuable technology and manufacturing know-how, support domestic employment, and create or expand their defense industries. Generally, the U.S. government does not negotiate, guarantee, or impose restrictions on offset arrangements. There are exceptions to this position. In 1989, the U.S. government interceded to limit offset arrangements between the Republic of Korea and two competing U.S. airframe manufacturers. As a result, the Korean government agreed to limit the offset to 30 percent of the contract value.

The Congress and some executive branch agencies have expressed concerns that offset obligations have been passed from the prime U.S. contractors down to defense subcontractors and lower tiers of production. There is a growing perception that offset arrangements contribute to the erosion of the industrial base as technology and component production is transferred to foreign sources to satisfy offset commitments. In response to these concerns, the Congress expanded the executive

branch's responsibilities with regard to offsets in areas of policy development, negotiations with foreign governments, and data collection primarily through enactment of P.L. 100-456.¹

Results in Brief

The President's April 1990 policy statement on offsets does not specifically discuss technology transfers and the effects of offsets on U.S. industrial base subsectors, as required by Public Law 100-456. Although it recognizes that certain offsets are economically inefficient and market-distorting, the policy essentially reaffirms and is consistent with the U.S. government's traditional policy of non-involvement in offset arrangements.

As part of his policy statement, the President directed that an inter-agency team, led by DOD in coordination with the Department of State, consult—not negotiate—with foreign nations with a view toward limiting the adverse effects of offsets in defense procurement. At the time of our review, it was unclear when consultations would begin. DOD has not developed regulations, in accordance with P.L. 100-456, requiring U.S. industry to notify the Secretary of Defense of offset arrangements exceeding \$50 million. DOD has received only three voluntary notifications from industry since the law was enacted in September 1988.

President's Policy Statement

Public Law 100-456 directed the President to establish a comprehensive offset policy addressing (1) technology transfer, (2) the application of offset arrangements, including cases in which U.S. funds are used to finance the purchase by a foreign government, and (3) the effects of offset arrangements on specific subsectors of the U.S. industrial base and for preventing or ameliorating any serious adverse effects on such subsectors.

The President's policy statement of April 16, 1990, which was developed by an interagency group chaired by the National Security Council, does not specifically address technology transfers and the effects of offsets on specific subsectors. It does note that the U.S. government views certain offsets for military exports as economically inefficient and

¹Regarding other recent legislation, the Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418), August 23, 1988, requires the President to establish an interagency group, chaired by the Secretary of Commerce, to review and evaluate (1) U.S. policy on countertrade and offsets and (2) the need for and feasibility of negotiating with other countries to reach agreements on the use of countertrade and offsets. Commerce determined that the interagency group would focus on commercial countertrade issues, not offsets in military exports. Commerce did, however, participate in the formulation of the President's offset policy statement.

market-distorting. For example, officials who participated in the policy review said that offsets can increase costs to the buying country because of inefficiencies entailed in establishing new facilities and training skilled workers to produce all or part of a weapon system. Moreover, offsets may cause U.S. industry to engage in inefficient commercial activities, such as marketing foreign products, to satisfy an offset commitment.

The policy statement recognizes the need to minimize the adverse effects of offsets without undermining U.S. firms' competitiveness. In addition, the policy statement specifies:

- "No agency of the U.S. Government shall encourage, enter directly into, or commit U.S. firms to any offset arrangement in connection with the sale of defense goods or services to foreign governments.
- "U.S. Government funds shall not be used to finance offsets in security assistance transactions except in accordance with currently established policies and procedures.
- "Nothing in this policy shall prevent agencies of the U.S. Government from fulfilling obligations incurred through international agreements entered into prior to the issuance of this policy.²
- "The decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved.
- "Any exception to this policy must be approved by the President through the National Security Council."

Policy Kept General and Flexible

Members of the National Security Council chaired policy review group said that it was important to keep the policy broad and not specifically address all offset related issues, such as technology transfer and the impact on lower-tier subcontractors. These officials noted that technology transfer is not limited to offsets, is difficult to address in a policy statement confined to offsets, and is addressed through established technology review and munitions licensing procedures.

²For example, in 1975, the U.S. government guaranteed offsets to the European Participating Governments (Norway, Denmark, Belgium, and the Netherlands) in connection with the sale of F-16s to those countries. Offsets include continued European coproduction of 15 percent of the value of all third-country sales of F-16s.

These officials also believed it was inappropriate to highlight offsets impact on specific subsectors of the U.S. industrial base because of limited information available and the lack of consensus within the executive branch about this specific issue. DOD officials who participated in the policy review noted that these and other issues related to specific offset arrangements should be addressed on a case-by-case basis.

Policy Statement Reaffirms U.S. Government's Hands- Off Approach to Offsets

Several members of the offsets review group described the President's policy as a reaffirmation of the status quo. They noted that since 1978, the U.S. government has played a limited role in offsets. This position was established by DOD and emphasized that U.S. contractors were responsible for negotiating offset arrangements with foreign governments. As a result, over the past 12 years U.S. companies have generally negotiated and implemented offset arrangements without direct U.S. government involvement.

Most members of the policy review group said that available information supported no basic change in the U.S. government's traditional approach to offsets. They noted that annual Office of Management and Budget reports showed that offsets have not had a significant adverse effect on the U.S. defense industrial base.³ Moreover, U.S. contractors generally did not favor active U.S. government involvement in negotiating or implementing offsets. As a result, the policy review group agreed that the most prudent policy was one which did not significantly modify the traditional U.S. government approach.

Industry Views Sought

The Commerce Department published a notice in the Federal Register in January 1990 requesting comments on offset policy. Commerce received responses from 31 companies, industry associations, and other interested parties. The majority of comments received were from large defense contractors and their affiliated associations. Many large companies and industry associations indicated that direct U.S. government involvement in negotiating and implementing offsets should be minimal and that the U.S. government should not take any unilateral action to control offsets through statute or regulation.

³Since 1985, the Office of Management and Budget has issued reports on offsets in military exports. These reports have used data, primarily from U.S. prime contractors in conjunction with an input-output model of the U.S. economy, to assess the impact of offsets on the output of specific industries. Such an analysis provides an assessment of the overall effects of offsets on major defense industries. However, it does not identify the impact of offsets on industry subsectors critical to defense.

Associations representing smaller contractors favored a more active U.S. government role. Generally, they noted that offsets resulted in lost sales and lost jobs but they did not provide evidence to support their position.

Offset Negotiations

Public Law 100-456 directed the President to enter into negotiations with foreign governments that have offset policies, with a view toward limiting the adverse effects that such arrangements have on the industrial base of each country. The legislation required that every effort be made to achieve these agreements within 2 years of its enactment. A December 1988 executive order delegated the negotiating functions to DOD and the U.S. Trade Representative. Negotiations were to be coordinated with State and conducted in consultation with the Departments of Commerce, Labor, and Treasury.

Policy Substitutes Consultations for Negotiations

The President's policy statement substituted consultations for negotiations. Various reasons were cited for the change. One reason was the constitutional issue of whether the Congress can direct the President to enter into negotiations with foreign governments. Another reason given was that under negotiations the United States would be expected to seek substantial changes in foreign nations' offset policies. According to DOD, consultations, however, would initially be focused on determining whether there is sufficient common interest between the U.S. government and foreign governments to limit the adverse effects of offsets.

As part of the policy statement, the President directed that the Secretary of Defense, in coordination with the Secretary of State, lead an interagency team to consult with foreign nations with a view to limiting the adverse effects of offsets in defense procurement. The team is required to report periodically on the results of the consultations and submit any recommendations to the National Security Council.

Shortly before the policy statement was issued, the U.S. Trade Representative requested that it not be required to play a leading role in the consultations primarily because of resource constraints. A Trade Representative official stated that his office might play a more active role, consistent with the executive order, if and when the consultation process makes progress. At the time of our review, consultations had not begun and it was unclear when they would be initiated due to other national priorities.

Bilateral Defense Agreements Are Used to Address Offsets

Although consultations to limit the adverse effects of offsets have not begun, the United States has attempted to address this issue through extensions of existing bilateral reciprocal defense agreements.⁴ These agreements have been entered into primarily with European nations, many of which require offsets. Reciprocal agreements are designed to facilitate armaments cooperation by allowing U.S. and foreign companies reciprocal access to the governments' defense markets.

In a February 1990 amendment to the U.S.-Swiss reciprocal agreement, both governments agreed to discuss measures to limit the adverse effects of offsets on the defense industrial base of each country. A June 1990 amendment extending the U.S.-French reciprocal agreement contained an identical provision. According to DOD officials, similar language regarding offsets is being sought in other agreements that must be renewed.

DOD officials said they were interested in using every opportunity to discuss offsets with foreign governments. They view the reciprocal defense agreements as one way to pursue the planned consultation process.

DOD Has Not Implemented Offset Notification Requirement

Public Law 100-456 requires U.S. industry to notify the Secretary of Defense of offset arrangements exceeding \$50 million. DOD, in consultation with Commerce, was to develop implementing regulations but had not done so at the time of our review. DOD had received only three voluntary notifications. DOD and State officials explored the possibility of using the munitions licensing process to implement the notification requirement. According to a DOD official, efforts to implement this requirement stopped, pending the outcome of proposed legislation reauthorizing and amending the Defense Production Act of 1950 that would require the collection of similar information for offset contracts exceeding \$5 million. At the time of our review, it was unclear if the proposed legislation would be enacted.

DOD officials told us that the collection of such data on offset arrangements, regardless of dollar amount, does not have much value because it does not reveal information about the terms and conditions of offset agreements. However, the proposed legislation would require U.S. firms

⁴The National Defense Authorization Act for Fiscal Years 1990 and 1991, November 29, 1989 (P.L. 101-189) states that in the negotiation or renegotiation of any memorandum of understanding between the United States and foreign countries relating to the reciprocal procurement of defense equipment, the President shall make every effort to achieve an agreement that would limit the adverse effects that offset arrangements have on the defense industrial base of the United States.

to provide the offset agreements, which presumably contain the critical terms and conditions of the offset.

Scope and Methodology

To determine the status of implementation of recent legislation involving offsets in military exports we examined applicable laws, executive orders, and implementing regulations. We also obtained information from various U.S. government agencies. We reviewed program files and interviewed officials from the Departments of Defense, State, Treasury, Commerce, and Labor; the Federal Emergency Management Agency; the Office of Management and Budget; the Office of the U.S. Trade Representative; and the National Security Council. The Department of State released a very limited number of documents to us, stating that virtually all offset-related information was pre-decisional.

To assess U.S. industry positions, we reviewed the responses to the Federal Register notice on offset policy. We also met with officials from various trade associations representing U.S. prime contractors and subcontractors. We met or had discussions with the Aerospace Industries Association of America, Inc., American Electronics Association, Electronics Industries Association, the National Tooling and Machining Association, and the National Council for Industrial Defense. We also met with officials from some U.S. companies that are members of the Defense Industry Offset Association.

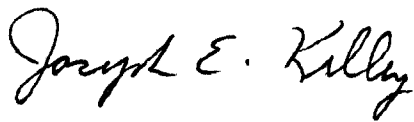
We did our work between January and June 1990 in accordance with generally accepted government auditing standards.

As requested, we did not obtain written agency comments on this report. However, we discussed its contents with responsible agency officials and included their comments as appropriate.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 10 days from its issue date. At that time we will send copies to interested congressional committees and cognizant U.S. government agencies. Copies will be made available to other interested parties on request.

Major contributors to this report were Stewart L. Tomlinson, Assistant Director, and Glen Levis, Evaluator-in-Charge. Please contact me at (202) 275-4128 if you or your staff have any questions concerning this report.

Sincerely yours,



Joseph E. Kelley
Director, Security and International
Relations Issues

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