
Offsets in Military Exports: U.S. Government Policy

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The objectives of a government making an arms purchase go beyond simply procuring arms at a cost-effective price. Considerations of the political acceptability of arms purchases from a foreign source, the maintenance and development of domestic defense and commercial industries, and the preservation of foreign exchange are often important, if exogenous, factors in the development of weapons procurement policies in many nations, including the U.S. In like fashion, the arms export policy of the U.S. Government is influenced by foreign policy/national security considerations that sometimes conflict with economic efficiency.

Offsets can alter the nature of arms transfers. Offsets can introduce rigidities and increased costs into the procurement process, because they may prevent the supplier from obtaining needed commodities from the most cost-effective sources. They can divert resources, which may enhance military capability at the expense of a more efficient use of those resources. However, in many cases, without the cooperative efforts that result from offsets the sale would not be consummated.

Arms transfers enhance the preparedness of allies and friends by providing them with modern means to defend themselves against foreign aggressors. Coproduction and licensed production directly contribute to allied preparedness by enhancing the ability of friendly nations to contribute to the overall productive capacity of the alliance.

Arms transfers contribute to U.S. power projection capabilities when such transfers are agreed to in whole or in part as consideration for the granting of basing or access rights for U.S. forces on foreign soil. Offsets indirectly contribute to U.S. power projection to the extent that where offsets are a condition without which an arms transfer cannot take place [if the offset is not granted], the U.S. would not receive the sale's external advantages, which may include base or access rights.

Arms transfers promote rationalization, standardization, and interoperability in that they result in allies and friends using common weapon systems. Coproduction and licensed production contribute positively and directly in this area. Coproduction and licensed production provide incentives for allies to standardize on common systems, and enhance the ability of allies to maintain and support the systems of other alliance members.

As U.S. government purchases account for over 80 percent of the sales of the U.S. defense industry, offsets have little direct impact on the defense industry's practical, non-wartime plant and equipment capacity and utilization rates. However, offsets directly contribute to the realization of foreign sales above and beyond the orders placed by the U.S. Offsets that enable such sales can therefore help to extend or expand production runs, which enhances the overall health of the defense industry. Conversely, when offsets expand foreign production capacity, they may reduce

the overall capacity and efficiency of U.S. defense firms competing against the expanded foreign production base.

Offsets can enhance collective security arrangements by making purchasing governments better able to defend such arrangements on grounds other than security. Moreover, to the extent that offsets lead to increased defense production in other countries, they can have the same effect of minimizing redundant research and development costs as have U.S. purchases of foreign manufactured defense goods.

Viewed in North Atlantic Treaty Organization political terms, some offsets can be seen as responses to the concerns of U.S. allies over the arms trade imbalances that gave rise to the European concept of the two-way street. To rectify this situation, the NATO countries learned to trade U.S. access to their market for domestic content in the form of coproduction or licensed production and technology transfer, as well as for indirect offsets from sellers. While this is an equitable solution from the perspective of our allies, it sometimes increases the overall cost of NATO armaments.

CURRENT SITUATION

The most significant statement of U.S. policy on offsets in military exports is a May 4, 1978 memorandum from then Deputy Secretary of Defense Charles Duncan. This memorandum noted the increased frequency of offset arrangements, designated management responsibility for evaluating and monitoring such agreements within the DOD, and established the following basic “. . . policy with respect to compensatory coproduction and offset agreements with other nations . . .”:

Because of the inherent difficulties in negotiating and implementing compensatory coproduction and offset agreements and the economic inefficiencies they often entail, DOD shall not normally enter into such agreements. An exception will be made only when there is no feasible alternative to ensure the successful completion of transactions considered to be of significant importance to United States national security interests (e.g., rationalization of mutual defense arrangements).

The same document specifies that when compensatory agreements are necessary, they should 1) be as broad as possible to obtain maximum credit for U.S. purchases of defense goods and services, 2) avoid offset targets whether stated in percentage or money terms, 3) be used to reduce administrative barriers to defense trade by all parties, 4) encourage equal competition between U.S. and foreign firms concerning bidding on contracts, and 5) specify that the burden of fulfilling any commitments rests with the U.S. firms directly benefitting from the sale.

The current version of the Security Assistance Management Manual puts the basic policy this way:

It is DOD policy not to enter into government-to-government offset arrangements because of the inherent difficulties in negotiating and implementing such arrangements. Any foreign government requesting offset should be informed that the responsibility for negotiating any offset arrangements resides with the U.S. contractor involved. The U.S. Government will not commit a U.S. contractor to an offset commitment without having its prior concurrence.

The Defense Security Assistance Agency has established guidelines concerning the use of appropriated funds in connection with offset agreements. The FMS guidelines for direct commercial purchases contain the following with respect to offsets:

Loan financing is discouraged for purchases containing offset provisions as a condition for securing the purchase. Offset provisions are agreements by the seller to make investments or procurements in a country other than the U.S., either concurrent with or subsequent to the purchase for which financing is being requested. No FMS loan funds will be authorized or disbursed to pay for mandatory direct offsets. Mandatory direct offsets are procurements of a foreign-made component required by the foreign government as a condition of sale, for incorporation or installation in a U.S.-produced end item being sold. While FMS loan funds will not be authorized for foreign-produced content resulting from mandatory direct offsets, such funding can be authorized for the U.S. content.

There are also limitations on the use of appropriated funds outside the United States. Section 42(b) of the AECA prohibits the use of U.S. security assistance funds to finance coproduction or licensed production of defense articles of U.S. origin outside the United States unless the Secretary of State notifies the Congress in advance of the effects of the proposed transaction on employment and production within the United States. A predominant portion of any item which is financed with military assistance funds must be of U.S. origin unless otherwise approved by DSAA. Section 42(c) of the AECA, which requires a determination that the net benefits from procurements outside the United States outweigh any adverse effects upon the U.S. economy, industrial mobilization base, or balance of payments situation, also affects the use of such funds.

There have been four exceptions to current U.S. policies on offsets. Offset agreements already in force when the 1978 Duncan Memorandum was promulgated that involved U.S. Government guarantees were honored. During the 1980s, exceptions involved waivers of the rules on the use of foreign aid funds for Israel and Egypt, and a direct DOD commitment to the Netherlands [as described below].

The FMS financing guidelines pertinent to Israel, [are identified in] a separate document effective July 17, 1987, and include the following:

In the case of the GOI, there is an exception for direct offsets related to its commercial purchases. A direct offset is the procurement of Israeli made components for incorporation or installation in the U.S. produced end item being sold which is required by the GOI as a condition of the sale. In all instances the U.S. content must equal 55 percent or more of the prime contract price, and final assembly must take place in the United States. FMS loan funds normally cannot be used under subcontracts for operations and maintenance, overhaul, translation, warranties, training, storage, testing, and other services of this nature.

For the last several years, Israel has sought to require offsets in commercial contracts with U.S. companies supplying goods and services paid for with FMS financing. Prior to fiscal year 1984, this Israeli policy was largely ignored because the dollar value was not significant. As dollar value rose and U.S. Government cognizance of the problem increased, the need for a policy was recognized. Consequently, for fiscal year 1984, Israel was allowed to take "directed offsets" on up to 15 percent of the total value of Israeli purchases of items on a commercial basis. This decision gave the Israelis over \$225 million worth of offset business.

For 1985, Israel was allowed to take a lesser amount in offsets, this time expressed as a specific dollar ceiling of \$200 million rather than a percentage of purchases. This program was reduced to \$150 million for fiscal years 1986 and 1987, after which it was planned to terminate the exemption. On September 9, 1987, in connection with the decision by the Israeli government to cancel the LAVI fighter aircraft project, it was decided to extend the \$150 million directed offset exception to fiscal years 1988 and 1989. On June 26, 1988, directed offsets were authorized for fiscal year 1990 in a letter which reads, in part:

With respect to directed offsets, we [the United States] will continue this special authority for FY 1990 at the level of \$100 million with the understanding that any direct offsets associated with . . . [the recent purchase of F-16 aircraft], which are to be financed with FMS credits, will be counted against the authorized directed offset ceiling.

The term "directed offsets" means those activities that are called "subcontractor production" elsewhere in the [annual OMB offset] report, and that are financed by FMS financing appropriations. Excluded from these limitations are offset requirements negotiated between Israel and U.S. corporations that are not financed by the U.S. Government. In addition, the law permits the Israelis to use another \$400 million per year of FMS financing for procurements in Israel—the functional equivalent of directed offsets from the recipient's perspective. Egypt has also been authorized to use FMS financing for directed offsets. To date up to \$40 million of 1987 FMS financing is planned for use in Egypt.

The exception for the Netherlands was a one-time arrangement. As part of the offset package associated with the sale of four Patriot surface-to-air fire units in 1984, the U.S. Army agreed to buy 1,980 Patriot missile canisters produced in the Netherlands. U.S. Army procurement appropriations of \$70 million were used for this purpose.

There is another special situation where the U.S. Government has established policy concerning offsets in military export trade. On October 1, 1985, legislation establishing a new type of international procurement arrangement—called a NATO Cooperative Project—became law. Coverage of these provisions was extended beginning with fiscal year 1987, to "any friendly foreign country . . . if the President determines that the cooperative project agreement with such country would be in the foreign policy or national security interest of the United States." The 1985 cooperative projects law included a prohibition against offset demands on contracts pursuant to this new procurement scheme unless specified in the government-to-government agreement that establishes the project. The cooperative project approach, as distinguished from the traditional government-to-government or commercial sales method, represents a growing percentage of the U.S. arms transfer business. Thus, this provision may be an important limitation on offsets in the future. To the degree that cooperative projects (where work share is divided before development and production begins) replace sales (where offsets are often offered as a substitute for work share), the overall value of offsets should decline.

Strictly speaking, U.S. government policy on offsets in military exports is also affected by two provisions in the fiscal year 1989 DOD authorization act, but neither is expected to have much operational impact. The first provision prohibits U.S. officials from entering into international agreements connected with contracts involving offset arrangements, and which require the transfer of technology that would significantly and adversely affect the U.S. defense industrial base and result in a substantial financial loss to a U.S. firm. Exceptions can be made by the Secretary of Defense on national security grounds subject to consultation with the Secretaries of State and Commerce, and certification to the Congress. Any U.S. firm required by an international agreement to transfer technology can protest the determination to the Secretary of Defense. Hopefully, the U.S. Government won't negotiate too many agreements which will result in such industry protests. The second provision in the new DOD authorization act requires notification to the Secretary of Defense of offset arrangements valued over \$50 million.

A number of U.S. trading partners contend that the United States government has a *de facto* offsets policy with respect to its military imports. The U.S. requires that there be a domestic production capability for each critical weapon system or component in its inventory. For this purpose, domestic production includes Canadian production. Unlike some countries that apply

offset requirements to any foreign purchase above an established value threshold, the U.S. is selective in that the policy applies only to critical defense items.

The essential difference between the U.S. policy and those of most other countries is that the U.S. requirements are based on national security concerns rather than economic ones. It may be argued, however, that the economic effect of the U.S. policy is very similar to that of foreign offset policies. In addition, there are a variety of statutes and regulations, detailed in the 1988 [OMB offset] report, that limit the ability of foreign contractors to sell to the U.S. government. In general, however, the U.S. has one of the most open and transparent procurement systems in the world.

NEGOTIATIONS

The legal authority for the U.S. to negotiate limitations on military offsets with other governments derives from several sources. Under the Constitution, the power to regulate commerce with foreign nations resides with the Congress, while the President, with the advice and consent of the Senate, has the constitutional power to make treaties. The Trade Agreements Act of 1934 and successor legislation have augmented the authority of the President to enter into and enforce trade agreements to reduce both tariff and non-tariff barriers to trade. Separate constitutional and legislative authority exists for regulating the foreign transfer of military goods, related services, and technology for national security or foreign policy reasons.

The current authority to negotiate agreements limiting non-tariff trade distorting measures was extended by the Omnibus Trade and Competitiveness Act of 1988 and will expire June 1, 1993. Under this authority, the President may negotiate agreements related to military offsets as a trade distortion. Any such agreement must be submitted to the Congress for approval under the expedited procedures contained in the Trade Act of 1974, as amended, before this agreement and domestic enforcement provisions can enter into effect for the United States.

While Section 309 of the Defense Production Act (hereinafter, DPA 309) requires a report on offsets that includes a discussion of bilateral and multilateral negotiations on offsets, it does not provide any additional negotiating authority. However, the National Defense Authorization Act, Fiscal Year 1989, Section 825(c), provides a mandate for the President to enter into negotiations that would “. . . limit the adverse effects that such arrangements have on the defense industrial base”

The General Agreements on Tariffs and Trade (GATT) is the principal international body concerned with negotiating the reduction of trade barriers and with international trading relations. The original GATT document contains several exceptions, including a badly worded “Security Exceptions” article. This Article XXI, among other things, exempts the actions taken by the contracting Parties with respect to “ammunition and implements of war . . . for the purpose of supplying a military establishment” from the obligations contained in the other GATT articles.

Over the last 30 years, the GATT’s activities and its legal instruments have been expanded in response to shifts in the global economic structure. During the last major round of multilateral negotiations, an Agreement on Government Procurement was written for a sector that previously had not been subject to the GATT disciplines. This code provides for national, non-discriminatory treatment by signatory governments, and the specific agencies of those governments, as agreed among the signatories. While most defense agencies are covered by this code, “procurement indispensable for national security or for national defense purposes” is excepted.

Another separate code, the Agreement on Trade in Civil Aircraft, which went into effect in 1980, provides for freer trade in this sector among signatories by eliminating duties on all civil aircraft, their engines, and parts. This code also provides that purchases of covered products be

based "only on a competitive price, quality, and delivery basis," and that signatories shall not require nor exert unreasonable pressure on aircraft buyers to make a purchase from a particular source. While the purchasing country can, under this code, require that a manufacturer consider bids "on a competitive basis" from national suppliers for those components for which the aircraft seller was inviting bids from outside suppliers, the intent is to preclude mandatory offsets by parties to the agreement.

As part of the Uruguay Round of multilateral trade negotiations, the United States has proposed several areas currently covered by GATT rules that need strengthening, as well as the development and application of GATT rules to new trade areas. In an area directly related to military offsets, within the Agreement on Government Procurement, there have been ongoing efforts to tighten the disciplinary provision of the agreement, expand the entity coverage, extend the participation in the agreement to new signatories, and to apply the agreement to services. In the area of investment, the U.S. has been seeking to establish effective discipline over such trade-distortive measures as local content and export performance requirements. There are several economic similarities between these measures and various types of offsets defined in this report. While governmental actions, services, and procurements, seized with national defense, are not currently under consideration as targets for GATT modification, improved discipline in related areas of governmental activity could ameliorate some of the possible negative impacts of military offsets for civilian goods, particularly through countertrade requirements.

The Organization for Economic Cooperation and Development (OECD) several years ago engaged in an examination of the countertrade issue. While this issue originally arose in the context of East-West trade, where countertrade has long been a significant attribute, the U.S. has encouraged the expansion of the OECD efforts to the issue of countertrade more generally. It is anticipated that the countertrade issue will continue to be a subject of some multilateral interest within the OECD, but that there may be some reticence to examine strictly military offsets.

In July, 1983, the U.S. Government, acting through the U.S. Trade Representative (USTR), chaired the Trade Policy Staff Committee. The Committee established a formal set of national policy guidelines on Countertrade and Barter, which like offsets, condition the completion of an import transaction on a separate purchase or exchange of goods from the importing country. While not directly applicable to all types of military offsets, these guidelines are applicable to civilian countertrade related to government mandated military offsets which are not directly contributing to U.S. national security goals.

Increased demands by foreign governments for offsets to pay for purchases of U.S. arms, and the possible negative impact of these demands on our industrial base and trade interests, have become an increasing concern to the Administration, Congress, and American defense industries and their suppliers. While the concept of negotiations on offsets in military trade seems attractive, it will be difficult to resolve a number of threshold issues in order to move this concern to the negotiation stage with a reasonable opportunity that these negotiations will lead to a timely and successful result.

Military contractors and subcontractors through the Defense Policy Advisory Committee on Trade, the Industry Sector Advisory Committees on Aerospace Equipments and on Electronics and Instrumentation have generally recommended seeking a multilateral arrangement that would discipline offsets, reducing their potential economic costs to both offset suppliers and demanders. They have also expressed concern about the coverage and enforceability of any resulting agreement. In the absence of such an agreement, however, they believe that the government should not take unilateral measures where foreign competition exists that might disadvantage U.S. exports. Lastly, they have recommended that offsets not be financed by U.S. security assistance funds as has been allowed by both Administration and Congressional action.

The USTR, with the concurrence and participation of the relevant departments and agencies, undertook consultation with foreign governments, both through the permanent embassy delegations to these governments and a special delegation dispatched for this purpose in the fall of 1984. This delegation held working level meetings in London, Paris, and Bonn, with appropriate government officials from the ministries involved in the offset issue. None of the foreign governments consulted had addressed the implications of military offsets or engaged in an information gathering effort. Each government expressed concern about any unilateral change in the offset policies of the United States.