United States General Accounting Office

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Report to Congressional Committees

May 2003

# DEFENSE TRADE

# Report and Recommendations of the Defense Offsets Commission Still Pending

GAO-03-649

May 2003

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# Highlights

Highlights of GAO-03-649, a report to Congressional Committees

# DEFENSE TRADE

# Report and Recommendations of the Defense Offsets Commission Still Pending

## Why GAO Did This Study

Export sales of defense-related products often include "offsets"—industrial and commercial benefits, such as technology transfer, which U.S. companies provide to foreign governments as incentives or conditions for purchasing military goods and services.

Over the past decade, offsets have increased and in 1998, they totaled about $3 billion per year. In December 2000, GAO reported that countries are becoming increasingly sophisticated in their use of offsets to achieve regional industrial and employment goals.

In 1999, Congress established a National Commission to report on the extent and nature of offsets in international defense trade by October 2001. The Director of the Office of Management and Budget (OMB) was designated chair of the Commission. Congress also required the President to report, within 90 days after the Commission's final report, on the feasibility and desirability of seeking a multilateral treaty with international trading partners on standards for use of defense offsets.

GAO's report responds to the congressional mandate for GAO to monitor and periodically report on the President's progress in reaching a multilateral treaty.

www.gao.gov/cgi-bin/getrpt?GAO-03-649.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Katherine V. Schinasi at (202) 512-4841 or schinasik@gao.gov.

## What GAO Found

In February 2001, the National Commission on the Use of Offsets in Defense Trade issued an interim report, *Status Report of the Presidential Commission on Offsets in International Trade*. However, the Commission's final report and recommendations are still pending—a year and a half after its mandated reporting date. The last Commission meeting was held on December 4, 2000, and no further activity is apparent. The 2001 change in presidential administrations resulted in vacancies in the five executive branch positions on the Commission, which have yet to be filled.

The interim report describes the extent and nature of defense-related offsets in both defense and commercial trade. For example:

- The cost to U.S. exporters of implementing defense offset transactions is a fraction of the transactions' value.
- The extent of defense offsets relative to defense exports has remained stable over time; however, offset demands may have grown qualitatively.
- Most defense offset transactions are with developed nations and are associated with the export of aerospace products.
- Because U.S. policy considers offsets "market distorting," it places no international restrictions on defense offsets and leaves responsibility for their negotiation and implementation with U.S. exporters.

The report also describes the effect that defense offsets transactions and agreements may have on the U.S. defense supplier base. For example, the Commission reported that while offsets may facilitate defense export sales—which can help maintain the economic viability of certain U.S. firms—offsets can also supplant a significant amount of work and jobs that would go to U.S. firms if export sales occurred without offsets. The Commission also reported that U.S. technology transfers through offsets often improved foreign firms' competitiveness but rarely resulted in technology transfer back to the United States. And while it found that technology transferred through offsets did not appear to create a security risk beyond that posed by other transfers by U.S. firms, it cautioned that offsets could exacerbate any existing weaknesses in U.S. export control processes.

While the National Commission's report remains pending and the President has not decided on a defense offsets multilateral treaty, Congress required GAO to monitor and periodically report to it on the progress in reaching a multilateral treaty. The Commission on the Future of the United States Aerospace Industry called for the pursuit of a multilateral solution to curtail offset demands in defense trade. It suggested that reactivating the National Commission may be the best alternative for developing recommendations on negotiating a multilateral agreement.

In commenting on a draft of this report, OMB officials provided technical comments, which were incorporated as appropriate.

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**Abbreviation**

| | |
|---|---|
| OMB | Office of Management and Budget |

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**United States General Accounting Office**
**Washington, DC 20548**

May 30, 2003

The Honorable Richard G. Lugar
Chairman
The Honorable Joseph R. Biden, Jr.
Ranking Minority Member
Committee on Foreign Relations
United States Senate

The Honorable Henry J. Hyde
Chairman
The Honorable Tom Lantos
Ranking Minority Member
Committee on International Relations
House of Representatives

Export sales of defense-related products often include "offsets"—industrial and commercial benefits, such as technology transfer, which U.S. companies provide to foreign governments as incentives or conditions for purchasing military goods and services. They include, for example, coproduction arrangements and subcontracting, technology transfers, in-country procurements, marketing and financial assistance, and joint ventures. In December 2000, we reported that countries are becoming increasingly sophisticated in their use of offsets to achieve regional industrial and employment goals.[1] Since 1993, when the Department of Commerce began collecting data on these transactions, defense offsets have increased. In 1998, defense offsets totaled approximately $3 billion. The increasing use of offsets in defense trade has generated congressional concern because offsets can distort the price of defense contracts and undermine competitiveness.

In an effort to identify current offset practices, the impacts of offsets on the U.S. economy, and their role in increasing dependence on foreign sources for defense goods, in 1999, Congress established a Commission[2] to report to it on the extent and nature of offsets in international defense

[1] U.S. General Accounting Office, *Defense Trade: Observations on Issues Concerning Offsets*, GAO-01-278T (Washington, D.C.: Dec. 15, 2000).

[2] Defense Offsets Disclosure Act of 1999, Public Law 106-133, section 1247.

trade. Congress also required the President to review and report, within 90 days after the Commission's final report to Congress, the feasibility and desirability of seeking a multilateral treaty on standards for use of offsets in defense trade. Congress further required us to monitor and periodically report to it on the progress in reaching a multilateral treaty.

## Results in Brief

A final report and recommendations from the National Commission on the Use of Offsets in Defense Trade are still pending, although under the Defense Offsets Disclosure Act of 1999 the report was required to be issued by October 2001. However, the 2001 change in presidential administrations resulted in vacancies in the five executive branch positions on the Commission, which have yet to be filled. The Commission's interim report—*Status Report of the Presidential Commission on Offsets in International Trade*, issued February 2001—describes the extent and impact of offsets in both defense and commercial trade.[3] The report also describes the effect of defense offset transactions and agreements entered into by U.S. firms over a 6-year period. For example, the Commission reported that while industry estimates and other evidence indicate that offsets facilitate exports, they also supplant a significant amount of work and jobs that would go to U.S. firms if export sales occurred without offsets. The Commission also reported that in a number of cases, U.S. technology transfers improved foreign firms' competitiveness but rarely resulted in technology transfer back to the United States.

The interim report includes potential policy recommendations that, according to the Commission, require additional deliberation of the possible advantages and disadvantages of each. However, the Commission has not met since December 4, 2000. Since the President's report on the feasibility and desirability of a multilateral offsets treaty is not required until 90 days after the Commission's final report is submitted to Congress, the President has not reported. Subsequent to the Commission's last meeting, another commission, set up to evaluate the health of the aerospace industry, recommended that the United States pursue a multilateral solution to curtail offset demands. That commission also suggested that reactivating the National Commission on the Use of Offsets

[3] To address the use of offsets in commercial trade, the President established the Presidential Council on the Use of Offsets in Commercial Trade. Membership of the Council was identical to the Commission.

in Defense Trade may be the best alternative for developing policy recommendations on this issue.

In commenting on a draft of this report, the Office of Management and Budget officials provided technical comments, which were incorporated as appropriate.

## Background

Foreign governments often seek defense offsets to reduce the financial impact of their purchases, obtain valuable technology and manufacturing know-how, enhance domestic employment, create or expand their defense industries, and make the use of their national funds for foreign purchases more politically palatable. However, Congress has expressed concern about the use of offsets in defense trade because they can undermine fairness and competitiveness and distort the price of contracts. Offsets are frequently negotiated in connection with the purchase of U.S. aerospace systems, such as military or commercial aircraft, and sometimes in connection with the purchase of U.S. goods and services in other high-tech industries, such as power generation or telecommunications.

The Defense Offsets Disclosure Act of 1999[4] established, as the sense of Congress, the need to

- pursue efforts to address trade fairness by establishing reasonable, business-friendly standards for the use of offsets in international trade between the Unites States and its trading partners and competitors;
- require the Secretary of Defense, the Secretary of State, the Secretary of Commerce, and the United States Trade Representative, or their designees, to discuss with industrialized nations the need for reasonable standards to govern the role of offsets in international trade;
- enter into discussions regarding the establishment of multilateral standards for the use of offsets in international defense trade through the appropriate multilateral forum; and
- include in those discussions the distortions produced by other benefits and subsidies provided by various countries, such as export financing.

The act also established a National Commission on the Use of Offsets in Defense Trade, requiring the President, with the concurrence of congressional leaders, to appoint 11 members to the Commission. The act

[4] Defense Offsets Disclosure Act of 1999, Public Law 106-133, section 1244.

required the Commission to submit a report to Congress addressing all aspects of the use of offsets in international defense trade within a year of its establishment. It also specified that the Commission include 5 members from the executive branch, 3 from industry, 1 from labor, and 2 members from academia. In October 2000, the President appointed the 11 members. The act designated the Office of Management and Budget (OMB) member as the chair of the Commission. Since the change of administrations in 2001, the President has not appointed new executive branch members. Consequently, the Commission has ceased activity and has not issued its final report.

## Commission's Findings on Extent and Nature of Defense-Related Offsets

The Commission released its interim report in February 2001. The report described the following extent and nature of defense-related offsets.

- The cost to U.S. exporters of implementing defense offset transactions is a fraction of the transaction value.
- The extent of defense offset agreements relative to defense exports has remained stable over time; however, offset demands may have grown qualitatively.
- Most defense offset transactions are with developed nations.
- Most defense offsets are associated with the export of aerospace products.
- The most common types of defense offset transactions are counterpurchases, subcontracts, and technology transfers.
- There are no international restrictions on defense offsets. U.S. policy considers offsets "market distorting" and leaves responsibility for their negotiation and implementation with U.S. exporters.

The Commission also found the following on the impacts of defense offsets:

- Offsets have a direct effect on U.S. jobs by facilitating exports, but they also supplant a significant amount of work and jobs that would go to U.S. firms if export sales occurred without offsets.
- In some cases, offsets hurt the U.S. defense supplier base by transferring work to foreign firms, but the erosion has yet to show up in overall trade statistics.
- At the same time, defense export sales may be important to the economic viability of aerospace firms and may provide an incentive for their development of new defense products and technologies.
- In a number of cases, U.S. technology transfers improved foreign firms' competitiveness but rarely resulted in technology transfer back to the United States.

- Technology transferred to foreign firms through offsets does not appear to pose a special security risk above and beyond that posed by other technology transfers by U.S. firms.
- However, recent examples show that U.S. export control processes are not flawless in preventing the transfer of sensitive technology abroad and that offsets could exacerbate any leakages.

## Status of the Commission's Work

The Commission's interim report outlines areas for future Commission study and several potential recommendations. However, the Commission has yet to determine whether these potential policy recommendations are feasible or desirable.

**Table 1: Commission's Potential Policy Recommendations, with Advantages and Disadvantages**

| Potential Commission recommendation | Possible advantages | Possible disadvantages |
|---|---|---|
| The U.S. government could seek a multilateral agreement with its trading partners to reduce or prohibit the use of offsets in defense trade. | • Could diminish adverse effects on U.S. jobs, economic competitiveness, and national security.<br>• Could attract support from labor and industry groups. | • Would likely reduce U.S. export sales.<br>• May be difficult to monitor and enforce.<br>• The United States may be asked to provide concessions, such as greater access to the U.S. defense procurement market. |
| The U.S. government could work cooperatively with other countries to shift the type of offsets they request away from defense subcontracting or production. | • Could help reduce adverse effects of offsets on U.S. economy and national security.<br>• Could provide foreign governments with needed political support to import major U.S. defense systems.<br>• Could be tried bilaterally as well as multilaterally, and on a pilot basis.<br>• Could yield technological and economic benefits to U.S. exporters and other U.S. firms. | • Some foreign governments may not be willing to shift their offset demands.<br>• A shift in the types of offsets currently sought by foreign nations could alter the competitive playing field.<br>• Does not focus on reducing or eliminating defense offsets.<br>• Could undermine the competitiveness of non-defense industries. |
| The U.S government could increase foreign firms' involvement in the research and development stages of new defense systems to reduce their governments' subsequent demand for offsets. | • Could help reduce offset demands.<br>• Could facilitate reciprocal technology transfer.<br>• Foreign firms' participation in subsequent production of the defense system—a natural extension of their initial involvement—would result in few adjustment costs relative to offsets. | • No assurance that participating nations would reduce offset demands.<br>• Participating nations may demand work guarantees, which are similar in effect to offsets. |

Source: *Status Report of the Presidential Commission on Offsets in International Trade.*

According to the interim report, the Commission was to continue its deliberations and prepare a final report and recommendations by October 2001. The final report is still pending. Further, according to OMB officials, the President has not determined the feasibility and desirability of seeking a multilateral treaty on standards for use of offsets in defense trade.

However, the issue of defense offsets has continued to raise concerns. The Commission on the Future of the United States Aerospace Industry recommended that the United States pursue a multilateral solution to curtail offset demands and suggested that reactivating the Commission may be the best alternative for developing policy recommendations on this issue.

## Conclusions

As a major factor in the competitiveness of a company's offer to sell goods and services, offsets are an accepted feature of defense trade. However, their use has been shown to distort markets. Recognition that unilateral U.S. government constraints could limit U.S. company competitiveness has led Congress to establish a commission to address the use of offsets in defense trade. It also led Congress to require the President to determine the feasibility of a multilateral treaty on standards for the use of offsets. While the Commission has taken concrete steps toward fulfilling its mandate, it has not completed its work in that it has not issued a final report. In addition, the President has not reported on the feasibility and desirability of a multilateral treaty. However, the President's report is not due until 90 days after the Commission's final report to Congress under the Defense Offsets Disclosure Act of 1999.

## Agency Comments

In commenting on a draft of this report, OMB officials provided technical comments, which were incorporated as appropriate.

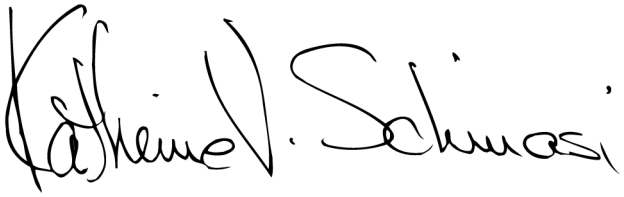
## Scope and Methodology

To determine the progress in reaching a multilateral treaty, we reviewed legislation pertaining to offsets to determine the roles and responsibilities of the presidential Commission. In addition, we reviewed the Commission's interim report to identify its potential recommendations to the President. We also interviewed several officials from the Department of Commerce, the Office of Management and Budget, and the Office of the United States Trade Representative who had knowledge of the Commission's deliberations.

We conducted our work from January through May 2003 in accordance with generally accepted government standards.

We are sending copies of this report to the Secretaries of Commerce, Defense, and State, and the Director, Office of Management and Budget. Copies will be made available to others on request. In addition, this report

will be available at no charge on the GAO Web site at http://www.gao.gov. If you have questions, please contact me at (202) 512-4841. Major contributors to this report were Thomas J. Denomme, Gregory K. Harmon, John Neumann, Karen M. Sloan, Robert L. Ackley, and Marie P. Ahearn.



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