

The Offset Issue: An Industry Perspective

By

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[The following is a reprint of a prepared statement which Mr. Johnson presented in testimony before the Subcommittees on Arms Control, International Security, and Science, and on International Economic Policy and Trade of the House Committee on Foreign Affairs on June 24, 1987. This statement has been incorporated in the Subcommittee's 1988 report of June 24 and July 27, 1987 hearings, entitled *Countertrade and Offsets in International Trade*, Report No. 82-322, pp. 24-37.]

I am pleased to have the opportunity to participate in this hearing on behalf of the members of the American League for Exports and Security Assistance [ALESA]. Our members, which include 24 corporate and four union members, wish to facilitate government policies that stimulate U.S. exports of defense equipment within the context of prudent security considerations. I have attached a list of those members to my printed testimony. [See listing at end of this article.]

I am fortunate to have with me this afternoon two officers from ALESA member companies who have long experience with offset practices. Mr. Al Urban is Director of Offset Management for Pratt and Whitney, a division of United Technologies. He has come from Hartford, Connecticut for the hearings. Mr. Edward Bursk, Jr. is Director of International Relations for the Raytheon Company. I might note that both men are also members of the Defense Industry Offset Association [DIOA], which includes 55 U.S. based aerospace and defense companies that probably account for well over 95% of all defense related offset obligations of U.S. firms. Mr. Urban is in fact the past Chairman of the DIOA. With the help of these gentlemen, I am certain we can answer any specific questions on how offsets are actually demanded, negotiated, and administered in today's economic environment. I should note, incidentally, that they will be commenting in their personal capacity, and not representing the DIOA, which takes no formal positions on public issues.

The general topic of discussion this morning is the impact of offset practices on international trade and the competitiveness of U.S. companies. At the outset, however, I should note that the offset issue is extremely complex because it involves more than just economic questions. This is particularly true in the case of offsets related to exports of defense equipment. Although these hearings, and this testimony, are primarily focused on the economic aspects of offsets, we cannot lose sight of the fact that trade in general, and especially trade in defense equipment, involves more than economic transactions. U.S. security, influence, and foreign policy interests are also intimately associated with such trade.

For example, the U.S. has a number of specific security objectives, such as enabling friendly countries to defend themselves, increasing the commonality of our weapons systems and those of our closest allies, and finding economic means to increase conventional warfare capacity in Europe so as to reduce the likelihood of having to resort to nuclear weapons. These objectives are all related to trade in defense equipment, and often to associated offset arrangements. The blend of economic, security, and foreign policy issues which is involved in defense trade and related offset questions makes this a difficult issue for the U.S. Government to address. In the executive

branch, trade issues and security issues tend to be handled by different agencies, or by different bureaucracies within the same agency. Similarly, in the Congress these issues tend to be handled by different committees. In fact, the House Foreign Affairs Committee, with jurisdiction over the Arms Export Control Act and the Export Administration Act, is one of the few places these issues actually come together in the same body. It is most appropriate, therefore, that these two subcommittees should take a look at the offset question.

I would also note that I will not propose carefully delineated definitions of offsets and their components. There are as many definitions as there are writers about the subject and practitioners of the activities. For purposes of this testimony, by offset I mean a transaction in which the foreign purchaser requires that the seller perform some service for the purchaser in addition to providing the good or service which is the immediate subject of the transaction. Such services may include joint production, incorporation of goods made by the consuming country into the end product being purchased by that country, technology transfer, the promotion of sales in the U.S. or third country markets of goods and services produced by the purchasing country, and the acceptance of other goods and services produced by the consumer as partial payment for the product. When I use the term countertrade, I will be referring to a component of an offset agreement which requires that the seller also accept or dispose of a certain amount of goods produced by the purchasing country.

Regardless of specific definitions, there is general agreement that in recent years the demand by foreign customers for offset arrangements has increased. We certainly see evidence of this phenomenon at the company level where corporations have increasingly established offices to help negotiate, coordinate, and conduct offset and countertrade operations. The questions we need to ask are what is responsible for this increase in offset demands, what has been the response of U.S. industry, what are the impacts on our economy, and is there any action required on the part of the U.S. government? I will attempt to address each of these questions in the remainder of the testimony.

CUSTOMER INTERESTS

The factors motivating countries to require offset arrangements are reasonably clear. In general these offset requirements involve purchases with taxpayers funds of expensive, highly visible foreign products, particularly related to defense equipment, but also to sectors such as transportation and power generation. These are goods which many foreign countries cannot produce locally, but must have, regardless of their economic circumstances, if they are to provide for their defense and improve their economic growth prospects. Such products generally have high unit prices, and hence are a major drain on foreign exchange and credit lines. They incorporate high technology, and therefore represent areas in which other countries would like increased investments and knowledge. Governments consequently feel a need to demonstrate to their public that they have obtained the best possible deal in terms of price, jobs, sales of domestic products, and technology transfer.

I should point out that the U.S. Government faces many of the same political pressures. Even in domestic purchases of defense equipment, the Congress adds a number of additional requirements on defense contractors in addition to the provision of the given weapons systems. Companies are required to establish small business, minority business, and depressed area set asides, leader-follower programs, affirmative action programs, [and to] follow accounting practices peculiar to DOD requirements, etc. In other words, the U.S. Government wants more for its money than simply the defense hardware in question.

Internationally, while the U.S. Government makes no formal offset demands, in general DOD requires that any major defense system bought from offshore suppliers ultimately be manufactured in the United States. Thus, such foreign designed systems as the Harrier jump jet, Hawk trainer,

Berreta automatic revolver, and Mobile Subscriber Equipment System are or will be primarily produced in the United States. In the case of the U.S., the primary motivation behind the requirement that foreign systems be produced in this country is related to security concerns involving access to a production line in times of global conflict. However, political reality certainly supports this policy.

In addition to the above considerations, current global economic conditions have also increased the pressure for countertrade provisions as part of an offset package. Especially for many developing countries, a combination of foreign exchange shortages, over-valued exchange rates, diminished access to industrial country markets, and serious indebtedness makes a countertrade component of an offset agreement attractive. Particularly for high cost transactions, in fact, such arrangements may be the only way a country can realize a purchase.

- Purchasing foreign goods generally requires use of a hard currency. For countries facing severe shortages of such currencies, countertrade may be used as a way to generate such currency to offset the original outlay.

- Ordinarily foreign exchange is obtained through exporting ones own products. Industrial countries have recently increased trade restrictions against commodities and goods which developing countries can produce on a commercially competitive basis. This encourages them to demand countertrade arrangements, in which the marketing structures of large foreign companies can be used to help find new markets. Offset agreements can include technology transfer provisions to assist countries in producing new items, often in high technology areas, which are less protected in industrial country markets.

- The foreign exchange problem often is further complicated by over-valued exchange rates in the Third World, which makes the prices of a developing country's goods unattractive on open markets. Countertrade offers the customer a *de facto* way to discount the real prices of those goods while avoiding the politically sensitive step of devaluation.

- Finally, in a number of cases, countries are under IMF [International Monetary Fund] programs which restrict their ability to acquire new debt, or the countries are simply such poor credit risks that they cannot obtain credit through commercial channels. A countertrade transaction helps overcome these limitations.

Incidentally, it might be noted here that in the case of developing countries in which the U.S. Government has an interest in promoting the capacity for self defense and/or economic development, one way around the lack of resources is for the U.S. to provide increased foreign assistance. At a time of severe budget limitations, however, this is increasingly difficult. Thus, in some instances offset arrangements may well have to be regarded as an alternative to direct U.S. Government concessional assistance.

U.S. COMPANY PERSPECTIVES

While the reasons foreign customers increasingly require offset and countertrade arrangements are clear, the more interesting question is why companies accept offset requirements. Most would certainly prefer not to do so. Corporations in the business of producing aircraft, or power plants, or locomotives are not enthusiastic about getting into activities such as marketing unrelated products or becoming technical advisors to foreign companies or governments. Most companies would prefer to do what they do best--produce a quality product--and get paid cash for what they sell.

The simple truth, however, is that in a competitive world environment, if one bidder on a contract is willing to make such concessions, others will have to, unless their product is so unique

that they have no other competition. Realistically, today there are strong competitors for most U.S. products. In the defense area, for example, for the last four years in a row, U.S. sales of defense equipment in the international market have declined, and the U.S. share of that market has also declined. In addition to traditional competitors such as the USSR, France, and the United Kingdom, many other countries are increasing their market shares such as Israel, Brazil, Italy, and Spain. Increasingly tight export controls for security reasons make it even more difficult for a U.S. product, which can obtain approval for export by the U.S. Government, technically to be substantially superior to those of our competitors.

Thus, from the perspective of the U.S. companies, the question is not whether to accept a deal with or without countertrade or offsets. The question U.S. companies face in the current competitive international environment is between business with offsets or no business at all; increasing employment by obtaining new contracts with some offset provisions, or maintaining or decreasing employment because of no new foreign business.

The need to participate in the world of offsets, however, should by no means imply that companies have no control over what they offer. Clearly a company only makes offers which it is convinced on balance will leave it better off than if it did not have the business. Companies must make profits to survive. Thus, they will only sign contracts which are to their net economic benefit. They will no more sign an offset commitment which is on balance harmful than they will accept a price for a product which will result in financial loss.

Furthermore, companies are very aware that technology transfer can create future competition. They are most unlikely, therefore, to transfer production technology that is the state of the art. If they do, it is likely that the company knows it has something even better in the development stage for near-term incorporation into the production process. The time horizon of most companies extends beyond the immediate transaction, and consideration is given to future competition.

It should be noted in this context that production technology is itself a highly perishable commodity. When it is new, it can command a very high price. When it is obsolete, it cannot be given away. The challenge for companies incorporating technology transfer into an offset transaction, as in a direct sale, is to determine the point at which the technology still has a value, but will not threaten the ability of the firm to compete in the international market over the longer term.

ECONOMIC IMPACT

Given that offsets have become an economic fact of life with which most U.S. firms have learned to cope, it must still be asked what overall impact such offsets have on the U.S. economy. We are perfectly aware that what may be in an individual firm's best interest, may not necessarily serve the overall interests of the economy. Recent studies conducted by the International Trade Commission (ITC) and by the executive branch under the coordination of the Office of Management and Budget (OMB) have generally concluded that sales with associated offsets are on balance favorable for the U.S. economy. We would agree with that conclusion.

First, it is useful to put offsets in some kind of context. Last year, the U.S. had a total GNP of nearly \$4 trillion and exports of over \$200 billion. Total defense exports run about \$9 billion a year. The figures contrast with annual performance of offset obligations in the vicinity of \$3 billion. And, as we shall see, that \$3 billion figure is itself an exaggerated number with respect to the real impact on the U.S. economy. Thus, relative to the overall economy, trade, and defense trade, offsets are not particularly important.

Second, as the OMB study points out, it should be remembered that for every export, at some time from some place there must be an import of equal value. The only exception is when exports

are being given in the form of foreign assistance, for which no economic return is expected. Offsets tend to close this circle in a finite time period with respect to specific products and a specific country, but they in no way change the overall economic requirement that exports and imports must balance over the long run.

If offsets are not a problem in a macro sense, there are still several specific concerns which must be addressed. These include the following:

Jobs: It is often alleged that offsets transfer work overseas which would otherwise have been performed in the United States, and hence that they cost jobs. In part this is true. However, without the offset, the sale itself would have likely gone to an overseas producer, and hence there would have been no work created in the United States. The OMB study found, in fact, that offset requirements may actually reduce jobs lost through imports. This is because, as already pointed out, for every export, at some point there must be an import. Traditional exports from most countries tend to be more labor intensive than exports associated with offsets. Thus offsets, by concentrating reverse trade in higher technology areas, result in imports with lower labor content than would otherwise be the case.

Technology Transfer and Competitiveness: Concern is often expressed that the technology transferred through offset agreements will be used by the recipient country not only in the immediate undertaking, but ultimately to produce products which will compete with similar U.S. products in the world market, and even in the U.S. market. Our general impression is that this is not a major problem. As already noted, companies are very aware of the importance of maintaining a technological edge over the competition. The best way to do that is not through guarding current technology, but by always having new and better technologies under development. By the time technology is made available through an offset and actually employed overseas, the U.S. firm is almost certain to be incorporating even newer technology in its own production processes.

It should also be remembered that the vast bulk of process-technology transfer occurs naturally through normal commercial transactions, not through offsets. We have companies in this country which specialize in building steel mills and petrochemical plants here and overseas. We encourage exports of our machine tools, which help other countries manufacture goods which are competitive to our own, and we are currently actually discouraging the import of foreign machine tools, which is in essence a technology transfer to us. To note one such irony, the modern automobile plants being built in this country to compete with Japan are partly dependent on the installation of Japanese robots, which of course, is a technology transfer to us. If the Congress is concerned about technology transfer and U.S. competitiveness, it should probably review that issue as a whole. Within such a review, offsets will likely prove to play a very modest role.

Erosion of Industrial Base: The claim is also made that offsets tend to involve shifting work from certain U.S. subcontractors and vendors to their overseas counterparts. Thus, it is argued that while the prime and major subcontractors may benefit from sales associated with offsets, some subcontractors are hurt. In extreme situations, offsets may result in an actual decline in the industrial base, which will ultimately harm both the prime contractors and our defense industrial readiness in case of hostilities.

We doubt that this is the case, but we certainly would agree that some more analytic work in this area is justified. It should be noted that in spite of hearings over three years on this subject, and several major government studies, there still does not seem to be any concrete evidence, or even anecdotal cases, which link offsets to a decline in any specific industry. Obtaining good data on the contractor base underlying the defense industry is very difficult. While there are but a few dozen major defense companies which account for most prime contracts and major subcontracts, there are thousand of subcontractors with some interest in defense business. For example, the

manufacturer of one of our front-line jet fighters estimates that it has contracts with at least 5,300 domestic and 55 foreign subcontractors and vendors involved in the production of the aircraft. And that does not include the roughly 50% of the equipment for the plane which is provided by DOD, such as jet engines, weapons systems, canopies, etc. If we assume that the prime contractors for the government furnished equipment have the same sort of subcontractor and vendor base, then that one plane probably has well over 10,000 subcontractors and vendors involved in its production.

Undoubtedly among those 10,000 suppliers are some who would get more business if it were not for offsets, assuming that sales of the aircraft were made at all. More important, there are other subcontractors who are not providing parts for the plane which might have been able to do so had it not been for offsets. The problem is finding a subcontractor who doesn't have a job, but might have, and deciding whether he doesn't have a contract because of offset requirements, or because of such other factors as exchange rate disparities, performance, price, or quality problems. We are most dubious that any questionnaire would illuminate this issue in a convincing way. However, we are certainly willing to help the government in future analytic efforts on this issue.

Distorting the Trading System: A final complaint against offsets is that they are one more distortion to the world trading system--along with such problems as subsidized export credits, nontariff barriers, and performance requirements. Offsets are, of course, one more departure from a perfect world trading system in which the only two variables are the quality of the product and its price in a convertible currency. But that system hardly exists in the real world. And offsets seem to parallel what is happening overall in the complex world of selling high priced, low volume goods. Even domestically, sales of commercial aircraft involve incredibly complicated issues in addition to the price and performance characteristics of the airplane--parts support, technical assistance, training, warranties, and vendor financing are all parts of the package. In such a world, it is not surprising that international customers should also demand a package of services when they buy major capital equipment. Nonetheless, could we wave a magic wand and return to a simpler world in which our companies would compete on the basis of price and performance, we would certainly be happy to do so.

U.S. GOVERNMENT POLICY

We do not believe that the evidence accumulated to date indicates that offsets pose a particular economic or security threat to the United States which warrants any urgent government response. However, some government actions might be helpful, while others could greatly complicate the current situation or considerably reduce U.S. exports. We would like to suggest three recommendations with respect to such government actions:

Data Collection: The Defense Production Act currently requires an annual analytic report by the executive branch on the general impact of offsets on the U.S. economy. Section 303 of the Trade and Tariff Act of 1984 requires an annual National Trade Estimate to Congress on Foreign Trade barriers. The first two such reports have included offsets among the practices covered. Section 912 of H.R. 3 would impose a major new reporting requirement on U.S. industry. We strongly oppose that latter requirement for a number of reasons.

In the first place, data on any particular offset can be quite misleading, and aggregating data on a number of offsets is certain to confuse more than enlighten. Every deal is different. Offsets may be defined in terms of the percentage of the sale or in constant or current dollars. The period over which the offset is to be performed almost always varies from the period over which the product involved in the original sale is to be delivered. Both periods tend to cover several years. Values on particular parts of an offset may involve negotiated prices (e.g., the value of a particular technology transfer for which there is no commercial market price). Even individual credits toward meeting an offset obligation which are based on market prices may vary on a transaction-by-

transaction basis. For example, helping a country place a high technology product in the world market or encouraging tourism in the off-season may be valued at a multiple of the dollar value actually involved, while placing a traditional product or encouraging tourism in the normal season may only entitle the company to a fraction of the actual dollar value of the transaction. When all these numbers are added together for a specific offset obligation and then compared with similar aggregate numbers for other offset agreements, the results may be close to meaningless.

For the U.S. company making a sale, its negotiating objective is to come up with the largest offset number possible with the minimum actual performance requirement. In many cases, the government which is purchasing the U.S. product may also decide that an inflated offset number is politically desirable, as the country wants the product with a minimal domestic political cost. In such cases, neither the seller or the buyer has an interest in the U.S. Government determining that the offset terms are actually overstated. Yet, if that does not happen, U.S. Government data could convince the American public that offsets are more onerous than they actually are.

Making a great deal of data available on offset agreements can also have the unintended side effect of increasing both our potential customer's knowledge of how to squeeze more offset out of U.S. companies, and in instructing our competitors as to what kind of deals U.S. companies are offering. The end result would, of course, be to make real offset demands and offers considerably larger in the future. In sum, we strongly urge that data requirements imposed on industry be kept to the minimum necessary for specific analysis, and that all raw data be treated confidentially.

This does not mean that information on current offset demands of foreign governments should not be collected and made public. In fact, the *National Trade Estimates* are supposed to do just that. Yet, the first study in 1985 only included offsets as a trade barrier for one country. The 1986 version touches on offset demands for only seven countries. Clearly, this is one area the U.S. Government could do better. Similarly, providing information to U.S. companies on how to deal with countertrade demands, and how to use countertrade as a means of financing exports, is quite useful. In that context, Section 345 of H.R. 3 would seem to move in the right direction, and would likely especially benefit companies new to the export world.

Unilateral Actions: The worst action the U.S. Government could take would be to move unilaterally to try to "fix" the offset problem by limiting the ability of U.S. companies to engage in offset activities. In some respects, offset practices are analogous to the problems encountered in dealing with official export credits. The U.S. can unilaterally restrict or end its official credit programs, but if competitor nations do not follow suit, the end result will be to shift contracts, jobs, and profits to other producers. Similarly, if American companies are restricted in their ability to compete head-to-head in the area of offsets and countertrade, as long as these practices are seen as desirable by foreign customers, contracts will go to those countries and companies which can include such components in their offers.

It should be noted that the U.S. already has in place a complex system of reviewing any technology transfer from a national security perspective. As became clear during the long process involved in renewing the Export Administration Act, there is great controversy among agencies and within the Congress as to how best to assure that transfer of technology does not constitute a threat to U.S. security. Were the government also to try to judge in specific cases whether technology transfer would or would not constitute a future threat to U.S. competitiveness, the likely bureaucratic wranglings would be far worse. Our members are convinced that they are quite capable of judging what the economic implications of technology transfer are from an economic standpoint, and that this is not an area in which increased governmental involvement would be helpful.

If the U.S. Government wishes to make offset practices less attractive, it can best do so by improving the general climate within which trade takes place. If countries can gain access to

industrial country markets, including our own, through the elimination of unreasonably restrictive trade barriers, their interest in countertrade will diminish, and the need to move prematurely into high technology products will also decrease. If a system can be devised in which exchange rates are less volatile and more accurately reflect true underlying shifts in market factors and comparative advantage, then countries will also feel less need to move towards a barter economy. Finally, if the debt problem of many developing countries can be handled in a way which allows for increased access to short and medium term credits, the need for less conventional means of doing business will be lessened.

Bilateral and Multilateral Discussions: If the government wishes to deal directly with offsets, it can only do so constructively in the bilateral or multilateral context. For example, in the new general round of trade negotiations, this subject might be on the agenda, particularly insofar as it affects other trade issues such as relate to government procurement or to subsidies. Alternatively, major supplier countries might discuss the subject within the OECD [Organization for Economic Cooperation and Development] context, as has been the case with the question of export credits.

Similarly, the question of offsets might be discussed by the U.S. Government on a bilateral basis with certain trading partners. A few countries with substantial trading surpluses with the U.S. are among the toughest demanders of offsets, such as Canada and Korea. Even Japan is beginning to press for offset agreements. The number of countries offering offsets is also limited, and in some cases companies from the U.S. and only one other country may be competing for a sale.

Once again, however, the government must be cautious not to take steps which simply divert trade away from U.S. exporters. A bilateral agreement in which a country agrees not to ask for offsets from U.S. producers, but then turns to other suppliers, would not benefit the U.S. economy. A bilateral or multilateral agreement limiting offset offers which was laxly enforced by other signatories could simply drive offset practices underground and disadvantage U.S. producers. Nonetheless, insofar as H.R. 1652 clearly emphasizes a bilateral and multilateral approach, we would support the general thrust of the bill.

In this context, the Defense Department might want to take another look at its current policy with respect to offsets, which has been in effect since 1978. Basically, DOD has a hands-off attitude towards such practices--it will not help a U.S. company meet its offset obligations nor guarantee to a foreign purchaser that these offset obligations will be met. Nor will it stand in the way of offsets, except insofar as it may not agree to the transfer of certain technology based on U.S. security interests. Yet last year, DOD purchases of foreign defense products amounted to about \$3.5 billion, much of that from countries which place major offset demands on U.S. companies. It might be useful to at least examine whether this volume of purchases could not be used in some way either as leverage to reduce offset demands, or to help U.S. companies meet their offset obligations.

CONCLUSION

To summarize, the experience of ALESA companies, and the studies undertaken by the U.S. Government, indicate that while offsets may be an annoying addition to the world trading system, they are a fact of life in the international market place, and one which does not seem to have any serious negative impact on the U.S. economy or on U.S. security. On the contrary, sales with associated offset agreements are on balance a plus for American business and jobs. It is unlikely that new, massive data collection efforts imposed on U.S. industry will change this overall conclusion, but might well increase the magnitude and sophistication of offset demands. While any unilateral efforts to restrict the ability of U.S. companies to use offset offers as a competitive

tool will almost certainly result in a shift of business to our foreign competitors, there might be some useful steps which could be taken on a bilateral or multilateral basis.

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