Chapter 14
US Offset Policy

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14.1 Introduction

In this paper we review in detail the evolution of US offset policy. While this history is complicated it may be characterized broadly by two observations. First, the United States, through the activities of its defense contractors, is largely in the role of offset provider because its firms are net international suppliers of military systems. This means that the US government has not had to develop much in the way of an offset policy covering its own defense procurement, though we argue that there is such a policy in implicit terms. More importantly, US policy has been aimed at regulating international conditions for providing offsets and at either helping or not interfering with American firms. Second, there is significant uncertainty, even in theoretical terms, about whether foreign offset demands have damaged US military, economic, or political interests. This fact has led to an ambivalent US policy, which might fairly be described as benign, albeit somewhat confused, neglect. We describe how political concerns are mounting in the United States about offsets, suggesting that additional efforts will be mounted to place restrictions on their use.

14.2 Background and Definitions

A significant problem in the economic analysis of offsets and the establishment of national policies to deal with them, derives from the breadth of current definitions. The meaning of the term has varied during the post-World War II period and while the mechanisms have remained largely unchanged, their goals and purposes have varied widely.

Thus, through the 1950s the United States was

> ... not overly concerned with economic interests vis-à-vis its European allies ... nor was the United States particularly concerned with the economic costs incurred in maintaining forces in Europe. Indeed the US balance-of-payments deficit on military account was considered yet another positive mechanism of assisting European recovery. Rather the United States urged its NATO allies to expand their military forces as ***their*** contribution to the Atlantic Alliance and provided more than $10 billion in military grant aid (through the Military Assistance Program) to assist them in this task. (italics added)[1]

In other cases the recipients paid for the equipment.

The primary motivation for such weapons transfers was to assist in providing a counter to any possible Soviet thrust into Western Europe. The same objective underlay US aid for the restoration of European defense industry. In furtherance of this objective, by the late 1950s direct transfers of military equipment were being replaced by licensed production of American weapons. Early candidates for such licensed production included the F-86 and F-104 fighters, the M113 Armored Personnel Carrier, and several utility helicopters.

Joel Johnson has described this period as one with significant and long-lived implications for the US.[2] This production assistance program was administered in the Defense Department by an office which reported to the Undersecretary for International Security Affairs. First identified as the Office of Programming and Control it later became the Office of Military Assistance. It evolved further into the current Defense Security Assistance Agency in 1971. Its function was to help allies secure and/or produce weapons for their defense, "not to sell American products".[3] Johnson also explains the early role of US defense firm officials involved in these programs as assisting the Europeans in assimilating US weapons and technology. He sees this as establishing a mind set which became fixed in the subsequent outlook of US firms toward Europe.

By 1960, economic conditions had changed. European prosperity was widespread and the US was facing a balance-of-payments deficit. President Kennedy put forth a 14 point program in 1961 designed to correct the situation. One of his recommendations called for efforts to reverse the imbalance in US military outlays abroad by urging financially capable allies to buy newer US weapons.[4] According to Bare, this proposal had two objectives: force improvement for military purposes, and reduction of the US payments deficit through larger purchases of weapons from the United States.[5]

In July, 1961 the US and West Germany signed the first of seven so-called "offset" agreements, designed to minimize the impact on the American balance-of-payments of maintaining US military forces in Germany. German procurements from the US offset roughly 80 per cent of the balance-of-payments costs of maintaining US forces in Germany.[6]

The similarity of these earlier measures to current offset practices is emphasized by such additional measures as:

> ... increased non-military government procurement in the United States, special financing agreements for some of these purchases and for the loans, establishment of a fund to promote German investment in the United States and, in the 1972–1973 agreement, German financing of a program to rehabilitate troop facilities used by American forces in the FRG (Federal Republic of Germany). This last measure introduced a new concept to the agreement — budgetary relief.[7]

By the late-1960s and early 1970s a subtle change had occurred in the approach of European governments toward acquiring American weapon systems. Objectives began to appear in addition to the acquisition of attractive equipment well designed to meet defense needs. Such additional objectives included:

- the economizing of scarce foreign exchange to protect a nation's balance-of-payments position;
- technology transfer to the buying industry or perhaps more broadly diffused throughout industry in the buying country;
- investment by the seller in the industry of the buying nation, and perhaps the buyback of some of the output resulting from the investment; and
- the provision of an argument to counter political complaints that domestic tax revenues leak out of the country if it orders military equipment from abroad, thus benefiting foreign industry, and workers.

Two important early cases of US offset sales occurred in 1975; the purchase by Switzerland of F-5 military aircraft from Northrop, and the purchase by a consortium of Belgium, the Netherlands, Norway, and Denmark of the F-16 fighter from General Dynamics. These two transactions were among the first major sales of US military equipment linked to offset obligations and they had significant implications on future US offset policy. While the US government was involved in both transactions, there was a significant difference in the role which the US government agreed to play in the two cases. Specifically in the Swiss F-5 case, the US Department of Defense agreed to act as guarantor for the offset commitments entered into by the major US prime contractors — Northrop and General Electric. Thus, if these two firms were unable to successfully complete their offset obligations under the contract (initially set at 30 per cent) within the life of the contract — originally set at eight years, the US Defense Department agreed to enter and take action to make up the difference. No such government role was envisioned in the F-16 sale to the four smaller NATO states.

The F-5 offset program in Switzerland was slow in gaining momentum and the US Defense Department found itself obliged to intervene to insure that the official offset commitment was attained. In part, this involved expanded direct purchases and attempts to encourage the acquisition of Swiss products by other US government agencies. Substantial frustration resulted from direct encounters with trade restrictions other than the Buy American Act.[8] This contributed to a Pentagon decision to abandon what had become an increasingly awkward role. On May 4, 1978, Deputy Secretary of Defense, Charles Duncan, signed a memorandum which effectively placed full responsibility for meeting any further offset commitments on the US firm which had agreed to such conditions, removing

the US government from any back-up role. This significant change in US offset policy was a direct consequence of the Swiss F-5 program.

Through the late-1970s and 1980s the incidence and magnitude of offset goals both grew and in the spring of 1994, offset goals set at 100 per cent or more of the purchase price were not unusual.

14.3 Recent Developments Regarding Offsets in Equipment Sales[9]

Recent US offset policy, (or perhaps, more accurately, offset history since a coherent policy doesn't exist), has been marked by numerous statements critical of the phenomenon by economists in the Departments of Treasury and Commerce, and by a small number of members of Congress. The former oppose offsets on theoretical grounds as constituting impediments to competitive markets and therefore leading to trade distortion and welfare reduction. The latter usually express concern for the economic interests of firms and employees in their districts or states. They believe these firms or employees pay the costs of production work being transferred abroad, or suffer "spoiling" of their markets when US prime contractors agree to buy from foreign suppliers (in the case of indirect offsets).

Efforts to limit or abolish offsets have been frustrated by a troublesome fact of life: the lack of jurisdiction by the US Congress over the behavior of foreign firms and foreign governments. American firms competing with foreign firms for orders outside the United States would be placed at a severe competitive disadvantage if prohibited by US law from offering offset deals while their competitors experience no such limitations. This leads to the anomalous condition of US prime contractors resisting ostensible offers of help from their government.

14.3.1 Reporting Requirements

With very few exceptions, the product of US offset policy consists of a series of reports on the economic effects on the US economy of offsets awarded in military exports and/or several reports on negotiations concerning such offsets. Section 309 of the Defense Production Action (DPA) of 1950 (50 U.S.C. 2099) as amended in 1984 (P.L. 98-265) and 1986 (P.L. 99-441), required a series of annual reports on offsets in military exports. In response to this law, a group of documents containing interesting and valuable information was issued annually from 1986 through 1990. They were produced by an inter-agency group chaired by the Office of Management and Budget. In addition to tracing domestic and

international developments in the area of defense offsets, they include case studies of US military aircraft and missile sales to other countries.[10]

This Act expired on October 10, 1990 and with it, the requirement for the report. Thereafter, the Act was twice revived and allowed to expire, and finally revived again on October 29, 1992, retroactive to March 1, 1992. While considerations other than offsets played more significant roles in this strange sequence of expirations and recoveries, when the DPA returned, so did the offset reporting requirement — but with interesting differences. Now the Secretary of Commerce was designated as (1) responsible for the preparation of the report, and (2) responsible to function as the President's Executive Agent for carrying out the requirements of Section 309. It should be noted that this shifted the responsibility for the preparation of the annual report on the impact of offsets away from the Office of Management and Budget which had aroused the ire of Congressional critics with its conclusions that the impact of offsets on the US economy and defense technology base had been relatively minor.

In addition, the revised DPA charged the Secretary of Commerce with the responsibility to issue regulations covering the reporting on offsets agreed to in sales of defense items by US firms to foreign buyers. During the subsequent eighteen months, neither the requisite Executive Order nor the regulations concerning industry reporting on offset agreements required of the Commerce Department had appeared. Finally, on April 26, 1994 the **Federal Register** carried proposed regulations to cover the "new" reporting requirements. They were put forward by the Bureau of Export Administration of the US Department of Commerce and provided a 30-day submission period for written comments from interested parties.[11] This long delay in a response from Commerce in meeting its obligations suggests that offset matters do not represent a high priority of the Clinton Administration. A reluctance on the part of the Administration to undertake actions which might threaten export sales in the high technology area may explain this foot-dragging on possible restrictions on offset sales.

Section 825 of the National Defense Authorization Act for fiscal year 1989, as amended by the similar acts for fiscal years 1990 and 1991, contains a requirement that whenever a US firm contracts to sell weapons systems or other defense-related items abroad, and the offset deal exceeds $50,000,000, the firm must notify the Secretary of Defense of the proposed sale in accordance with regulations to be prescribed by the Secretary of Defense in consultation with the Secretary of Commerce. (This paragraph is identified as Section S2505 (c) of Chapter 148 of Title 10, US Code, as amended by Sections 821 and 824.)

No such regulations have ever been prescribed. In the words of a former executive branch official associated with offset matters, DoD has simply "stonewalled" on this issue, arguing that this information probably will be

reported in any event when firms apply for licenses to ship arms under the terms of export control regulations or when foreign governments arrange to purchase armaments under the Foreign Military Sales (FMS) program of the Defense Security Agency. It might be added that such information may also be collected under the terms of the new "Feingold Amendment," which is discussed below.

14.3.2 Efforts to Control Offsets

Despite the suggestions in the initial OMB reports that offsets have had limited impacts on the US economy, many in Congress and in some Executive Departments remain unpersuaded. The Congressional language in Section 825 of the National Defense Authorization Act, fiscal year 1989 (Public Law 100-48; 102 Stat. 1517) made it clear that concern was growing among legislators that the use of offsets threatened US technology loss, economic costs, and potentially weakened the US defense industrial base. Section 825 mandated a series of reports (published in 1990, 1991, and 1992 and very much abbreviated compared to the economic impact reports previously mentioned) that present information on the progress of negotiations concerning offsets in military exports. The President was directed to initiate negotiations with offset-demanding countries purchasing defense equipment from the United States to secure an agreement to limit the "adverse effects" of such offsets on the respective defense industrial bases of each country. Further, in negotiating or renegotiating Memoranda of Understanding which attempt to lower barriers to defense trade through the reciprocal waiver of Buy National Acts, the President was directed to make every effort to "limit the adverse effects that offset arrangements have on the defense industrial base of the United States".[12]

The United States has signed general Memoranda of Understanding with twenty-one nations. Of these, nine contain language committing the parties to consult for the purpose of limiting the "adverse effects of offsets". Four others are in the process of being negotiated while the remaining eight are more recent MOU's which have not yet come up for renegotiation. A US Defense Department official concerned with this matter noted that while discussions have, in fact, taken place with the representatives of several of the nations whose MOU's contain the above clause, they have "essentially been of the fact-finding variety". They have aimed at determining what such offset policies (if any) require and what the philosophy of the government is on the general topic of offsets. He also noted that there were also discussions on offsets with other NATO members during negotiations on the NATO Code of Conduct (see below).

Another DoD official commented that if a country has overriding political goals that are viewed as advanced by offsets, "no amount of talking by the

United States is likely to change that". Of particular interest is the effort by the Netherlands when renegotiating its MOU with the United States to add words calling for consideration of the adverse effects of "other Buy National initiatives."[13] The final agreement includes words to the effect that the two governments "intend to discuss measures to limit the adverse effects of offsets *and other regulations* on the industrial base of each country" (italics added). Apparently other countries have shown interest in similar wording.

Other portions of Section 825 called for the establishment by the President of a comprehensive offset policy in connection with contractual offset arrangements dealing with defense equipment [S2505(a)]; the protection of the US defense industrial base and the financial position of US firms from damages resulting from technology transfer to foreign countries or firms under offset arrangements [S2505(b)(1)]; the waiver of paragraph (b)(1) under certain cases of national security (b)(2); and an appeals procedure for US firms damaged by such waiver (b)(3).[14]

An Executive/Legislative Branch disagreement transpired when congressional actions in 1988 required a new presidential policy statement concerning offsets. After fifteen months, the Bush Administration released a statement on April 16, 1990 which essentially restated the Duncan Memorandum, to the effect that the US government would not fulfil the role of guarantor of offset commitments incurred by private American firms.

Although Congress is the driving force behind efforts to control offsets, there was one interesting case of the Executive Branch attempting to limit the magnitude of an offset percentage negotiated in sales efforts by US firms. In the summer of 1989 the Republic of Korea was engaged in negotiations for the purchase of a new military aircraft. The competition had narrowed to two US aircraft: the F-16 of General Dynamics and the F/A-18 of McDonnell-Douglas. While early in the negotiations, the Koreans had presented a demand for a 30 per cent offset level (their usual requirement), they later raised their demand to a level approaching 60 per cent. In addition there were signs that the heavily competing US firms might advance offers to 100 per cent. In an unprecedented and somewhat puzzling step, the acting director of the Defense Security Assistance Agency of the Department of Defense sent an identical letter to the chairmen of the two American firms, which appeared to oppose an offset level in excess of 30 per cent. In somewhat obtuse language, the letter concluded, "... we are not prepared to support a sale which includes an offset offer which exceeds the amount determined after final discussions between our two governments".[15]

This attempted intervention was justified in the letter by reference to Section 825 of the Defense Department Authorization Act of 1989. On the face of it, the government of the Republic of Korea and the two American firms

acceded to the perceived message in the letter by limiting the offset level to 30 per cent. It would appear that this supported the conventional view that intervention to limit offsets could work if the competitors were of the same nationality and thus subject to the pressure of their common government. In fact the matter is more complex because the final decision of what specific items will receive offset credit and on what terms, remains in the hands of the buying state. While South Korea agreed to a 30 per cent offset level, its control of the details enabled the South Korean government, in effect, to extract a level of purchases by the seller which substantially exceeded 30 per cent. Here again one sees the futility of an attempt by a single government to control offsets.

Another American Executive Branch action relevant to the offset issue is the so-called NATO Code of Conduct. A US proposal of March 1990 called for negotiations within NATO to consider a more open alliance-wide market for weapons coupled with the gradual elimination of offsets. Not much progress has been achieved toward this objective despite the approval of a text in April 1993 by the Council of National Armaments Directors and its transmission to the North Atlantic Council for approval. In the opinion of a well-informed former US Executive Branch official, the Code of Conduct will achieve little, even if it is finally adopted, "because the words subordinate progress on the reduction of offset to achievement of other conditions that have little chance of success".[16] The same author attributes the lengthy negotiation process to the reluctance of smaller NATO members to forego the advantages of offsets on their purchases, problems associated with agreement on language covering technology retransfer, and general uncertainties concerning the future of NATO.

An analysis of US government actions on offsets since the late-1970s shows a consistent dichotomy in approach between the Congress and the Executive Branch with the latter more reluctant to intervene to restrict offsets. This divergence in attitude is clearly illustrated by a comparison of Congressional and Executive Branch "findings" on offsets. The congressional comments are contained in the National Defense Authorization Act, FY 1989, (approved September 29, 1988) as amended by the similar acts of FY1990 and 1991 (approved November 29, 1989). The following quotation is taken from Section 825(a): "Congress makes the following findings:

a. Many contracts entered into by United States firms for the supply of weapon systems or defense-related items to foreign countries and foreign firms are subject to contractual arrangements under which United States firms must agree:
   i. to have a specified percentage of work under, or monetary amount of, the contract performed by one or more foreign firms;

ii. to purchase a specified amount or quantity of unrelated goods or services from domestic sources of such foreign countries; or
iii. to invest a specified amount in domestic business to such foreign countries.

Such contractual arrangements, known as 'offsets', are a component of international trade and could have an impact on United States defense industry opportunities in domestic and foreign markets.

b. Some United States contractors and subcontractors may be adversely affected by such contractual arrangements.
c. Many contracts which provide for or are subject to offset arrangements require, in connection with such arrangements, the transfer of United States technology to foreign firms.
d. The use of such transferred technology by foreign firms in conjunction with foreign trade practices permitted under the trade policies of the countries of such firms can give foreign firms a competitive advantage against United States firms in world markets for products utilizing such technology.
e. A purchase of defense equipment pursuant to an offset arrangement may increase the cost of the defense equipment to the purchasing country and may reduce the amount of defense equipment that a country may purchase.
f. The exporting of defense equipment products in the United States is important to maintain the defense industrial base of the United States, lower the unit cost of such equipment to the Department of Defense, and encourage the standardized utilization of United States equipment by the allies of the United States."

Such alarmist "findings" by the Congress stand in stark contrast with the following observations in the fifth annual report by the Office of Management and Budget on offsets in defense trade.[17]

Overall ... it is clear that military export sales, net of their associated offsets, to the extent that they have measurable effects, result in positive impacts on the US economy as a whole and to the defense sectors in particular.[18]

The effects of offsets on total US employment are minor. That is to say, military sales abroad with contractually required offsets are likely to increase domestic employment by somewhat more ... than would comparable sales without offset ... largely because offsets are a substitute for (but are less labor intensive than) the imports that would replace them to finance the foreign sales ...

... such offsets are inefficient ... these inefficiencies, however, are reflected more in the distribution of US employment across industries than in the level of total employment ... relative to normal trade, offsets reduce employment in industries in which the US and the purchasing countries have a comparative advantage and increase employment in industries in which both ... have a comparative disadvantage ...

Independent of their effect on total US employment, the magnitude of the distortions (and therefore inefficiencies) introduced by offsets is positively related to the degree of their concentration in industries in which the US has comparative advantage.[19]

... in industrial sectors affected by defense sales and offsets, there was a very small positive net effect on total US imports and exports. There was a corresponding drop in trade in other sectors, a small appreciation of the dollar, and no net effect on the US trade balance. Instead the main effect ... was on the distribution of trade among sectors.[20]

... some of the controversy over offsets has resulted from the fear that offsets in the form of direct investment and technology transfer would lead to the creation or expansion of new industries abroad.... While this may take place from time to time, the major effect ... (is) to strengthen existing competitors and expand their markets ...[21]

The most recent instalment in this conflict began in the spring of 1994. As usual, the offset-related material is embedded in an omnibus bill hardly devoted to the topic of offsets — in this case the State Department Authorization Bill. Section 732 dealing with Reports Under the Arms Export Control Act is amended to require that:

Each such numbered certification shall contain an item indicating whether any offset agreement is proposed to be entered into in connection with such letter of offer to sell ... and a description from such contractor of any offset agreements proposed to be entered into in connection with such sale. (As enacted into law, a complete description of the offset agreement will only be required if requested by the Senate Foreign Relations Committee or the House Foreign Affairs Committee.)

No United States supplier of defense articles or services sold under this Act, nor any employee, agent, or subcontractor thereof, shall, with respect to the sale of any such defense article or defense service to a foreign country, make any incentive payments for the purpose of satisfying, in whole or in part, any offset agreement with that country.

... the civil penalty for each violation of this section may not exceed $500,000 or five times the amount of the prohibited incentive payment, whichever is greater.

It is still too early to know the full implications of these amendments, particularly how widely the prohibition on "incentive payments" will be applied. To some extent, the answer depends on the frequency of direct payments to third parties *in the United States* in order to secure offset fulfilment. If the practice is widespread such incentives may soon be shifted to beneficiaries abroad.[22] However, it is clear that for the first time, Congress has entered into regulation of the substantive side of offsets. In addition, a new group of congressional committees, those dealing with foreign relations/affairs, has been brought into the subject of offsets.

The sponsor of these amendments was Senator Russ Feingold of Wisconsin. His involvement resulted from an action taken by Northrop Corporation under its offset agreement negotiated under the terms of the F/A-18 sale to Finland.

Northrop had offered to pay part of the transportation cost involved in a proposed sale of paper-making machinery by a Finnish company (Valmet Corporation) to the International Paper Company of Selma, Alabama. According to a Northrop official, their proposed payment to a shipping company subsequently would have been charged to the Finnish government as offset administrative costs (see below) but Senator Feingold saw it as a "bribe" to the potential US buyer. After a determination by the US General Accounting Office that the deal would have been legal,[23] Senator Feingold, speaking on the floor of the Senate, described the situation as falling "between the cracks of ... the Anti-Kickback Act [and] the Foreign Corrupt Practices Act ...".[24]

The Senator's motivation is easier to understand when one learns that the Finnish firm was in competition for the Selma sale with a company in the Senator's home state of Wisconsin. The sale was finally secured by the Wisconsin firm — the Beloit Corporation subsidiary of Harnishfeger Industries — after it lowered its price for the paper-making equipment.

This case also involved an unsuccessful attempt by the Secretary of Commerce to have the Secretary of Defense consult with the Government of Finland on the matter under the terms of the bilateral Memorandum of Understanding between the United States and Finland.[25]

Another constituency in the United States is now being mobilized to oppose offsets in defense trade. This group is that which advocates strict arms control and sees offsets as a major contributor to the proliferation both of armaments and arms-making technology. An example of this position is found in the publications of the Federation of American Scientists, an essentially pacifist organization. The January/February 1994 issue of their publication "F.A.S. Public Interest Report" is devoted to this topic.[26] It is difficult to predict what success this effort will attain, but if a sufficient number of groups with their own particular dissatisfactions with offsets manage to ally themselves into a unified group whose goal is severely to limit or prohibit offsets, they may acquire sufficient political power to convert offsets into a significant domestic political issue.

In late June, 1994 a new report by the US General Accounting Office (GAO), which is Congress' investigative arm, attacked the practice of nations purchasing US weapons with American aid grants and then demanding offsets on such purchases. The study dealt with weapons trade between four nations that receive significant arms aid, Israel, Turkey, Egypt, and Greece, and their US suppliers. While the firms were not named in the report, in order to protect proprietary information, press treatments identified the likely companies as McDonnell-Douglas, General Dynamics, Lockheed, United Technologies' Pratt and Whitney engine division, and the engine division of General Electric.

The GAO study examined a sample of $11.6 billion in sales, of a total of $60 billion in US weapons sales to the four countries, over the last two decades. The required US offsets amounted to about 41 per cent of the contract amounts. While the GAO report limited itself to examining the use of offsets when a foreign nation uses US grant funds to purchase American defense goods, Representative Cardiss Collins of Illinois, chairwoman of the House Subcommittee on Commerce, Consumer Protection, and Competitiveness (of the House Energy and Commerce Committee), which requested the study, commented that offset agreements "are hurting our country and taking jobs away from the United States." A Wall Street Journal story noted that Representative Collins and her Subcommittee were "scrutinizing arms sales with an eye toward tougher limits on offsets."[27] Industry spokespersons who defend the general concept of offsets have largely opposed the demand for offsets by US aid recipients as a form of "double dipping." However, they are inclined to interpret Representative Collins' statement as a trumpet call signifying the arrival on the scene of yet another champion of domestic industry and foe of the offsets concept. This development signifies a further spread of concern over offsets among Congressional committees.

14.3.3 Change in Rules Governing the Recovery of Offset Administrative Costs

US firms incur costs in administering offset terms which they have agreed to as part of a sales contract. Historically their ability to recover such costs has hinged, in part, on the nature of the general contract. If it was negotiated as a straight commercial deal between a foreign government and an American contractor, the likelihood of recovering such costs depended upon the talent of those representing both parties during the period of the contract negotiations and the policies of the buying governments.

Buyers interested in securing US weapon systems have the option of buying under terms of the Foreign Military Sales (FMS) program of the US Department of Defense. Under this program the US government via its Defense Security Assistance Agency acts as intermediary between the foreign government and US defense contractors, purchasing the desired equipment under its own procurement regulations and then transferring it to the foreign buyer. Certain governments, particularly those with limited experience in buying sophisticated equipment, prefer to use the FMS route which ensures that the weapon systems acquired meet US military standards. While FMS rules permit producers up to a 3 per cent administrative charge, these have historically **not** included offset administrative costs as an allowable cost.

In July, 1991 a change was introduced by the Defense Department which now allowed offset administrative costs to be recovered under FMS contracts provided the Letter of Offer and Acceptance (LOA) contained a note with certain specific information. The nature of the note was carefully detailed in the regulations. It had to:

a. i. Specifically address offsets;
   ii. Advise foreign governments that the price of contracts awarded in support of the LOA might include administrative costs associated with implementing the foreign purchaser's offset agreement with the contractor; and
   iii. Include a statement that the US government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs.
b. Offset administrative costs must be reasonable and readily identifiable ... and their estimated level must be included in foreign military sales pricing information provided to the foreign government as early as possible, but before submittal of the LOA.
c. Some examples of offset administrative costs —
   i. In-house and/or purchased: organizational, administrative and technical support, including offset staffing, quality assurance, manufacturing, purchasing support; data acquisition; proposal, transaction and report preparation; broker/trading services; legal support; and similar support activities;
   ii. Off-shore operations for technical representatives and consultant activities, office operations, customer and industry interface, capability surveys;
   iii. Marketing assistance and related technical assistance, transfer of technical information and related training;
   iv. Employee travel and subsistence costs; and
   v. Taxes and duties.[28]

After complaints by the industry and other sources, the Department of Defense issued a proposed new rule with request for public comments.[29] Industry response has been favorable.[30] In the proposed revision all references to a note in the LOA informing the foreign government that "the price of contracts awarded in support of the LOA may include administrative costs associated with implementing the foreign purchaser's offset agreement with the contractor ..." have been deleted. At the time of this writing in the late spring of 1994, the expectation among informed sources is that the proposed revision will be adopted.

14.3.4 Offset Policy on Civilian Sales

Given the spread of offset requirements into civil trade, it may be useful to note that a United States government policy on countertrade in non-military exports was developed within the Executive Branch and put forth in a guideline document on July 29, 1983. For whatever reason, this document was classified and never publicly released. However, it was summarized by the Department of Commerce in a 1992 publication, as follows:

> The policy prohibits US agencies from promoting countertrade and states that, although the US Government views countertrade as generally contrary to an open free-trading system, it will not oppose participation by US companies in countertrade transactions unless such activity could have a negative impact on national security. Consistent with this policy, US agencies may provide advisory and market intelligence services to US businesses and advise US businesses that countertrade goods are subject to US trade laws, including quotas.
>
> In addition, US agencies are to review applications for government export financing for projects containing countertrade/barter on a case-by-case basis, taking account of the distortions caused by these practices. The policy states that the United States will continue to oppose government-mandated countertrade and should consider raising its concerns about such practices with relevant governments and in multilateral fora. Finally, the policy urges US agencies to exercise caution in the use of their barter authority, reserving it for those situations that offer advantages not offered by conventional market operations.[31]

Section 2205 of the Omnibus Trade and Competitiveness Act of 1988, approved August 23, 1988, provided for:[32]

a. the establishment by the President of an interagency group on countertrade to be chaired by the Secretary of Commerce with representatives from such departments and agencies as the President deem appropriate (In Executive Order 12661, Section 2–101, dated December 28, 1988 the President designated as members of this committee the Secretaries of Commerce, State, Defense, Treasury, Labor, Agriculture, and Energy, the Attorney General, the Administrator of the Agency for International Development, the Director of the Federal Emergency Management Agency, the US Trade Representative, and the Director of the Office of Management and Budget — or their designated representatives.)
b. the review and evaluation of
    i. US policy on countertrade and offsets in light of current trends in international countertrade and offsets and the impact of those trends on the US economy;
    ii. the use of countertrade and offsets in US exports and bilateral US foreign economic assistance programs; and

iii. the need for and the feasibility of negotiations with other countries, through the Organization for Economic Cooperation and Development and other appropriate international organizations, to reach agreements on the use of countertrade and offsets; and

c. the making of recommendations to the President and Congress on the basis of the review and evaluation.

According to Eisenhour, no such reports have ever been published due to interagency disputes.[33]

Section 2205 also provided for the establishment within the International Trade Administration of the Department of Commerce of an Office of Barter whose functions were:

d. i. to monitor trends in international barter;
ii. organize and distribute information relating to international barter useful to business firms and other organizations and individuals including commercial opportunities for barter transactions beneficial to US enterprises;
iii. notify Federal agencies with operations abroad when it would be beneficial for the Federal Government to barter government-owned surplus commodities for goods and services purchased abroad by the Federal Government, and
iv. provide assistance to enterprises seeking barter and countertrade opportunities.

The Office of Barter primarily exists to provide information to US industry on barter opportunities and plays no role in the formulation of offset policy. Of some significance is the fact that it is located in a different part of the Commerce Department than the group responsible for offset reporting and weapons trade.[34]

14.4 US Military Offset Policy (as Buyer)

One informal US military procurement policy has a bearing on the offsets issue and should be noted. For years it has been a central procurement practice to require a North American source for all major weapons systems purchased by the US military. While certain American government officials insist that this is a national security matter and thus has nothing to do with offsets which they believe to be economically motivated, all do not agree.[35] The opinion of most foreign observers is that such a requirement is indistinguishable from a standard offset requirement and that the motive is irrelevant. This requirement continues

to provide ammunition for those who charge the US with inconsistency when it assumes an anti-offsets stance.

14.5 US State Offset Policies

Another interesting point on offset policy in the United States relates not to the federal level of government but to the state level. Beginning at the turn of the decade, the State of Maryland began to insist that offset credit be provided to it for state purchases abroad from countries requiring offset credits on their own purchases. Maryland reserves the right to assign offset credits granted on its foreign purchases to American firms based in Maryland with the specific details to be worked out between the US firm and the supplying nation. In addition, the states of Missouri and New York have established similar programs but they are not yet fully functional. Ohio, Washington, and Arizona also are exploring the possibility of taking such action.

14.6 Assessing US Offset Policy

To this point, we have reviewed the particulars of US offset policy in substantial detail. Two outstanding characteristics of US policy emerged. First, because US defense contractors are largely suppliers of military equipment, the US government has been predominantly faced with developing a policy regarding the provision of foreign offsets. Second, in doing so the United States has displayed a marked ambivalence about the issue. On the one hand, US authorities have, in the past, worked actively to assist American firms in acquiring foreign contracts subject to offset. More recently, however, the government has preferred not to get involved heavily in setting details of how American firms compete internationally. Indeed, such a hands-off policy is consistent with the US tradition of *laissez faire*. On the other hand, there are undeniable concerns that the demands for offsets on the part of foreign procurement authorities may damage US interests in certain dimensions. Thus, the government has imposed numerous reporting requirements and has pushed for some international rationalization of offset policies. Overall, however, there is no coherent US policy on offsets.

In an important sense, of course, the absence of policy represents the choice not to intervene, thereby leaving the field largely open to foreign governments. In that context, it is interesting to assess briefly the implications of this situation for the United States. This is a complicated situation and we only touch on various issues here.[36] The main point of this review is that there is substantial uncertainty about how offsets influence American interests. This fact points to the

importance of further study of both the directions and importance of the various effects.

There are four groups of issues surrounding global offsets that concern US policymakers. The first is the impact on certain American security objectives. It has been a long-standing US goal to increase interoperability of weapons systems among its allies. Offsets may tend to force subcontractors in many nations to employ technologies for producing parts that are consistent with the final weapons (e.g., fighter aircraft) of the most successful prime contractors. To the extent that this is true, there is some convergence of aircraft types and subsystems. The United States also has an interest in expanding the range of military suppliers available. It is clear that American prime contractors, through the offset process, have become increasingly aware of the significant technical capabilities of smaller firms in Western Europe and elsewhere. The subsequent introduction of these suppliers into the American procurement process has provided a greater range of choice and competition. Of course, to the extent that this has disadvantaged US subcontractors there could be increasing concerns for both military and political reasons. There seems to be little consensus of opinion in the United States about the extent of this latter effect. Finally, as a military matter, the US government may wish to limit transfer of sensitive technologies and it is conceivable that offset requirements make control of this process more difficult. The demise of COCOM (The Coordinating Committee on Multilateral Export Controls) in the Spring of 1994 will probably stir fears of technology loss. It is worth noting, however, that new export control procedures are currently under international review that may ease such concerns.

A second area of interest relates to economic objectives. In general, because the United States is primarily an offset supplier, the issues are the obverse of those detailed for offset-demanding nations.[37] The primary issue is the effect of foreign offsets on US employment. In an earlier section we reviewed the evidence put forward by the Office of Management and Budget,[38] which argued that the impact was negligible or even positive. In economic terms, OMB's arguments are sensible, because they are based on the presumption that market distortions such as offsets influence the interindustry (or interfirm) structure of employment but not the aggregate level. Moreover, at the time of OMB's latest analysis, military offset obligations that may have displaced American employment in defense contractors remained a fairly small proportion of domestic and foreign military sales. However, we note that since that time offsets have grown in frequency and magnitude and the domestic demand for military contracts has declined due to defense downsizing in the United States. It is conceivable that the sensitivity of American employment in the defense industry with respect to foreign offset demands has increased since 1990. This issue clearly bears further study.

There are other important economic objectives that may be influenced by offsets. To the extent that co-production requirements reduce output in US manufacturing facilities there may be a deleterious impact on economies of scale, raising the costs of procurement. Counterbalancing this problem are the possibilities that foreign input suppliers are more efficient than domestic ones and that foreign offsets may substitute for declining demand for military goods from the US government. Further, there may be substantial economies of scope that are generated by international operations and production sharing. Offsets likely enhance the process of international technology transfer, which is desirable from the standpoint of maximizing the return from military R&D. Some might argue that permitting technology transfers under offsets may enhance the pace of overall technology transfer, as any associated commercial technical spillovers from military technologies would be more likely to accrue to foreign countries than they would otherwise. This could represent a competitive disadvantage for US firms that would, in the absence of offsets, enjoy the fruits of the spillovers more rapidly than their international rivals.

A third general issue regards political problems from offsets. Overwhelmingly this relates to the impacts of foreign offsets on regional economic activity and employment. We have noted one such instance for a Wisconsin firm that was able to exert sufficient political pressure to win a contract that would otherwise have been lost to an offset, though the firm also had to lower its price in order to gain the order. Clearly, such problems underlie Congressional interests in placing limits on foreign offsets, as we have described.

The fourth area is perhaps least appreciated, but nonetheless potentially significant. There are concerns about the impact of offsets (and, more generally, barter and countertrade) on the international trading system. At their core, offsets should be understood as extensive forms of commercial regulation involving requirements for direct foreign investment, production, trade, and technology transfer. In that sense, offsets are in the domain of trade-related investment measures (TRIMs). Like other TRIMs, offsets must be analyzed in the decidedly second-best world of imperfect competition, scale economies, and government policy distortions. There is no clear theoretical case that TRIMs reduce economic efficiency and welfare. However, TRIMs are often so arbitrarily applied and complex that they seem almost surely to interfere with rational business decisions. Concern about this led to the inclusion of TRIMs in the Uruguay Round, where a set of disciplines has been negotiated over their use.[39] Among other things, these accords will ban the use of domestic content regulations and export performance requirements because these regulations directly distort trade. It remains to be seen whether and how offset requirements will be covered by these new disciplines.

In a related vein, substantive negotiations in the Organization for Economic Cooperation and Development and, in the near future, the new World Trade Organization will concern themselves with economic regulations that affect the conditions for competition. Elements such as antidumping procedures and anti-monopoly regulations will be scrutinized for potential harmonization and rationalization. Again, offsets may be viewed as fitting squarely into this domain and procurement officials will need to keep abreast of those developments.

14.7 Conclusions

Readers of this paper who live in countries governed under the Parliamentary system may find many of the details related above somewhat puzzling. Certainly much of what appears to be continuous conflict between the Legislative and Executive branches of the US government, regardless of which party is in power, is explained by the absence of discipline within the American political system.

In addition to competition for power and influence between the several branches of government, there is a similar competition between such Executive branch agencies as the Departments of Defense and Commerce and the Office of Management and Budget. These pursuits of political influence have led to a confusing tangle of laws and policies which are, at the least, overlapping and contradictory. When the divergent interests of principal defense contractors and smaller subcontractors and other suppliers are included the stewpot boils all the more. The time is overdue for a comprehensive review of legislation, executive orders, and other regulations dealing with offset policy but such a development is unlikely without a courageous act of leadership on the part of the President and the Congress.

Endnotes

1. Bare, C. Gordon, "**Burden-Sharing in NATO: The Economics of Alliance**," Orbis, Vol. 20, No. 2, Summer 1976, p. 418.
2. Johnson, Joel L., "**The United States: Partnerships with Europe**," in Ethan B. Kapstein, ed., *Global Arms Production: Policy Dilemmas for the 1990s* (Lanham, Maryland: University Press of America), 1992, p. 107.
3. *Ibid.*, p. 108.
4. US House of Representatives, Committee on Armed Services, **US Military Commitments to Europe**, 93rd Congress, 2nd Session, 1974, p. 53.

5. Bare, *op. cit.*, p. 418.
6. *Ibid.*, p. 419.
7. *Ibid.*, p. 420.
8. It should be noted that "Buy National Preferences" in the United States affect government purchases only and operate much like a tariff. This preference traces to the Buy American Act of 1933. The Defense Department has adopted a policy under the Act of giving a 50 per cent margin to domestic producers while other government agencies offer a six per cent preference to American suppliers (or 12 per cent if the item is produced by a "small" firm). However, a large number of outright restrictions and prohibitions on the purchase of foreign goods and components by defense agencies now exist. [For a recent study of such barriers, see the United States Department of Defense, **Impact of Buy American Restrictions Affecting Defense Procurement, A Report to the United States Congress by the Secretary of Defense**, (Washington, D.C: Department of Defense, July, 1989).
9. We wish to acknowledge our debt to Mr. John Howard Eisenhour formerly of the Institute for National Strategic Studies at the National Defense University for his generous assistance in sharing his encyclopaedic knowledge of the evolution of US offset policy.
10. These include sales of F-16s to Belgium, the Netherlands, Denmark, Norway, and Greece; Patriot missiles to West Germany and the Netherlands; AWACS aircraft to the U.K. and France, and F/A-18s to Canada, Australia, and Spain.
11. Two responses in particular are worthy of noting; from the US Defense Department and the Aerospace Industries Association of America, Inc. In the first, Kenneth S. Flamm, Principal Deputy Assistant Secretary of Defense expresses substantial dissatisfaction with the content of the proposed rule and the manner in which it was produced. He recommends "that Commerce withdraw the proposed rule and convene an interagency group to draft a new, coordinated rule." Among other complaints, Secretary Flamm lists "the significant paperwork burden that the rule would impose on the defense industry, (citing) the proposed rule's requirement for considerable additional reporting, twice yearly, on all transactions taken to implement offset agreements ... (and) an unnecessary retroactive reporting burden".

    In calling for the withdrawal of the proposed rule and the drafting of a new coordinated rule, Flamm also suggests that the interagency group "con-

sider the question of whether the Administration should seek repeal of the various statutory offset reporting requirements" (Flamm, Kenneth S., Principal Deputy Assistant Secretary of Defense, letter to Sue Eckert, Assistant Secretary for Export Administration, US Department of Commerce, dated May 24, 1994).

In addition, Joel Johnson, Vice President, International, of the Aerospace Industries Association of America also focused his dissatisfaction with the proposed new rule on the additional paperwork burden which it would impose upon industry. He also expressed concern over definitions and categories of data which "go well beyond what is needed to prepare a report for Congress". In his opinion, "Every offset is different, and trying to add negotiated numbers involving technology transfers, training, production, services, risk equity ventures, and sales of unrelated goods, will produce numbers that will be singularly uninformative. Commerce would learn far more about terms, trends, and effects of offsets by meeting once a year with five to ten offset managers from the forty or so companies that account for most US offset obligations, than it will through broad collection of data."

Finally, Johnson expressed concern that the data being collected focus largely on offsets with little attention to "the sales which precipitated the offset ... (their) support (of) US foreign policy interests ... (their strengthening) the US industrial base and (lowering) unit costs of equipment to the US armed forces" (Johnson, Joel L., Vice President, International, Aerospace Industries Association of America, Inc., letter to Brad Botwin, Director, Strategic Analysis Division, Office of Industrial Resource Administration, US Department of Commerce, dated May 23, 1994).

12. Office of Management and Budget, **Offsets in Military Exports, April, 1990**, Washington, D.C: US Executive Office of the President, July 16, 1990, p. 87.

13. See note 8.

14. *Ibid.*, pp. 85–86.

15. US Defense Security Assistance Agency, letters of August 8, 1989 from Glenn A. Rudd, Acting Director to Stanley C. Pace, Chairman and Chief Executive Officer, General Dynamics Corporation, and John F. McDonnell, Chairman and Chief Executive Officer, McDonnell-Douglas Corporation

16. Eisenhour, John Howard, **Offset: The Political Dimension of Countertrade**, unpublished manuscript, 1994, p. 65.

17. Office of Management and Budget, *op. cit.*

18. *Ibid.*, p. 43.
19. *Ibid.*, pp. 53-54.
20. *Ibid.*, pp. 54-55.
21. *Ibid.*, p. 59.
22 "**US Government Enacts New Offset Curb, Reporting Mandate**", *Countertrade Outlook*, Vol. XII, No. 10 (May 30, 1994), pp. 1–5.
23. Eisenhour, *op. cit.*, p. 55.
24. **Congressional Record** (Washington, D.C.), January 26, 1994, p. S117.
25. Letter from the Secretary of Commerce to the Secretary of Defense dated April 1, 1993, and from the Secretary of Defense to the Secretary of Commerce dated July 16, 1993. Excerpts from both letters appear in Eisenhour, *op. cit.*, p. 55.
26. "F.A.S. Public Interest Report," **Journal of the Federation of American Scientists (FAS)**, Vol. 47, No. 1, January/February 1994.
27. Jeff Cole, "**Report Assails Defense-Sector 'Offset' Deals**," *Wall Street Journal*, June 22, 1994, p. 3. See also John Mintz, "**GAO Report Critical of Military 'Offsets**'," *The Washington Post*, June 22, 1994, p. F-4.
28. **Code of Federal Regulations**, Vol. 48, Chapter 2, (Parts 201 to 251) especially, Part 225.7303 "Cost of doing business with a foreign government or an international organization," Revised as of October 1, 1993, pp. 203–204.
29. **Federal Register** Vol. 59, No. 72, April 14, 1994, Proposed Rules, pp. 17756–17757
30. For example, in response to the request for public comments, Joel Johnson, Vice President, International, of the Aerospace Industries Association of America observed that the proposal "removes an unnecessary irritant in our relations with potential customers, and treats those costs in the same way as other accounting differences between a sale to the US government and a sale to a foreign government. Furthermore, just as a customer must expect to pay for any nonstandard feature he requires on the equipment, he must expect to pay for costs associated with offsets, which are a cost the contractor must incur that would not be involved in a normal sale to the US government" (Johnson, Joel L., Vice President, International, Aerospace Industries Association of America, Inc., letter to Ms. Alyce Sullivan, Defense

Acquisition Regulations Council OASD (A&T) DP (DAR) the Pentagon, dated June 1, 1994).

31. Verzariu, Pompiliu, **International Countertrade: A Guide for Managers and Executives** (Washington, D.C: US Department of Commerce, International Trade Administration) August, 1992, p. 4.

32. While the following material is keyed to specific parts of the law, the wording has occasionally been altered to facilitate understanding.

33. Eisenhour, *op. cit.*, p. 43.

34. *Ibid.*

35. For example, in July of 1987 David G. Wigg, then Deputy Assistant Secretary of Defense, Policy Analysis, in testimony before a Congressional Committee observed:

> Even the US has an offset policy of sorts in that we require that there be a domestic production capability for each critical weapon system or component that we purchase from any foreign source except Canada (because they are considered part of the US industrial base) (US House of Representatives, **Countertrade and Offsets in International Trade**, Hearings before the Subcommittee on International Economic Policy and Trade, of the Committee on Foreign Affairs, June 24 and July 10, 1987).

36. Udis, Bernard and Keith E. Maskus, "**Offsets as Industrial Policy: Lessons from Aerospace**," *Defence Economics*, Vol. 2, 1991, pp. 151–164.

37. *Ibid.*

38. Office of Management and Budget, *op. cit.*

39. For an analysis of the options, see Maskus, Keith E. and Denise R. Eby, "**Developing New Rules and Disciplines on Trade-Related Investment Measures**," in Robert M. Stern, ed., *The Multilateral Trading System: Analysis and Options for Change* (Ann Arbor: University of Michigan Press), 1993, pp. 449–472.

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