

Why DOD Procurement Dollars Are Being Spent Overseas

By

Dr. James P. Wade, Jr.
Assistant Secretary of Defense
(Acquisition and Logistics)

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One of the principal reasons for offshore procurement of items for the Department of Defense is NATO cooperation. Overall, about 5 percent of the \$163.7 billion defense contract awards in fiscal 1985 were awards to U.S. or foreign concerns with a place of performance outside of the United States. This is consistent with past data, which reflect 5-6 percent foreign awards based on dollar values for each fiscal year since 1981.

We do not monitor defense trade balance figures with every country where DOD contracts have been awarded. We do attempt to maintain data on trade with our NATO allies with whom we have reciprocal procurement agreements, and [also with] selected other countries. Contrary to the commercial trade deficits, we still estimate a 2:1 fiscal 1985 defense trade surplus for the NATO countries. Excluding Canada, the U.S. fiscal 1985 trade balance is 2.9:1. The trends show that our defense trade surplus with NATO countries has narrowed, however, over the past several years.

In part, this reflects a conscious implementation of national policy to establish a two-way street of NATO armaments cooperation to improve military readiness. In part, it reflects implementation of international trade policy to reduce or eliminate non-tariff measures. Finally, it reflects the unhappy economic reality that in some industrial sectors, U.S. industry no longer enjoys its previous status as leader in the competitive international marketplace. In that respect, DOD purchases from foreign sources, as a result of open competition, merely mirror the commercial marketplace.

The current defense trade picture is one where our trading partners are increasingly searching out greater opportunities to establish reciprocal defense trade with the United States. There has been a perceptible increase in the level of their efforts to market the goods of their industries to the American defense customer. Countries that find a historical defense trade balance strongly in favor of the United States are actively seeking to increase their defense sales to the United States to balance defense expenditures. As in the United States, our allies' defense budget items are highly visible and in many cases are becoming increasingly tied to defense trade reciprocity issues.

Before examining the numbers and the reasons for them any further, however, I would like to comment on the issue of DOD contract awards to foreign sources in the context of the commercial trade deficits. Even though we're in an overall favorable trade posture in the defense sector, it could be tempting and politically expedient to take action to attach restrictions against DOD foreign procurement to assist particular damaged industries in the commercial sector of our economy. I

believe this would be shortsighted, both from a military perspective and from an economic one. Militarily, it is to our advantage for there to be strong U.S. and NATO industrial bases. There is evidence that when the Europeans can't participate as full partners in cooperative projects with the United States, they will develop their own consortium--even though the end result in some instances may be increased cost or sacrificed performance.

Congress has had the foresight this past year to reinforce its longstanding commitment to NATO rationalization, standardization, and interoperability. The Department of Defense appreciates Congress' recent legislative support for armaments cooperation, as seen in the removal of numerous statutory impediments in Section 1102 of the FY 86 Defense Authorization Act and the earmarking of \$125 million for cooperative research and development and side-by-side testing of selected weapon systems.

This has sent a strong signal to Europe that the United States is serious about NATO cooperation. At this critical juncture, I would hate to see that signal distorted by protectionist legislation directed at the DOD procurement dollar. I believe it would certainly invite retaliation and adversely affect NATO armaments cooperation. Secondly, I believe it would be unsound from an economic perspective. Narrow restrictions affecting only DOD purchases do nothing to improve the competitiveness of U.S. industry in the larger commercial sector. The U.S. approach to remaining a viable contender in the world marketplace must treat the root causes of the trade deficit rather than just the symptoms to achieve increased productivity and competitiveness.

Let me turn to an examination of the DOD acquisition process itself and explain some of the considerations that impact on the acquisition of foreign equipment and services.

The Buy American Act (41 USC 10 A-D) provides that the government generally give preference to domestic end products. This preference is accorded during the price evaluation process by applying a punitive evaluation factor to most foreign products. There are two notable exceptions to this practice: procurements subject to DOD's reciprocal procurement memoranda of understanding, and those subject to the Trade Agreements Act of 1979. This statute affirms the agreement on government procurement, which is one of the multilateral agreements, or codes, resulting from the Tokyo Round of Multilateral Trade Negotiations within the General Agreement on Tariffs and Trade.

DOD RECIPROCAL MEMORANDA OF UNDERSTANDING

The basis for DOD reciprocal memoranda of understanding begins with a history of strong congressional support for enhanced defense cooperation. A key element was the Culver-Nunn Amendment to the 1977 Defense Appropriation Authorization Act (94-361), which has since been enacted into law. This authorized the secretary of defense to make exception to the Buy American Act to promote a two-way street concept of cooperation in defense procurement among the NATO allies. The objective of this cooperation is to further NATO standardization as a means of improving military readiness. The Roth-Glenn-Nunn Amendment to the 1983 DOD authorization act reaffirmed the U.S. commitment to NATO cooperation. This statutory direction is the foundation of DOD's reciprocal memoranda of understanding program, which encompasses bilateral procurement agreements with all NATO allies except Iceland.

The memoranda of understanding do not guarantee business to firms located in NATO countries. They are reciprocal agreements that provide an opportunity for U.S. and allied industry to compete for defense business with lowered obstacles on both sides. Further, there are important exceptions to the memoranda of understanding. Small business and labor surplus area set-aside acquisitions are still reserved for appropriate U.S. concerns. Certain procurements are also reserved for domestic mobilization base suppliers. Finally, foreign participation in any DOD

acquisition is subject to the national disclosure policy for release of any classified data that may be required in connection with contract performance.

TRADE AGREEMENTS ACT OF 1979

This statute is the congressional affirmation of the agreement on government procurement. This agreement opened our government procurement market to international competition by signatory countries who likewise agreed to open their procurements; and it essentially closed the market to competition by non-signatory nations (the signatories include most of our NATO partners).

The Buy American Act punitive evaluation factor is not applied to offers of certain items from signatory countries. The scope of applicability is subject to some limits. Again, small business set-aside acquisitions are still reserved for U.S. small business. Currently, the act is applicable only to acquisitions of more than \$149,000. Further, the coverage extends only to categories of eligible products that are generally of a commercial nature. Excepted items are termed national security items. Further, even for items falling within groups currently designated as eligible, DOD may, in consultation with the United States trade representative, make case-by-case determinations to restrict acquisitions for national security reasons, e.g. to protect the mobilization base.

Thus, even if we did not have a military reason for and commitment to the implementation of NATO standardization through the reciprocal memoranda of understanding, the Trade Agreements Act would still dictate no preferential treatment of domestic offers on numerous DOD procurements. In fact, a recent review of the fiscal 1985 contract awards to NATO sources making up the trade balance figures, reflected that about 49 percent of the dollars awarded to NATO sources would have been awarded to them under the dictates of the Trade Agreements Act, even if the DOD reciprocal memoranda of understanding did not exist. That is, the awards were made for eligible commercial-type products, in acquisitions above the Trade Agreements Act dollar threshold.

CONSIDERATION OF FOREIGN EQUIPMENT IN THE DEFENSE ACQUISITION PROCESS

Until now, I have discussed the very narrow phase of the DOD acquisition process that dictates how offers will be evaluated on a price basis during contracting. To fully appreciate how NATO cooperation is being approached in DOD, one must look to requirements formulation and the planning, programming, and budgeting process.

We firmly believe that the collective security of NATO members depends upon greater integration of military requirements with alliance-wide defense-industrial cooperation. We must capitalize on each opportunity to advance in order to make the most efficient use of limited resources and enhance combined combat capabilities.

Many procedural steps are being taken within the military departments and the Office of the Secretary of Defense to institutionalize this objective and to ensure that foreign participation in its various forms--codevelopment, coproduction, and purchase of an existing allied system--are seriously considered at all critical decision points in the acquisition life cycle of a program.

Many avenues of participation in international activities are being exploited to identify capabilities, new technologies, and requirements of NATO allied nations for comparison with our own. These information exchange activities: provide candidates for the foreign weapons evaluation program; assure allied capabilities are properly and thoroughly considered before any new development efforts are begun; provide data for establishing operational and design requirements for future major weapons systems that are compatible with those of our allies; and

identify opportunities for cooperative research and development and coproduction projects. In fact, it is now a statutory requirement to prepare a formal arms cooperation opportunities document for use by the Defense Systems Acquisition Review Council prior to any major new start program.

INDUSTRIAL BASE CONSIDERATIONS

Along with NATO rationalization, standardization, and interoperability considerations, we must balance the essentiality of maintaining our own national capability of the industrial base to expand production for emergencies. The objectives of NATO rationalization, standardization, and interoperability and a strong U.S. industrial base are not always in conflict. For example, to the extent that we can enhance international cooperation to develop common user requirements, our industry will benefit from being able to spread non-recurring costs beyond a market that is based only on U.S. requirements.

Our defense policies direct maintenance of at least one domestic producer at a minimum sustaining rate for designated major weapons systems and secondary items. This guidance can usually be implemented on a fairly straightforward basis at the systems level. What we are finding, however, is that it is much more difficult to grapple with the question of foreign dependency at the subassembly and component levels. The U.S. vendors and suppliers producing these items are usually commercially oriented companies and, thus, are affected by overall national economic problems. There are many ongoing studies of this problem.

Visibility into various domestic industrial sector weaknesses is critical. Once that visibility is gained, ample tools are available to either prevent the loss of allocated emergency capacity or to create new industrial capacity. All of these measures involve a near-term expense. They include:

- Manufacturing technology investments to increase industrial productivity, reduce manufacturing leadtimes, and reduce dependency on imported raw materials;
- Industrial modernization incentives to increase defense contractor capital investments, improve productivity and quality, and reduce acquisition costs;
- Use of Title III, Defense Production Act projects to establish or expand the domestic capacity of critical materials and manufacturing processes; and
- Restriction of DOD peacetime procurements to domestic sources.

Domestic source restrictions have been imposed for items such as forgings, miniature and instrument ball bearings, and ammunition. Because of the attendant impact on DOD acquisition costs, we need to be judicious in applying this measure. It must be based on sound studies of existing industrial capacity, our surge requirements, and mobilization shortfalls. Unfortunately, in some cases these are only stopgap measures.

Because we are dealing with a commercial marketplace, the requirements of DOD alone may frequently be insufficient to stabilize a failing industry. It is not sufficient, however, to look only at the short-term aspects of this situation. I am personally concerned regarding the potential long-term loss of technology overseas. Technology could be lost irreversibly following a shifting of manufacturing jobs overseas as a result of the failure to be competitive economically. With the leverage provided by an annual procurement budget in excess of \$100 billion, the Defense Department plays a leading role in promoting manufacturing and productivity improvements important to the economic revitalization of our nation. Efforts that benefit the commercial industrial base are particularly important, since this base is ultimately the source of our defense capabilities.

TRADE BALANCE STATISTICS

We have developed improved reporting procedures over the past several years to monitor the defense trade balance (often called "the two-way street") with NATO allies. Admittedly, we have not found a method of calculation that is without some flaws or distortion due to the complexity and number of sources involved. For the past three years, we have adopted a relatively consistent method of compiling our data so that we are able to establish a basis for seeing trends. We tabulate agreements for NATO purchases through foreign military sales and purchases directly from U.S. industry that are licensed by the Office of Munitions Controls [in the Department of State].

On the other side of the balance, we tally prime contracts where the principal place of performance is outside the United States, and reports from U.S. DOD prime contractors of subcontracts they have placed overseas. Not all categories of purchases are included in accordance with the terms of our reciprocal memoranda of understanding. We do not count purchases of fuel, food, construction or support services. Otherwise, it is important to recognize that, when discussing defense trade, the definition of defense goods is one that applies to all purchases with appropriated funds. The purchases that flow across the borders, therefore, include high technology as well as support items.

The resultant trade ratio is susceptible to wide fluctuations due to major systems purchases, whose total contract value is loaded into a single year's data. Nevertheless, the data has consistently reflected defense trade balances in favor of the United States, but by a narrowing margin. In fiscal 1984, our data reflected a total of \$8.29 billion European defense purchases in the United States, contrasted with about \$1.19 billion of U.S. purchases in Europe. For every dollar spent by the United States in Europe, almost \$7 was spent by Europeans for U.S. defense goods and services. In fiscal 1985, the same data reflects a margin of 2.88:1. To a large extent, the year-to-year difference is attributable to major Turkish and Netherlands purchases of F-16 aircraft in fiscal 1984, which were not matched by comparable volumes of new foreign military sales agreements in NATO during fiscal 1985. DOD's purchases from European sources also increased from about \$1.19 billion to \$1.58 billion year to year.

Obviously, these numbers present only a surface picture of the economics of NATO cooperation. For example, there is no accounting in these ratios for the sizable economic burden the United States bears in maintaining troops stationed in Europe. Furthermore, they do not take into account the inextricable meshing of industrial concerns that has taken place internationally. For example, our data on DOD prime contracts is captured according to the principal place of performance. Companies included in the purchases from Germany, for instance, include U.S. subsidiaries such as 3M, Abbott Labs, and Digital Equipment of America. Clearly, there is a measurable economic flowback to the United States from these awards that is not fully captured in the trade ratios.

FAIRNESS ISSUES

One particular area that deserves comment is what I'll term the fairness issue. Simply put:

- Is there a level playing field for U.S. vs. foreign competitors from the standpoint of contractual requirements?
- Do we believe foreign government subsidies are playing a role in foreign firms obtaining DOD contracts?

On the first question, a line has to be drawn between what I term the business requirements of a contract and the socio-economic requirements. The business requirements are the same--same specifications, same qualification requirements, same delivery schedules, same rules of

determining capability to perform. There are differences, however, in the socio-economic requirements applicable to a U.S. contractor performing in the United States and those affecting a contractor performing in another country. For example, our contract requirements dealing with requirements for submission of a small/small disadvantaged business utilization plan; equal employment opportunity requirements mandated by Executive Order 11246; and labor laws, including the Contract Work Hours and Safety Standards Act, the Service Contract Act, and the Walsh-Healey Public Contracts Act which all stop at our territorial waters in accordance with underlying statutes.

I don't believe, however, that this necessarily means foreign firms have an advantage. They have their own socio-economic requirements--in some cases more stringent and in some cases less stringent than our own.

I can tell you this, however. I know of no practical way to deal with these kinds of differences in the bid evaluation process. I could no more establish a fair formula to weight the competitive advantages/disadvantages of national environmental pollution requirements than I could write a rule to evaluate competitive advantages conferred on U.S. companies by place of incorporation or differing state regulations.

In conjunction with the Department of Commerce, we're preparing a compilation of all foreign awards more than \$1 million and identifying those where there has been an anti-dumping or countervailing duty invoked as a result of a subsidy determination. This will be accompanied by an assessment of detrimental impact, if any, on the industrial base. The subsidy issue is also not that clear. From a European perspective, our tax structure, policies with regard to government-furnished property and facilities, and recognition of independent research and development and bid and proposal expenses in payments for contractor overhead costs are often viewed by our trade partners as a form of U.S. subsidy.

FORECAST FOR THE FUTURE

I do not have available a specific forecast of foreign procurements for fiscal 1987. In large measure, these could not be predicted in advance of actual competitive acquisitions. However, the fiscal 1986 Report to Congress on Standardization of Equipment within NATO, which should be available shortly, compiles a great deal of data on on-going and potential cooperative projects and foreign candidate equipment under evaluation.

This is a difficult time for treating the issue of international defense trade. Congress sent the department a strong message on the importance of competition in 1984 with the passage of the Competition in Contracting Act. Full and open competition includes competition by foreign sources also.

I sense a perception that NATO cooperation costs U.S. jobs. The United States, however, is increasingly faced with a choice. Cooperation with our allies keeps a portion of the work on their defense equipment at home in the United States. Failure to cooperate frequently means that the United States has no role at all in foreign sales. Many industry sectors have recognized that if they wish to expand beyond the U.S. military market, they must employ a production strategy that includes some portion of the work being done in the customer's country.

The Europeans will not tolerate, and rightly so, a two-way street that is in reality a one-way super-highway where the United States does not purchase its share of European-developed systems. We cannot tolerate a one-way super-highway in the other direction either. We believe there must be incentives to our allies to fund a greater amount of research and development to improve our collective military readiness.

We cannot expect them to do so, however, unless they are able to amortize some of that investment through export sales to the United States. This period is extremely important to our ability to achieve a stronger defense capability in partnership with our allies. NATO cooperation, as envisioned by Congress beginning with its 1977 support of enhanced NATO rationalization, standardization, and interoperability, contributes to military readiness, and, I believe, to the health of U.S. industry overall.

As a nation, we have tough choices to make. National trade and research and development policies will require government support of fundamental high-risk, long-term payoff research and creation of a policy environment in which business can function effectively and competitively. In turn, industry must: review its international policies, practices, and structure to give exports an even higher priority; increase funding for research and development; and increase capital investment to improve productivity, encourage innovation, enhance product quality, and lower unit cost, to be more competitive here and abroad.

We remain committed to cooperation with NATO in recognition of the improved military readiness that such cooperation can bring. We are mindful, however, of the equally important objective of maintaining a strong domestic industrial base. The Defense Department will continue to try to execute its role as a major customer in the international marketplace in a manner that supports each of these objectives.

ABOUT THE AUTHOR

Prior to assuming his present position as Assistant Secretary of Defense (Acquisition and Logistics), Dr. Wade served as the Assistant Secretary of Defense for Development and Support. He has also served as Principal Deputy Under Secretary of Defense for Research and Engineering. A former director of DOD's SALT Task Force and Deputy Assistant Secretary of Defense, International Security Affairs (Policy Plans and National Security Council Affairs), Dr. Wade is a graduate of the U.S. Military Academy and has received both MS and PhD degrees in physics from the University of Virginia.

Controlling the Transfer of Strategic Technology

[The following is a reprint of an April, 1986, *GIST*--a quick reference aid on U.S. foreign relations, published by the Bureau of Public Affairs, U.S. Department of State.]

Background: The purpose of controlling the export of strategic militarily relevant technology is to deny Warsaw Pact and certain other countries access to technology that would increase the effectiveness of their military establishments. Because development of sophisticated weapons today depends on many advanced supporting technologies that have dual use (civilian as well as military), it is increasingly necessary to identify and control those commercial technology transfers that could threaten U.S. national security. U.S. regulations require a license to be issued before any technology can be transferred to a potential adversary country. This requirement permits a review of the potential military utility of the technology, to ensure that transfers of militarily relevant technologies do not occur under the guise of civil-use projects. The need to maintain more effective controls on the transfer of Western technology to the East is highlighted by conclusive documentation of the USSR's past and continuing reliance on Western high-technology know-how in furthering its military buildup and in strengthening those elements of the Warsaw Pact industrial base that directly support Soviet war-making capability.

The Soviet Union is determined to obtain controlled Western equipment and technology by any means it can--including circumvention of export controls. The U.S., acting alone, could not prevent such diversions of controlled items, because in many cases we are no longer their sole producer. The cooperation of the Coordinating Committee for Multilateral Export Controls (COCOM) is therefore of greater importance than ever. As evidence of Soviet diversion efforts mounts, the COCOM nations' determination to improve enforcement capabilities has grown, and additional resources are being applied to this task.

Organization and major functions of COCOM: COCOM, established in 1949, now includes the U.S., Canada, Japan, and 13 European countries [Belgium, Denmark, France, Greece, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Turkey, United Kingdom, and West Germany]. Spain was the latest member to join, in late 1985. COCOM has no formal relationship with NATO. Although COCOM is not based on any treaty or executive agreement, there have been few instances when a member country has deviated from commitments made in COCOM.

A permanent COCOM secretariat is located in Paris, staffed by dedicated and highly experienced professionals. All 16 member countries have permanent delegations to COCOM, also based in Paris. The U.S. delegate and his deputy are Department of State officers. Their permanent staff is joined by teams of U.S.-based government technical experts and interagency policy-level personnel during negotiations on new or revised export control definitions and other substantive meetings.

COCOM is principally a coordinating and decision-making mechanism. Agreements are put into effect jointly by its member countries. As enacted, each member's publication of the agreed control definitions carries the force of law or of export control regulation, so that the definitions may be administered and enforced effectively. The controlled products may be grouped into three categories--direct military use, dual use, or atomic energy use. COCOM also reviews potential shipments of specific embargoed items to proscribed countries. All comments by other COCOM delegations are considered by the exporting member, which permits the export only when the risk of diversion to military use of the product or technology is deemed acceptably small. Equipment

capabilities may have to be altered in order to gain acceptance for shipment. Finally, the COCOM member countries act to harmonize their licensing practices on export controls and to coordinate their export control enforcement activities.

Improving COCOM's effectiveness: COCOM faces continued Soviet and Warsaw Pact efforts to obtain militarily sensitive equipment and technologies. At the July 1981 Ottawa summit, President Reagan raised the problem of transferring Western technology to the Soviet Union. These discussions led to a high-level COCOM meeting in Paris in January 1982, the first such Under Secretary-level COCOM meeting since the late 1950s. Subsequent high-level meetings took place in April 1983 and February 1985. Lower-level consultations are held regularly, as the U.S. is cooperating actively with other COCOM members for improvement in each of the three above mentioned functional areas. About \$2 million is now being spent to upgrade the computer equipment, software, and other facilities for the COCOM secretariat.

Relations with non-COCOM countries: One problem facing COCOM is how to protect against the export or re-export of embargoed commodities from non-COCOM countries to the countries of concern. The U.S. deals with this problem in part by requiring licenses for re-exports of U.S.-origin embargoed products. COCOM members also maintain continuing dialogues with a growing number of other countries regarding cooperation on export controls and avoidance of diversions. Some countries could choose to adopt full COCOM membership. Others that produce or trade in embargoed high-technology products have established methods for cooperating in the protection of militarily relevant items.