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Report to Congressional Requesters

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MILITARY EXPORTS

Offset Demands Continue to Grow

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National Security and
International Affairs Division

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The Honorable Robert C. Smith
Chairman, Subcommittee on Acquisition
and Technology
Committee on Armed Services
United States Senate

The Honorable Donald A. Manzullo
Chairman, Subcommittee on Procurement,
Exports, and Business Opportunities
Committee on Small Business
House of Representatives

As you requested, we reviewed the nature and extent of offset requirements associated with military exports. For the purposes of our review, we define offsets as the entire range of industrial and commercial compensation practices provided to foreign governments and firms as inducements or conditions for the purchase of military goods and services. They include coproduction, technology transfer, training, investment, marketing assistance, and commodity trading.

Since the mid-1980s, government figures show that U.S. companies have entered into offset agreements valued at over $84 billion. Our objectives were to (1) determine how the offset goals and strategies of major buying countries have changed; (2) identify the offset requirements of these countries and the types of activities being undertaken to satisfy their requirements; and (3) identify the impacts of offsets and what actions, if any, the U.S. government has taken on this issue. Our review focused on 10 buying countries from the Middle East, Asia, and Europe.[1] We obtained data from nine major defense contractors on their experiences in these countries over the past 10 years.[2]

Background

Offset arrangements are not new to military export sales. The use of offsets, specifically coproduction agreements, began in the late 1950s and early 1960s in Europe and Japan. A country's desire to coproduce portions

[1]These countries are Kuwait, Saudi Arabia, the United Arab Emirates, Singapore, South Korea, Taiwan, Canada, the Netherlands, Spain, and the United Kingdom.

[2]Much of the data provided by these companies is considered commercially sensitive or proprietary. As a result, we are less specific in some places than is normally our practice and, for illustration purposes, used examples of offset transactions involving U.S. and foreign companies from defense publications and trade journals.

of weapon systems was based on needs such as maintaining domestic employment, creating a national defense industrial base, acquiring modern technology, and assisting its balance of payments position. In 1984, we reported that offsets were a common practice and that demands for offsets on defense sales would continue to increase.[3] The United States is the world's leading defense exporter and held about 52 percent of the global defense export market in 1994 (the latest year for which statistics are available).

Offsets are often an essential part of defense export sales. Offset agreements may specify the level of offset required, normally expressed as a percentage of the sales contract. Offset agreements may also specify what types of activity are eligible for offset credit. Offset activities that are directly related to the weapon system sold are considered "direct" offset, while those involving unrelated defense or nondefense goods or services are considered "indirect." An offset may directly relate to the weapon system being sold or to some other weapon system or even nondefense goods or services. Countries may also include conditions specifying the transfer of high technology and where and with whom offset business must be done. Other provisions include requirements that offset credit be granted only for new business and that credits be granted only if local content exceeds a minimum level.

Negotiating offset credit is an important part of implementing offset agreements. Countries can grant additional offset credit to encourage companies to undertake highly desirable offset activities. For example, countries may offer large multipliers for advanced technology or training that can greatly reduce a company's cost of meeting its offset obligation.[4] However, a country can also establish criteria that make it difficult for a company to earn offset credit.

Some countries, such as the United Kingdom and the Netherlands, cite restrictions in the United States and other defense markets and note that their offset policies are needed to ensure that their defense industries are given an opportunity to compete. The United States does not require offsets for its foreign military purchases, but it does have requirements that favor domestic production. The Defense Production Act of 1950 allows the Secretary of Defense to preserve the domestic mobilization

[3] Trade Offsets in Foreign Military Sales (GAO/NSIAD-84-102, Apr. 13, 1984). Also see Related GAO Products.

[4] A multiplier is used to increase the value of an offset project when determining offset credit. For example, if an offset project is valued at $1,000, a multiplier of 10 will increase the amount of offset credit granted to $10,000.

base by restricting purchases of critical items from foreign sources. While not precluding foreign suppliers, regulations implementing the Buy America Act of 1933 allow price preferences for domestic manufacturers, and annual Department of Defense (DOD) appropriation acts sometimes contain prohibitions on foreign purchases of specific products.

The General Agreement on Tariffs and Trade (GATT) prohibits the practice of offsets in government procurement, except for procurement of military weapons. In 1990, the North Atlantic Treaty Organization (NATO) proposed a code of conduct for defense trade to regulate offsets in military exports, but did not adopt it. In addition, reciprocal memorandums of understanding between the United States and several major allies include provisions to consult on the adverse effects of offsets.

Results in Brief

Demands for offsets in foreign military procurement have increased in selected countries. Countries that previously pursued offsets are now demanding more. Countries are requiring more technology transfer, higher offset percentages, and higher local content requirements to offset their foreign military purchases. Further, countries that previously did not require offsets now require them as a matter of policy. The offset strategies of many countries in our study now focus on longer term offset deals and commitments. This shift highlights these countries' use of offsets as a tool in pursuing their industrial policy goals.

The types of offset projects sought or required by buyer countries in our review depend on their offset program goals, which in turn are driven by their industrial and economic development needs. Companies are undertaking a broad array of activities to satisfy offset requirements. Countries with established defense industries are using offsets to help channel work to their defense companies. Countries with developing defense and commercial industries pursue both defense- and nondefense-related offsets that emphasize the transfer of high technology. Countries with less industrialized economies often pursue indirect offsets as a way to encourage investment and create viable commercial businesses.

Views on the impact of offsets on the U.S. economy and specific industries are divided. Measuring the impact of offsets on the economy as well as specific defense industries is difficult without reliable data. The Department of Commerce is currently gathering additional information on the impact of offsets and is expected to issue a report in 1996. To date, the executive branch agencies have consulted with other countries about certain offsets associated with individual defense procurements, but have not had an interagency team hold the broad-ranging discussions on the ways to limit the adverse impacts of offsets as called for in a 1990 presidential policy statement. According to the Commerce Department, industry is not opposed to the initiation of consultations, but are concerned about unilateral U.S. government actions to limit the use of offsets. Moreover, representatives from several defense companies expressed doubt about the government being able to enforce restrictions on offsets.

Demand for Offsets in Selected Countries Has Increased

Over the last 10 years, the countries in our study have increased their demands for offsets, begun to emphasize longer term offset projects and commitments, or initiated offset requirements.

New Demands and New Entrants

All the countries in our review have increased their offset demands on U.S. companies to achieve more substantial economic benefits.

Canada, the Netherlands, Spain, South Korea, and the United Kingdom have all had offset policies since at least 1985. These countries are using new approaches in their offsets to increase economic benefits. These changes include targeting offset activities and granting offset credit only for new business rather than existing business. For example, Canada and the United Kingdom are less willing to grant offset credit for a company's existing business in the country, and South Korea has increased its demands for technology transfer and training as part of any offset agreement.

Since 1990, Kuwait, Taiwan, and the United Arab Emirates have all established a new policy for offsets on foreign military purchases. They are now using offsets to help diversify their economies or promote general economic development. Although these countries are new entrants, company officials said they are knowledgeable about the defense market, and their offset policies can be equally as demanding as countries with existing offset policies. For example, the United Arab Emirates requires 60 percent of the value of the contract to be offset by commercially viable business ventures and grants offset credit based only on the profits generated by these investments.

Singapore and Saudi Arabia have both recently reinstated their offset policies. Both countries have intermittently required offsets since the 1980s. However, company officials said these countries now regularly pursue offsets on their defense purchases. Saudi Arabia's new approach is less formal and relies on best effort commitments from companies rather than formal agreements.

Long-Term Offset Strategies

Previously, some of the countries in our review allowed companies to meet offset obligations with existing business in the country or with one-time purchases of the country's goods. A country's requirements for direct offsets were sometimes met through projects calling for the simple assembly of weapon systems components. These types of offset activities often did not result in any long-term economic benefits.

More recently, buying countries have changed their offset strategies in an attempt to achieve lasting economic benefits. Countries such as Kuwait and the United Arab Emirates are seeking offset activities that will help create viable businesses, increase local investment, or diversify the economy. Countries such as Canada, the Netherlands, and the United Kingdom are trying to form long-term strategic relationships with the selling companies to generate future work, instead of always linking offset activities to individual sales.

Types of Offsets Required by Countries Depend on Offset Goals and Economic Development

The types of offsets required by the countries in our review depend on their offset program goals and the country's economy—whether it is developed, newly industrialized, or less industrialized. Companies undertake a broad array of activities to meet these offset obligations.

A country's offset requirements policy outlines the types of offset projects sought by the country. All 10 countries in our review now have offset requirements. These requirements include the amount of offset required (expressed as a percentage of the purchase price); what projects are eligible for offset credit; how these projects are valued (e.g., offering multipliers for calculating credit for highly desired projects); nonperformance penalties; and performance periods.

Developed Economies

Countries in our study with developed economies encourage offsets related to the defense or aerospace industries. These offsets typically involve production and coproduction activities related to the weapon system being acquired but could also involve unrelated defense or aerospace projects. These countries have well-established defense industries and are using offsets to channel work to their defense companies, thus supporting their defense industrial base. Canada, the Netherlands, Spain, and the United Kingdom are all in this group.

We reviewed 40 offset agreements, with a stated value of $5.6 billion, between U.S. companies and countries with developed economies. The following are highlights from these agreements:

- The agreements with the United Kingdom reflected its focus on defense, requiring that offsets be satisfied through British companies certified by the government as performing defense-related work. A majority of the agreements required that 100 percent of the sale be offset, although the percentage specified in the agreements ranged from 50 percent to 130 percent.
- The offset agreements with the Netherlands focused on defense-related or high-technology nondefense projects and specify a minimum local content threshold before full offset credit will be granted. Such local content requirements effectively increased the amount of business activity required to generate credit. Most of the agreements required 100 percent of the sale to be offset with a range of 45 percent to over 130 percent.
- Coproduction of defense systems is a feature found in some of the offset agreements with Spain. These agreements specified the particular products that would be procured from Spain's defense industry as part of the offset program. The offset percentage required in these agreements ranged from less than 30 percent to over 100 percent.
- The offset agreements with Canada showed the country's focus on encouraging U.S. procurement and other arrangements with Canadian suppliers in defense, aerospace, and other high-technology industries. Most of the agreements also included requirements that contractors place work throughout the Canadian provinces and also specified that a portion of the offset be done with small businesses. The offset percentage required in these agreements ranged from less than 40 percent to 100 percent.

The following are examples of the offset projects that both U.S. and foreign firms have implemented or proposed in these developed economies:[5]

- The German company Krauss-Maffei agreed to coproduce tanks in Spain to offset Spain's purchase of 200 Leopard 2 main battle tanks. (Countertrade Outlook, Vol. XIII, No. 16, Aug. 21, 1995, p.10.)
- Lockheed will establish a Canadian firm as an authorized service center for C-130 aircraft to satisfy offset obligations for its sale of C-130s to Canada. This will ensure that the Canadian firm has ongoing repair and overhaul work for this aircraft. Lockheed will also procure assemblies and avionics in Canada for its C-5 transport aircraft. (Countertrade Outlook, Vol. XIII, No. 10, May 22, 1995, p.3.)
- McDonnell Douglas will offset the United Kingdom's purchase of Apache attack helicopters (valued at nearly $4 billion) by producing much of the aircraft in the United Kingdom, with British equipment. U.S. suppliers are committed to buying $350 million worth of British equipment for U.S.-built Apache helicopters. In addition, Westland Helicopters, a United Kingdom firm, has the potential to get up to $955 million worth of sales for future support services for Apache helicopters worldwide. (Defense News, Aug. 21-27, 1995, p. 12.)

Most U.S. companies we reviewed did not have significant difficulty meeting defense-related offsets in Canada, the Netherlands, and the United Kingdom because those countries have well-established defense industries. In addition, many of the companies have significant existing business in these countries, often making it easier for the companies to implement offset projects. Meeting Spain's offset demands was more difficult because its defense industry is not as advanced as other Western industrialized countries. Some of the U.S. companies in our review expressed concern about the impact of defense-related offsets on the U.S. defense industry, particularly the loss of production to U.S. defense subcontractors and suppliers.

Appendix I provides detailed information on the terms of the offset agreements and the requirements for each developed country we reviewed.

[5]Specific information on offset transactions is often considered commercially sensitive by the defense companies. The examples discussed in this report come from defense trade journals and magazines and do not necessarily involve the companies we visited.

Newly Industrialized Economies

Countries in our study with developing defense and commercial industries, such as South Korea, Singapore, and Taiwan, have pursued both defense-related and nondefense-related offsets. Offsets in these countries typically involve technology transfer in defense or comparable high-technology industries. They see offsets as a means to further develop their defense base and economy.

We reviewed 31 offset agreements, with a stated value of $5.1 billion, with countries that have newly industrialized economies. The following are highlights from these agreements:

- The agreements with South Korea emphasized work in the defense and aerospace industries, particularly the transfer of related high technology. Many agreements included multipliers to encourage work in these sectors. Many also required the purchase of unrelated products for export resale in the United States and other markets. Offset agreements generally required at least a 30-percent offset with a range of less than 30 percent to more than 60 percent.
- The offset agreements with Singapore focused on defense-related offset projects, including direct production of parts for purchased weapon systems. The offset percentage required in these agreements ranged from 25 percent to 30 percent.
- In contrast to other newly industrialized countries, the agreements with Taiwan focused on commercial projects aimed at developing long-term supplier relationships with foreign firms. The agreements offered multipliers for technology transfer, training, and technical assistance reflecting the priority the government places on these activities. These agreements all called for a 30-percent offset goal.

The following are examples of the offset projects that both U.S. and foreign firms have implemented or proposed in these newly industrialized economies:

- Dassault, as part of an offset arrangement for the $3.5-billion sale of Mirage fighter aircraft to Taiwan, agreed to form partnerships with firms in Taiwan to transfer technology and manufacture equipment for civilian markets. (Jane's Defence Weekly, Sept. 2, 1995, p.17.)
- Lockheed-Martin, as part of its offset obligation for the sale of 150 F-16 fighter aircraft to Taiwan, is seeking suppliers in Taiwan for repair contracts for more than 500 aircraft components. Taiwan regards the offset program as an opportunity to (1) become a regional aviation maintenance center and (2) obtain similar work on another aircraft under

development by Lockheed-Martin. (Countertrade Outlook, Vol. XIII, No. 13, July 10, 1995, p.4.)

- Lockheed-Martin Tactical Aircraft Systems, formerly the General Dynamics Fort Worth Company, is in the process of satisfying South Korea's offset requirements on the purchase of 120 F-16 fighter aircraft through several aerospace projects. These projects include codevelopment of a new trainer aircraft, training, transfer of castings and forgings technology, and repair and overhaul of aerospace equipment. As part of the sale, General Dynamics agreed to transfer relevant manufacturing and assembly know-how to allow South Korea to manufacture 72 aircraft and assemble an additional 36 aircraft from kits that were manufactured in the United States. The remaining 12 aircraft were to be completely assembled in the United States.[6]

U.S. companies generally considered the offset requirements of Singapore and Taiwan to be manageable. However, company officials noted that despite the relatively low percentage of offset required in South Korea, these requirements can be as difficult as a 100-percent offset requirement.

Appendix II provides detailed information on the offset requirements of each newly industrialized country and the terms of the offset agreements we reviewed.

Less Industrialized Economies

Countries with less industrialized economies, such as Kuwait, Saudi Arabia, and the United Arab Emirates, generally pursue indirect offsets to help create profitable businesses and build their country's infrastructure. These countries usually do not pursue direct offsets because they have limited defense and other advanced technology industries and are not interested in attracting work that would require importing foreign labor. The United Arab Emirates' new offset policy grants credit only for profits generated rather than the value of the investment.

We reviewed five offset agreements, with a value of at least $1.6 billion, with countries that have less industrialized economies.[7] The following are highlights of the agreements we reviewed:[8]

[6]U.S.-Korea Fighter Coproduction Program—the F-16 Version (GAO/T-NSIAD-91-53, Aug. 1, 1991).

[7]The value for some of these five agreements is not included because figures were not available or the agreement called for an unspecified "best effort" goal.

[8]Although the number of agreements we reviewed for this region is quite small, the terms of these agreements closely match the countries' offset requirements.

- The agreements with Kuwait required that 30 percent of the sales be offset through investment projects, including infrastructure development. Kuwait's offset policy grants multipliers up to 3.5 for investments in high priority areas.
- The agreements with Saudi Arabia were informal and did not require a specified offset percentage. The agreements primarily called for nondefense-related investment projects. The agreements required joint ventures between Saudi Arabian and foreign companies and assigned values to technology transfers at the cost the country would have incurred to develop them.
- The agreements with the United Arab Emirates required that 60 percent of the sale be offset through nondefense-related investment projects and granted multipliers for various types of investment projects.

The following are representative examples of the offset projects that both U.S. and foreign firms have implemented or proposed in these less industrialized economies:

- Several French firms have established manufacturing facilities or other investments in the United Arab Emirates to satisfy offset obligations. For example, Thomson-CSF started a garment manufacturing enterprise in Abu Dhabi in connection with a contract for tactical transceivers and audio systems. Giat Industries created an engineering company specializing in air conditioning as part of its offset commitment for the United Arab Emirates' purchase of battle tanks. (Countertrade Outlook, Vol. XIII, No. 8, Apr. 24, 1995, pp.3-4.)
- McDonnell-Douglas Helicopter Company entered into several joint ventures with firms in the United Arab Emirates to satisfy offset commitments for the sale of AH-64 Apache helicopters. Projects included forming a company to manufacture a product that cleans up oil spills and creating another firm that will recycle used photocopier and laser computer printer cartridges. The defense contractor is also paying for a U.S. law firm to draft the country's environmental laws. (Countertrade Outlook, Vol. XIII, No. 2, Jan. 23, 1995, pp. 2-3.)
- General Dynamics and McDonnell-Douglas contracted with companies in Saudi Arabia to satisfy offset obligations from several weapons sales. In one case, a Saudi firm will manufacture circuit boards for tanks, while in another instance, a Saudi company will manufacture components for F-15 fighter aircraft. (Countertrade Outlook, Vol. XIII, No. 6, Mar. 27, 1995, p. 5.)
- The United Arab Emirates is working with Chase Manhattan to establish an off-shore investment fund to provide international contractors doing

business in the country the opportunity to satisfy part of their offset obligations. (Countertrade Outlook, Vol. XIII, No. 2, Jan. 23, 1995, p. 1.)

Some company officials commented that indirect offsets make more sense for the countries than defense-related offsets. Although U.S. companies generally found meeting offset demands in Kuwait and Saudi Arabia manageable, some companies expressed concern over the limited number of commercially viable investment opportunities in these countries. Further, the United Arab Emirates' offset demands were seen as particularly costly and impractical since offset credits were based on profits actually generated by the newly established enterprise.

Appendix III provides detailed information on the offset requirements of each less industrialized country and the terms of the offset agreements we reviewed.

Divided Views on Effects of Offsets

Views on the effects of offsets are divided between those who accept offsets as an unavoidable part of doing business overseas and those who believe that offsets negatively affect the defense industrial base and other U.S. interests. It is difficult to accurately measure the impact of offsets on the overall U.S. economy and on specific industry sectors that are critical to defense.

Company officials told us that without offsets, most export sales would not be made and the positive effects of these exports on the U.S. economy and defense industrial base would be lost. Offsets help foreign buyers build public support for purchasing U.S. products, especially since weapon procurement often involves the expenditure of large amounts of public monies on imported systems. Other company officials indicated that export sales provide employment for the U.S. defense industry and orders for larger production runs, thus reducing unit costs to the U.S. military. They also noted that many offset deals create new and profitable business opportunities for themselves and other U.S. companies.

Critics charge that offsets have effects that limit or negate the economic and defense industrial base benefits claimed to be associated with defense export sales. Mandated offshore production may directly displace U.S. defense firms that previously performed this work, and offsets that transfer technology and provide marketing assistance give foreign defense firms the capabilities to subsequently produce and market their products, often in direct competition with U.S. defense companies. According to company officials, indirect offsets involving procurement, technology transfer, marketing assistance, and unrelated commodity purchases[9] may harm nondefense industries by establishing and promoting foreign competitors.

Data on Impact of Offsets Limited

Defense exports involving offsets are small relative to the economy as a whole, making it difficult to measure any effects using national aggregated data. Similarly, the impact of offsets on specific sectors of the U.S. economy cannot be accurately measured because reliable data on the number and size of offset agreements and the transactions used to fulfill these offsets are not readily available. In addition, it would be difficult to isolate the effects of offsets from numerous other factors affecting specific industry sectors. According to officials from large defense firms and an association representing U.S. suppliers, reliable information on the impact of offsets is difficult to obtain because company officials are generally not aware that a particular offset arrangement caused them to lose or gain business. Only limited anecdotal information from these companies is available.

The lack of reliable information is a long-standing problem. Recognizing the need for more information, Congress required in 1984 that the President annually assess the impact of offsets. The President tasked the Office of Management and Budget (OMB) to coordinate these assessments and submit a report to Congress. However, OMB was not able to accurately measure the impact of offsets on U.S. industry sectors critical to defense with the information it collected.[10] The Defense Production Act Amendments of 1992 directed the Commerce Department to take the lead in assessing the impact of offsets. As part of this effort, the statute requires companies to submit information on their offset agreements that are valued at $5 million or more. Commerce plans to issue its first report in 1996.

Actions Taken to Address Offsets

In response to concerns raised about the impact of offsets, the President issued a policy statement in 1990 that reaffirmed DOD's standing policy of not encouraging or participating directly in offset arrangements. This policy statement also recognized that certain offsets are economically

[9]Offset agreements have required U.S. defense companies to help sell, on a one-time basis, large quantities of nondefense goods such as dental equipment, automobiles, printing press parts, forklifts, and wire.

[10]Defense Production Act: Offsets in Military Exports and Proposed Amendments to the Act (GAO/NSIAD-90-164, Apr. 19, 1990).

inefficient and directed that an interagency team, led by DOD in coordination with the Department of State, consult with foreign nations on limiting the adverse effects of offsets in defense procurement. In 1992, Congress adopted this policy as part of the Defense Production Act Amendments.

According to the Commerce Department, DOD and the State Department have not consulted with foreign nations on the adverse effects of offsets as detailed in the 1990 presidential policy statement or the 1992 law. However, in 1990, as part of the discussions over the NATO Code of Conduct for defense trade, U.S. officials proposed to limit offsets in defense trade, but no action was taken because countries could not agree to the Code. DOD took action to include, as part of memorandums of understanding between the United States and its allies, a provision to consult on the adverse effects of offsets.[11] DOD has discussed offsets on a case-by-case basis with several countries in the context of specific weapon sales.

Commerce officials noted that offsets are driven by the demands of foreign governments against private U.S. companies. These demands place second and third tier U.S. suppliers at a disadvantage since their interests are not usually represented in these sales. Commerce officials said that DOD should take action, in accordance with the 1990 presidential policy, to consult with other nations to limit the adverse effects of offsets. One DOD official noted that negotiating the offset issue by itself would not give the United States a strong bargaining position because of U.S. reluctance to change Buy America and small business preferences.

According to the Commerce Department, industry is not opposed to the initiation of consultations on offsets, but is concerned that the U.S. government might unilaterally limit the use of offsets. Officials from several large defense companies we interviewed also expressed concern about any unilateral action by the U.S. government that would limit offsets. Similarly, several officials expressed doubt that any multilateral agreement limiting offsets would be enforceable, and some noted that any ban would likely force offset activity underground. In addition, some company officials said that unilateral action banning offsets or an unenforceable multilateral agreement would place U.S. exporters at a competitive disadvantage in winning overseas defense contracts.

[11]Reciprocal defense memorandums of understanding seek to facilitate armaments cooperation by allowing U.S. and foreign companies reciprocal access to the governments' defense markets, and calling for reductions in certain barriers, such as buy-national laws and tariffs.

Commerce and DOD officials agreed that unilateral action to limit offsets could harm U.S. defense companies.

Agency Comments

The Departments of Commerce, Defense, and State were given the opportunity to comment on a draft of this report. The Department of Commerce provided written comments (see app. IV) and the Departments of State and Defense provided oral comments. Commerce said our report provides a balanced view of the subject. State commented that the report accurately describes the growth in offset demands and the requirements countries place on their purchases of foreign military equipment. DOD concurred with our report and commented that it should contribute to a better understanding of the nature of offset demands and the role of offsets in military export sales.

We have made minor technical corrections to the report where appropriate based on suggestions provided by Commerce and Defense.

Scope and Methodology

To assess how countries' offset requirements have evolved and how companies were meeting these obligations, we focused our analyses on 10 countries. We selected these countries based on their geographic distribution and their significant purchases of foreign military equipment. We then visited nine major U.S. defense companies. These firms were chosen based on their roles as prime contractors and subcontractors that provide a full range of defense goods and services.

We interviewed company officials regarding each country in our study and obtained the offset agreements that they entered into with these countries since 1985. For the limited number of agreements that we could not obtain, we relied on summarized data provided by the company. Due to the proprietary nature of the offset agreements, we are limited in our ability to present specific information on a particular contract. However, to illustrate the types of offset projects U.S. and foreign companies undertook in the countries we reviewed, we used examples from various defense journals. We did not corroborate the information reported in these journals.

To determine what each country's offset policy required, we interviewed company officials and reviewed each country's requirements, as provided by the companies in our study. We then reviewed other government studies that examined offset requirements for these countries. We did not discuss these policies with officials from each country to confirm their accuracy.

To examine the implications of offsets on the U.S. economy, we examined studies of defense offsets performed by other U.S. government agencies and other groups. We interviewed DOD, Commerce, and State officials on offset trends and any U.S. actions taken regarding offsets. We also interviewed officials from prime contractors as well as trade associations that represent mostly smaller U.S. companies.

The companies in our study were cooperative and provided the information we requested in a timely manner. However, our ability to fully review the actual offset projects was affected by access restraints. This information is considered commercially sensitive by defense companies, and information on projects implementing the offset agreements was selectively provided by the companies. The companies reviewed our report to ensure that no sensitive information was disclosed.

We conducted our review from May 1995 to February 1996 in accordance with generally accepted government auditing standards.

We are sending copies of this report to interested congressional committees and the Secretaries of Defense, State, and Commerce. We will also make copies available to other interested parties upon request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Major contributors to this report were Karen Zuckerstein, Davi D'Agostino, David C. Trimble, Tom Hubbs, and John Neumann.

David E. Cooper,
Associate Director
Defense Acquisition Issues

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Abbreviations

DOD	Department of Defense
GATT	General Agreement on Tariffs and Trade
NATO	North Atlantic Treaty Organization
OMB	Office of Management and Budget

Offset Policies and Practices of Developed Economies

Canada

Canada seeks offsets through its Industrial and Regional Benefits policy to develop and maintain the capabilities and competitiveness of Canadian companies. It solicits offsets that will benefit its manufacturing and advanced technological capabilities, including technology transfer, investments in plants or productivity improvement, and coproduction with Canadian suppliers. Offset agreements generally range from 75 percent to 100 percent of the weapon systems contract's value. Most offsets involve purchasing products from Canadian firms in the defense, aerospace, or other high-technology industries. The official guidelines do not state a threshold for requiring offsets, and offsets have been provided on contracts with values as low as $12 million.[1]

Canada is distinctive in its emphasis on distributing offset projects across its various regions, particularly in its lesser-industrialized Western and Atlantic provinces. Most offset agreements require regional distribution, including several that specify which suppliers and regions should receive offset work. In addition, some agreements contain penalty provisions for not achieving a certain percentage of offset in each Canadian region. Many offset agreements also specify that small businesses must receive a portion of the offset projects.

Several agreements included detailed requirements for determining the amount of offset credit. For example, offset projects will receive credit only if the minimum Canadian content requirement is met, which was 35 percent in several of the agreements. Also, offset credit will only be granted for new business or increases in existing business. Companies are now usually not able to get offset credit for existing business in the country, as they were in the past.

Generally, the companies in our study did not have significant difficulty meeting offset requirements in Canada. Several companies found the defense-related offsets easy to implement because Canada has a developed defense industry and the companies have a significant amount of existing business in the country. Table I.1 summarizes Canada's offset guidelines and agreements.

[1]We reviewed 40 offset agreements with a stated value of $5.6 billion between U.S. companies and countries with developed economies. We are unable to report the total number of agreements we examined with each country because doing so might identify the companies in our review.

Table I.1: Canada—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	1991	1985-94
Program objectives	Generate long-term industrial benefits.	Agreements generated long-term industrial benefits with an emphasis on the defense and aerospace industries.
Offset threshold	Not stated.	Value of contracts with offsets started at $12 million.
Offset type	Both direct and indirect offsets are accepted, with emphasis on high-technology industries.	Many agreements show preference for offsets related to defense or aerospace industries.
Offset percentage	Not stated.	Recent agreements required offsets ranging from 75 percent to 100 percent of the contract value.
Multipliers	Not stated.	Two agreements provided for 20-percent additional credit for an increase in direct offset amount.
Banking[a]	Not stated.	Banking permitted in several agreements.
Penalties	Not stated.	Penalties varied from 2.5 percent to 12 percent of shortfall. Several agreements did not have penalties.
Performance period	Not stated.	Ranged from less than 5 years to over 10 years.
Milestones	Not stated.	Several agreements had yearly milestones for completing offset commitments.
Local content	Not stated.	Several agreements required a minimum of 35-percent Canadian content to receive any offset credit.
Targeting	Request offset projects that promote regional and small business development and provide subcontracts to Canadian suppliers.	Most agreements included regional distribution and small business requirements. Several recent agreements specified the actual suppliers to be used in carrying out offset agreements.
New business	Not stated.	Recent agreements only provided offset credit for new business.
Oversight	Not stated.	Several agreements have high administrative oversight to determine if offset resulted in new business and met Canadian content and other requirements.

[a]Banking refers to the practice of allowing companies to earn extra offset credit under one offset agreement and save or "bank" those credits to satisfy a later offset obligation.

The Netherlands

The Netherlands uses offsets to maintain and promote its technical capabilities in defense and other industries. The country has a well-established defense industry and requires offsets that are related to defense or high-technology civilian industries. The defense-related offsets typically involve coproduction of components, parts and assemblies, and technical services rendered by Dutch firms. Nondefense-related offsets include a wide range of activities designed to contribute to the

Netherlands industrial base, including purchasing products from Dutch firms in the aircraft, automotive, electronics, optical, or shipbuilding industries.

The Netherlands' guidelines require offsets on all weapons contracts valued at more than $3 million. The standard offset demand is 100 percent, and the majority of agreements over the last 10 years reflect this requirement. Many of the agreements require that 70 percent to 85 percent of any product purchased be produced in the Netherlands in order to receive full credit toward the offset obligation. In addition, several recent agreements state that credit will only be granted for new business created or an increase in existing business.

Company representatives told us that implementing defense-related offsets in the Netherlands is not a problem, given the country's sophisticated and highly developed industrial base. Several companies identified offsets as a critical factor in winning a contract in the Netherlands and believe the country would choose a less-desired weapon system to get a better offset package. Table I.2 summarizes the Netherlands' offset guidelines and agreements.

Table I.2: The Netherlands—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	1992	1986-95
Program objectives	Maintain and increase the industrial capacity of the defense industry.	Most agreements included defense-related offsets.
Offset threshold	All defense contracts valued at more than $3 million require offsets.[a]	All agreements exceeded the official offset threshold.
Offset type	Both direct and indirect offsets are accepted, with emphasis on dual-use (military and civilian) technology.	Agreements showed preference for direct offsets or indirect offsets in the defense or other technologically equivalent industry.
Offset percentage	Government seeks 100-percent offset.	Most agreements over last 10 years required 100-percent offset.
Multipliers	Not stated.	Multipliers are rarely included. However, according to company officials, the amount of credit granted for an offset project can be negotiated, achieving the same results as a multiplier.
Banking	Not stated.	Banking permitted in several agreements.
Penalties	Not stated.	Penalties not stated. However, according to a May 1995 press report, the Netherlands legislature requested that penalties be included in one offset agreement.
Performance period	Not stated.	Ranged from 4 years to 15 years.
Milestones	Not stated	Milestones are generally not included in the agreements.
Local content	Not stated.	Most agreements required a minimum of 70-percent local content to receive 100-percent offset credit.
Targeting	Not stated.	Some agreements specified the actual suppliers to be used in carrying out the offset agreement or required that a portion of the offset activities be fulfilled by collaboration with small- and medium-sized businesses.
New business	Require indirect offsets to include new business or a significant increase in existing orders.	Several agreements specified that offset credit would be granted only for new business or an increase in business.

[a]The guidelines specify an offset threshold of 5 million guilders, which is equivalent to approximately $3 million based on exchange rates as of October 26, 1995.

Spain

Spain uses offsets on defense orders to support and develop its defense industry. Although Spain does not have written offset guidelines, it does have a policy of demanding offsets, including coproduction by designated Spanish firms, technology transfer, and export of Spanish defense products. Spain's standard offset requirement is 100 percent; however, the agreements over the last 10 years have ranged from 30 percent to

100 percent of the value of the weapon system. Spain does not have a stated threshold amount for requiring offsets, but all of the offset agreements over the last 10 years were for weapons sales over $7 million.

In some agreements, Spain has included provisions to only credit offset projects that create new business or represent an increase in existing business, and not grant credit for companies' current business in the country. In addition, Spain has sometimes included a local content requirement for offset projects, providing credit only for the portion of the projects that are produced in Spain. Companies report that to get approval for offset projects, the work usually has to be spread across various Spanish regions, even though the agreements do not explicitly contain this requirement. In addition, Spain has targeted specific Spanish companies that it wants to get offset work.

One U.S. company said offsets were relatively easy to implement in Spain because Spain's participation has consisted of producing less sophisticated components. Another company observed that offsets are more difficult to implement in Spain than in other European countries because of Spain's less diverse industrial base. Table I.3 summarizes Spain's offset guidelines and agreements.

Table I.3: Spain—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	Has official offset policy, but not written guidelines.	1985-94
Program objectives	Provide support for Spain's defense industry.	Some agreements reflected goal of providing opportunities for defense industry.
Offset threshold	Unknown.	Agreements were for contracts valued at over $7 million.
Offset type	Emphasis on defense-related offsets.	Agreements reflected preference for offsets in the defense industry, including coproduction, technology transfer, and export of Spanish defense products.
Offset percentage	100 percent is the standard offset demand.	Agreements required from 30-percent to 100-percent offset.
Multipliers	Unknown.	Some agreements included multipliers for technology and production licenses and joint development programs.
Banking	Permitted.	Banking excess credits common.
Penalties	Generally requires penalties.	Some agreements included penalties ranging from 3 percent to 5 percent of offset commitment shortfall.
Performance period	Unknown.	Ranged from 5 years to 8 years, with grace periods sometimes included.
Milestones	Unknown.	Only one agreement had milestones.
Local content	Sometimes grants credit only for value of local content.	Included in some agreements.
Targeting	Sometimes specifies regional or supplier requirements.	Some agreements specified the actual supplier to be used in carrying out offset agreement. In addition, companies are encouraged to spread offset projects out over Spanish regions.
Oversight	Unknown.	Some agreements required regular reporting of offset implementation status.

United Kingdom

The United Kingdom uses offsets to channel work to its defense companies. The country has a well-established defense industry and requests offsets that are related to defense, including production, technology transfer, capital investment, and joint ventures. Offset agreements focus on procurement of defense-related products and services from British firms.

According to the country's guidelines, offsets are not mandatory, but are used as an assessment factor in contract evaluations. Offsets are commonly sought from North American companies and on a case-by-case basis from European companies. Offsets are encouraged for weapon sales worth more than $16 million. A majority of the agreements required 100 percent of the sale to be offset.

Some companies stated that implementing defense-related offsets in the United Kingdom is not a problem, given the country's sophisticated and diverse industries and the significant amount of existing business these companies have in the country. However, several recent agreements specify that offset credit will be given only for new business or a verifiable increase in existing business, based on a prior 3-year average. A company's existing business in the country is not eligible for offset credit. Furthermore, recent agreements specify that any purchase orders or subcontracts for offset credit must be placed with one of the companies on the country's registry of recognized defense companies. However, this is not a problem for U.S. companies partly because many British firms are on the registry. Table I.4 summarizes the United Kingdom's offset guidelines and agreements.

Table I.4: United Kingdom—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	1995	1985-94
Program objectives	Compensate for loss of work to the United Kingdom's defense industrial sector.	Agreements reflected guidelines' goal to provide work to the defense industrial sector.
Offset threshold	All defense contracts valued at more than $16 million require offsets.[a]	Most were for contracts valued above the threshold amount.
Offset type	All offsets must be defense-related.	Agreements reflected requirement for defense-related offsets.
Offset percentage	Government seeks 100-percent offset.	Offset percentage ranged from 50 percent to 130 percent. Most agreements required at least 100-percent offset.
Multipliers	Offset credit can be negotiated.	Offset credit can be negotiated. For example, one agreement provided for "extra credit" if a specific offset project was undertaken.
Banking	Permitted in certain circumstances.	Banking permitted in most agreements.
Penalties	Not stated.	No penalties; agreements call for "best efforts" to fulfill.
Performance period	Not to exceed the delivery period of the contract.	Ranged from 3 years to 13 years.
Milestones	Not stated.	Not stated.
Targeting	Offset activities must be placed with a qualified United Kingdom defense manufacturer. Such companies are listed in a central registry and are from various regions of the country.	Most agreements specified that offset credit would only be granted for work with recognized United Kingdom defense contractors.
New business	Offset activities must be new and consist of products not previously purchased, products purchased from new suppliers, or new contracts for existing business valued at over $50,000.	Several recent agreements specified that offset credit would be granted only for new business or an increase in business.
Oversight	Offset proposals commonly submitted at time of contract tender for approval. No other mention of oversight.	Several agreements required regular reporting of offset activity progress. Staff to review offset credit.

[a]The guidelines specify an offset threshold of 10 million pounds, which is equivalent to approximately $16 million based on exchange rates as of October 26, 1995.

Offset Policies and Practices of Newly Industrialized Economies

Singapore

Singapore uses offsets to build its capability to produce, maintain, and upgrade its defense systems. It has required offsets on an ad hoc basis since the mid-1980s, but has recently begun to consistently demand offsets. Singapore's official policy requires all major purchases to be offset with a 30-percent offset performance goal.[1]

All the offset arrangements we reviewed emphasized defense-related projects. These arrangements required producing components for the weapon system being purchased or establishing a Singaporean firm as a service center for a weapon system. Singapore seeks technology transfer and training, and most offset agreements include multipliers or provide credits in excess of contractor costs for highly desired projects. For example, manufacturing technology transferred for one weapon system was valued at several times the cost to the company to provide it.

Generally, companies that had offset agreements with Singapore considered the requirements manageable. Table II.1 summarizes Singapore's offset guidelines and agreements.

[1]We reviewed 31 offset agreements with a stated value of $5.1 billion between U.S. companies and countries with newly industrialized economies. We are unable to report the total number of agreements we examined with each country because doing so might identify the companies in our review.

Table II.1: Singapore—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	1987	1986-94
Program objectives	Assist the Ministry of Defense in building up Singapore's capabilities to provide necessary maintenance, production, and upgrade capability to support equipment and systems the Ministry has procured. To be accomplished through technology transfer, technical assistance, participation in research and development, and marketing assistance.	Consistent with the guidelines.
Offset threshold	All "major" purchases of equipment, material, and services; however, the guidelines do not provide a specific threshold.	All the agreements we reviewed were for sales valued at over $5 million.
Offset type	Direct offset is preferred but indirect offset is acceptable.	Most included a mix of direct and indirect offset transactions.
Offset percentage	At least 30 percent of main contract value, expressed as a goal.	Ranged from 25 percent to 30 percent.
Multipliers	Not stated.	Some agreements provided multipliers for activities such as technology transfer (valued at up to 10 times the cost), training, or technical assistance.
Banking	Not stated.	Permitted banking in most agreements.
Penalties	10 percent of unfulfilled obligation.	3 to 5 percent of unfulfilled obligation.
Performance period	Concurrent with the duration of the main contract up to a maximum of 10 years, plus a 1-year grace period.	Agreements are generally consistent with the guidelines.
Milestones	Not stated.	Generally not stated.
Targeting	Firms owned by the Ministry of Defense are given first preference on bidding for work with U.S. contractors.	Agreements are generally consistent with the guidelines. The Ministry of Defense is very involved in selecting Singaporean firms that U.S. defense contractors must work with.

South Korea

South Korea uses offsets to acquire advanced technologies for its defense and commercial industry. Technology transfer and related training has consistently been a high priority for South Korea, and it has received increased emphasis in recent years as South Korea has developed its aerospace industry. To obtain technology transfer and training, South Korea grants multipliers and awards offset credit that exceeds the actual cost to the company of providing these items.

As a result of U.S. government pressure to reduce offset demands in the late 1980s, South Korea's policy calls for a 30-percent offset on defense purchases exceeding $5 million. Although some agreements required a 30-percent offset, others required an offset of 40 percent or higher.

South Korea has a preference for defense-related offsets, but is also willing to accept a wide variety of indirect offsets to help develop its industry, especially its aerospace industry. In addition, South Korea frequently has required U.S. contractors to buy products, such as forklifts and printing press parts, for export resale that were unrelated to the weapon system being purchased.

Several U.S. companies indicated that it can be difficult to work with South Korea. They noted that the 30-percent offset requirement is tougher to satisfy than the old 50-percent requirement and can be as tough as a 100-percent requirement. Several company officials also noted that they have had difficulty in not being allowed to use banked credits. However, some contractors commented that South Korea was consistent in its requirements and would negotiate if the U.S. company was trying to meet its offset obligation. Table II.2 summarizes South Korea's offset guidelines and agreements.

Table II.2: South Korea—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	Offset requirements first begun before 1985. Latest version published in January 1992.	1985-94
Program objectives	Acquire key advanced technologies required for defense and commercial industry research and development and production; enhance depot maintenance capability; enhance opportunities for manufacturing equipment and its components; and provide opportunities to repair and overhaul foreign military equipment and to export defense-related products.	Agreements were generally consistent with the guidelines. However, certain offset projects had no relationship to the weapon systems being purchased.
Offset threshold	Military procurements exceeding $5 million are subject to offset.	Several offset agreements prior to 1992 involved contracts that were below the current $5-million threshold. In addition, according to one contractor, South Korea combined two separate purchases into one contract to reach the offset threshold.
Offset type	Direct offset is preferred, but indirect offset is acceptable.	Agreements were generally consistent with the guidelines and reflected a willingness to accept indirect offset, especially involving technology transfer and training, that will contribute to economic development.
Offset percentage	At least 30 percent of contract value.	Since 1985, agreements have generally required at least a 30-percent offset—and frequently more.
Multipliers	Limited use of multipliers. Facilities, equipment, and tooling provided by the contractor free of charge are given a multiplier of two times their actual cost.	Several offset agreements provided multipliers that were larger than the published guidelines, especially for technology transfer and training. For example, providing on-the-job training for South Korean engineers at a U.S. contractor's plant was valued at 10 times the cost of providing the training.
Banking	Permitted.	Banking excess credits allowed in several individual agreements, but most were silent on banking.
Penalties	10 percent of unfulfilled obligation.	Agreements were consistent with the guidelines.
Performance period	Generally corresponds to the performance period for the main contract.	Agreements were generally consistent with the guidelines.
Milestones	Not stated.	Agreements occasionally required and paralleled overall contract performance periods.
Targeting	Not stated.	Many agreements were prescriptive and specified the South Korean partners to be used by U.S. contractors or the exact training to be provided by the U.S. contractor to South Korean workers.
Unrelated purchases	Not stated.	Agreements frequently required U.S. contractors to buy South Korean products for export resale that had no relationship to the contract.

Taiwan

Taiwan instituted its offset policy about 1993. Taiwan uses offsets to encourage private investment, upgrade its industries, and enhance international competitiveness. Taiwan's goal is to form long-term supplier relationships with foreign companies, using training and technology transfer to gain expertise. Taiwan emphasizes these areas by offering large multipliers for such projects. For example, the agreements included multipliers as high as 25 for technology transfer, while other activities such as purchases from local firms received no or very low multipliers. Company officials noted that Taiwan recently passed a requirement calling for 30-percent offsets.

Taiwan's offset guidelines are broad, laying out several categories of industrial cooperation and methods to achieve it—from production of weapon system components to local investment. Offset agreements appear flexible, with projects targeted to areas considered strategic for economic development. In contrast to South Korea and Singapore, Taiwan generally prefers commercial offset projects rather than defense-related projects. Although some agreements include defense-related offset projects, such as coproduction of weapons components, the agreements more commonly involve commercial projects, such as marketing assistance.

Generally, the companies we visited believe that Taiwan's offset requirements have been easily managed. Table II.3 summarizes Taiwan's offset guidelines and agreements.

Table II.3: Taiwan—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	1993	All are after date of guidelines.
Program objectives	To achieve the timely introduction of key technologies and high-tech industries to Taiwan. Targeted industries include aerospace, semiconductors, advanced materials, information products, precision machinery and automation, and advanced sensors.	Agreements are consistent with the guidelines.
Offset threshold	To be determined on a case-by-case basis; both civilian and military government procurements are subject to offset.	The smallest contract we reviewed with an offset requirement was for about $60 million.
Offset type	Both direct and indirect offsets are acceptable.	Agreements reflected preference for indirect offset; they either required indirect offset only or were heavily weighted toward indirect.
Offset percentage	To be determined on a case-by-case basis. However, company officials noted that Taiwan's legislature passed a law in 1994 requiring 30-percent offsets.	Most of the agreements we reviewed required 10-percent offset with an additional 20 percent expressed as a goal; however, the most recent agreement required 30-percent offset.
Multipliers	Range from 2 for local purchases to 10 for technology transfer.	Multipliers provided for a broad range of transactions—technology transfer, training, technical assistance, marketing assistance, investments, and joint ventures—valued at between 2 and 25 times the cost of the service provided.
Banking	Permitted.	Most agreements do not specifically discuss banking excess credits.
Penalties	None. Guidelines based on good faith. However, the policy notes that a contractor's track record in fulfilling an offset obligation is considered when awarding future contracts.	Agreements did not include penalties.
Performance period	Concurrent with master contract.	All agreements had a 10-year performance period.
Milestones	Not stated.	Not stated.
Long-term relationship	Goal is to participate in long-term supplier relationships, using training and technology transfer to gain expertise. Guidelines are broad, laying out several categories of industrial cooperation and methods to achieve it—from production of weapon system components to local investment.	Consistent with guidelines, the offset projects were targeted to areas considered "strategic" to economic development.

Offset Policies and Practices of Less Industrialized Economies

Kuwait

In 1992, Kuwait began requiring offsets for all defense purchases over $3 million. Kuwait pursues offsets that will generate wealth and stimulate the local economy through joint ventures and other investments in the country's infrastructure.[1]

The limited number of agreements we reviewed call for U.S. contractors to propose investment projects and then manage and design the projects selected by the Kuwaiti government. The agreements required offsets equal to 30 percent of the contract values, as stated in Kuwait's offset policy.

U.S. companies have had limited experience with Kuwait's offset program to date, but generally consider it manageable. Table III.1 summarizes Kuwait's offset guidelines and agreements.

Table III.1: Kuwait—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	Offset policy instituted in July 1992. Revised guidelines issued in March 1995.	All are after the institution of the 1992 guidelines.
Program objectives	Promote and stimulate the local economy.	Agreements are consistent with program goals.
Offset threshold	Offset threshold is about $3 million.	Exceed threshold.
Offset type	Indirect offsets.	Agreements involved indirect offsets.
Offset percentage	30 percent of the value of the contract.	Agreements required 30-percent offset.
Multipliers	The relative value of multipliers reflect Kuwait's preference for capital expenditures, research and development, training, and increased export sales of locally produced goods and services (multipliers of 3.5). Other activities are given smaller multipliers.	Not stated.
Banking	Allowed up to 100 percent of offset obligation.	Banking permitted.
Penalties	6 percent of unfulfilled obligation.	Not stated.
Performance period	8 years.	Not stated.
Milestones	50 percent of the offset should be completed within 4 years.	Not stated.
Investment	Long-term investment through joint ventures is encouraged.	Agreements reflected interest in developing viable businesses.

Saudi Arabia

Saudi Arabia has intermittently required offsets since the mid-1980s. Officials at one company observed that Saudi Arabia has recently pursued

[1]We reviewed five offset agreements between U.S. companies and countries with less industrialized economies. The value of the agreements where figures were available totaled $1.6 billion. We are unable to report the total number of agreements we examined with each country because doing so might identify the companies in our review.

"best effort" agreements with U.S. defense contractors, rather than formal offset agreements. Saudi Arabia uses its offset policy to broaden its economic base and provide employment and investment opportunities for its citizens.

The offset agreements are informal with no set offset percentage, although officials at one company estimated their arrangement was equivalent to a 35-percent offset agreement. The agreements include a requirement that companies enter into joint ventures with local companies to implement offset activities. The offset activities consist of defense- and nondefense-related projects. In some instances, the offset projects include local production of parts or components for the weapon system being purchased. However, these represent small portions of the overall offset projects, and the Saudi government agreed to pay price differentials to make Saudi manufacturers price competitive. The agreements do not include explicit multipliers, but some agreements grant credits for technology transfers at the cost Saudi Arabia would have incurred to develop the technology.

Companies commented that Saudi Arabia wants to establish strategic partnerships and long-term relationships with its suppliers and that the Saudi government has been fairly flexible in negotiating offset agreements. Table III.2 summarizes Saudi Arabia's offset guidelines and agreements.

Table III.2: Saudi Arabia—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	Undated.	1990-93 (One prior agreement in 1988.)
Program objectives	Broaden the economic base, increase exports, diversify the economy, transfer state-of-the-art technology, and provide investment opportunities for Saudi Arabian investors.	Agreements were consistent with program goals.
Offset threshold	Not stated. Offset applies to both military and civil federal procurement.	Agreements were associated with high-dollar value contracts.
Offset type	Indirect offsets are preferred.	Mostly indirect offsets that were unrelated to defense.
Offset percentage	35 percent of contract value.	Agreements were consistent with the requirement or called for “best efforts” commitment.
Multipliers	Offset credit for training Saudi Arabian nationals will be given at two times the contractors’ cost (i.e., a multiplier of two). No other multipliers cited.	Not stated. However, technology transfers were valued at the cost Saudi Arabia would have incurred to develop the technology, plus the value of future benefits.
Banking	Not stated.	Not stated.
Penalties	Not stated.	Not stated. Agreements generally called for “best efforts” as part of Saudi Arabia’s desire to establish long-term relationships.
Performance period	10 years.	10 years.
Milestones	Not stated.	Not stated.
Eligibility	Oil- and gas-related projects are not eligible for credit.	Offset activity involved mostly nondefense-related projects unrelated to the oil and gas industry.
Investment	Should be 50 percent of total offset obligation. Joint ventures sought between foreign and Saudi firms; foreign firm’s ownership share may decrease to 20 percent by end of 10 years.	Agreements required joint ventures, but appeared to be less formal than published guidelines. Agreements cited specific Saudi Arabian firms for joint venture partners.

United Arab Emirates

The United Arab Emirates first instituted its offset policy in 1990. In 1993, it issued new requirements granting offset credit only for the profits generated by offset projects. The policy requires a 60-percent offset on all contracts valued at $10 million or more. The United Arab Emirates uses offsets to generate wealth and diversify its economy by establishing profitable business ventures between foreign contractors and local entrepreneurs.

The United Arab Emirates is interested in a wide range of nondefense-related offset projects.

Company officials generally questioned the feasibility of the United Arab Emirates' current offset requirements. They said only a small number of viable investment opportunities exist and such projects take several years to generate profits. Table III.3 summarizes the United Arab Emirates' offset guidelines and agreements.

Table III.3: United Arab Emirates—Offset Guidelines and Agreements

Category	Offset guidelines	Offset agreements
Date	New guidelines issued about 1993. Prior guidelines dated 1990.	All after the institution of the 1990 requirements.
Program objectives	Generate wealth by creating commercially viable businesses through partnerships with local entrepreneurs.	Agreements were consistent with guidelines in effect at the time.
Offset threshold	For all "substantial" defense procurement. Requirements specifically cite a $10-million threshold for any government procurement.	All agreements exceeded the threshold.
Offset type	Policy implies nondefense, wealth-generating investments are preferred. The policy explicitly discourages, however, labor-intensive projects.	Agreements involved indirect offsets unrelated to defense.
Offset percentage	At least 60 percent of the value of the imported content.	All agreements required a 60-percent offset.
Multipliers	Not mentioned under current policy. Credit is based on profit generated rather than a valuation (using multipliers) of the investment in the project. The 1990 policy permitted multipliers.	Some agreements that pre-date the new offset policy included multipliers that reflected the United Arab Emirates' preference for investment.
Banking	Banking of offset credits is permitted.	Agreements permitted banking of offset credits and buying of excess credits from other companies.
Penalties	8.5 percent of the unfulfilled obligation.	Consistent with guidelines.
Performance period	7 years.	Some agreements exceeded the 7-year performance period requirement.
Milestones	To be negotiated for each offset proposal.	Agreements included milestones throughout the obligation.
Eligibility	Companies must demonstrate that offset ventures are new work or extensions of existing activities.	Agreements required projects to be preapproved for eligibility and offset credit.
Investment	May require financial investment in an offset development fund in lieu of conventional offsets.	Chase Manhattan is working to set up a United Arab Emirates investment fund. According to company officials, the fund will require a minimum $5-million investment for at least 10 years, with a guarantee of at least a 2.5-percent return. The country will provide 20-percent offset credit against investments in the fund.
Granting offset credit	Offset credit for technology transfer, training, parts production, and all offset projects is granted based on the profits generated by these activities rather than the contractor's implementation cost.	Company officials noted that this requirement was impractical.

Comments From the Department of Commerce

THE SECRETARY OF COMMERCE
Washington, D.C. 20230

JAN 30 1996

Mr. David E. Cooper
Associate Director
Defense Acquisition Issues
National Security and International
Affairs Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Cooper:

Thank you for the opportunity to comment on the General Accounting Office's draft report titled "Offset Requirements Associated with Military Exports." We are pleased with the overall content of the report and believe that it provides a balanced view of complicated subject matter. The data and specific country information detailed in the report will help us complete our report, "Offsets in Defense Trade," for the Congress early this year. That report is required by the Defense Production Act of 1950, as amended.

We do, however, recommend one change to your draft report. I understand that BXA officials discussed the following with your staff. Under the heading on page 3, "Results in Brief," the third paragraph, fourth sentence ("Although DOD...") should read as follows:

> "To date, DOD and the Department of State have not consulted with other countries about the impact of offsets as detailed in the 1990 Presidential Policy on Offsets. While industry is not opposed to the initiation of consultations on offsets, it is concerned over U.S. Government actions that would unilaterally limit the use of offsets."

Thank you for your cooperation.

Sincerely,

Ronald H. Brown

Ronald H. Brown

Related GAO Products

Trade Offsets in Foreign Military Sales (GAO/NSIAD-84-102, Apr. 13, 1984).

Foreign Military Sales and Offsets (Testimony, Oct. 10, 1985).

Military Exports: Analysis of an Interagency Study on Trade Offsets (GAO/NSIAD-86-99BR, Apr. 4, 1986).

Security Assistance: Update of Programs and Related Activities (GAO/NSIAD-89-78FS, Dec. 28, 1988).

Defense Production Act: Offsets in Military Exports and Proposed Amendments to the Act (GAO/NSIAD-90-164, Apr. 19, 1990).

Military Exports: Implementation of Recent Offset Legislation (GAO/NSIAD-91-13, Dec. 17, 1990).

U.S.-Korea Fighter Coproduction Program—The F-16 Version (GAO/NSIAD-91-53, Aug. 1, 1991).

Military Sales to Israel and Egypt: DOD Needs Stronger Controls Over U.S.-Financed Procurements (GAO/NSIAD-93-184, July 7, 1993).

Military Aid to Egypt: Tank Coproduction Raised Costs and May Not Meet Many Program Goals (GAO/NSIAD-93-203, July 27, 1993).

Military Exports: Concerns Over Offsets Generated With U.S. Foreign Military Financing Program Funds (GAO/NSIAD-94-127, June 22, 1994).

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