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THESIS

**THE DETERMINANTS OF UNITED STATES
GOVERNMENT POLICY AND PRACTICE TOWARDS
OFFSETS IN INTERNATIONAL TRADE**

by

Joseph E. Milligan, III

December 2003

Thesis Advisor:
Second Reader:

Richard Doyle
Raymond Franck

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PRACTICE TOWARDS OFFSETS IN INTERNATIONAL TRADE**

Joseph E. Milligan, III
Civilian, Department of the Navy
B.S., Marquette University, 1983

Submitted in partial fulfillment of the
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**NAVAL POSTGRADUATE SCHOOL
December 2003**

Author:

Joseph E. Milligan, III

Approved by:

Dr. Richard Doyle
Thesis Advisor

Dr. Raymond Franck
Associate Advisor

Dr. Douglas A. Brook
Dean, Graduate School of Business & Public Policy

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ABSTRACT

Offsets are countertrade practices through which sellers in exporting countries provide concessions to buying governments as a condition of sale. Offsets are increasing as a percentage of defense exports. Because US industry leads worldwide defense exports, US offsets policy and the potential impact of offsets on US national security are highly significant. US policy considers offsets to be economically inefficient and market distorting, restricts US government agency involvement in offsets, and places responsibility for such arrangements with businesses. Offset policy has been the subject of intense and frequently conflicting policy initiatives undertaken between 1973 and 2003, involving both the executive and legislative branches of government. This thesis details why and how US policy on offsets evolved, identifying key participants and policy decisions. This thesis concludes that initially the primary policy drivers were DOD desires to preserve prerogatives to domestically produce foreign designs and to avoid unnecessary friction with allies. DOD led policy development within the executive branch with the publication of offsets policy memoranda by the Deputy Secretary of Defense. While no single focus for congressional offsets policy was identified, a primary policy driver was the perceived loss of jobs resulting from offsets, as legislators from states and districts where organized labor was strong led efforts to mandate restrictions and reporting requirements. Important differences emerged between the legislative and executive branches, regardless of administration, regarding offsets. These included differences regarding the effect of offsets on domestic employment and technology transfer and the appropriate US response to demands for offsets.

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LIST OF ACRONYMS AND ABBREVIATIONS

AECA	Arms Export Control Act
AFTA	ASEAN Free Trade Agreement
AIA	Aerospace Industries Association
App.	Appendix
ASEAN	Association of South East Asian Nations
ASPR	Armed Services Procurement Regulations
BAOR	British Army of the Rhine
BEA	Bureau of Economic Analysis
BIS	Bureau of Industry and Security, Bank for International Settlements
BOB	Bureau of Budget
BXA	Bureau of Export Administration (DOC)
CEA	Council of Economic Advisors
CFR	Code of Federal Regulations
CR	Congressional Record
D	Democrat
DAC	Defense Acquisition Council
DAR	Defense Acquisition Regulations
DEPSECDEF	Deputy Secretary of Defense
DFARS	Defense Federal Acquisition Regulation Supplement
DOC	Department of Commerce
DOD	Department of Defense
DODA	Defense Offsets Disclosure Act
DOL	Department of Labor
DOS	Department of State
DPA	Defense Procurement Act of 1950, as amended
DPACT	Defense Policy and Advisory Committee on Trade
DPC	Defense Procurement Circular
DSAA/DSCA	Defense Security Assistance Agency/Defense Security Cooperation Agency
E.C.	European Commonwealth
EIA	Electronic Industries Association
EO	Executive Order
EPG	European Participating Group
EPI	Economic Policy Institute
EU	European Union
FAR	Federal Acquisition Regulations
FDCH	Federal Document Clearing House
FFG	Guided Missile Fast Frigate
FMF	Foreign Military Financing
FMS	Foreign Military Sales
FNS	Federal News Service
FR	Federal Register

GDP	Gross Domestic Product
GFE	Government Furnished Equipment
GPA	Agreement on Government Procurement
H.R.	Refers to legislation originated in the House of Representatives
HMG	Her Majesty's Government
IC/IPA	International Coproduction/Industrial Participation Agreements
ITA	International Trade Agency
ITAR	International Traffic in Armaments Regulations
KFP	Korean Fighter Program
MAP	Military Assistance Program
MASM	Military Assistance and Sales Manual
MDE	Major Defense Equipment
MFN	Most Favored Nation
MOD	Ministry of Defense
MOU	Memorandum of Understanding
MTN	Multilateral Trade Negotiations
NAFTA	North American Free Trade Agreement
NATO	North Atlantic Treaty Organization
NDAA	National Defense Authorization Act
NEC	National Economic Council
No.	Number
NSC	National Security Council
NSIAD	National Security and International Affairs Division (GAO)
NTB	Non-tariff Trade Barrier
OECD	Organization for Economic Cooperation and Development
OMB	Office of Management and Budget
OTCA	Omnibus Trade and Competitiveness Act
P.L.	Public Law
R	Republican
ROK	Republic of Korea
S.	Refers to legislation originated in the Senate
SAMM	Security Assistance Management Manual
Stat.	Statute
STEP	Science, Technology, and Economic Policy
TCA	Agreement on Trade in Civil Aircraft
UK	United Kingdom
US	United States
U.S.C.	United States Code
USG	United States Government
USITC	US International Trade Commission
USTR	US Trade Representative
WTO	World Trade Organization

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I. INTRODUCTION

A. PURPOSE

The purpose of this thesis is to enhance understanding of offsets and the determinants of United States Government (USG) policy and practice towards offsets. In particular, this thesis will examine how and why US policy on offsets developed as it did. After first defining offsets and placing them in the context of international trade, this study will examine in detail the extent of both legislative branch and executive branch involvement in offset activities and policy development. Additionally, offset-related linkages and discontinuities within and between the legislative and executive branches of the USG will be explored. These areas will be examined to identify and explain the critical factors that have determined USG policy and practice towards offset.

B. BACKGROUND

Offsets are international, compensatory countertrade practices that require a seller in an exporting country to provide concessions to (or compensate) the buying government as a condition of sale. Offset practices include counterpurchase, co-production, licensed production, and technology transfer.¹ Some researchers in this field regard offsets holistically as part of a complex transaction. However, most practitioners look upon offsets as secondary transactions independent of the price or quality of the goods or services sold as part of a primary contract. Most governments throughout the world require some form of offsets as a matter of trade policy. Though worldwide efforts such as the General Agreement on Tariffs and Trade (GATT) and other regional trade agreements have attempted to restrict the use of offsets, governments continue to employ offsets in varying degrees for public purchases (largely defense items) that exceed specified monetary thresholds.

In addition to the buying government and seller, a number of stakeholders are involved in varying degrees with offsets and offset implementation, to include unions,

¹ The Department of Commerce (DOC) delineates various offset practices as Technology Transfer, Subcontractor Production, Co-production, Licensed Production, Purchases, Training, Investment, Marketing, and Countertrade. Descriptions of these practices are provided in numerous government documents and not repeated in this thesis.

trade associations, and government personnel. Not surprisingly, involved stakeholders hold different views regarding offsets. Some strongly support offsets as an essential advantage to conducting business in an increasingly global marketplace. Others view offsets as a “necessary evil.” Still, others view offsets as unfairly impacting domestic job markets as well as distorting world markets.

Given these many viewpoints, offsets are considered quite controversial. One area of controversy includes the transactional costs to implement an offset since offsets are not free. The cost to implement an offset transaction must either be borne by the seller as a cost of doing business or passed along to the buying government in the form of higher costs for the purchased goods or services. Some offset critics argue that greater economic benefits would accrue and costs would be less if the purchasing government made two separate transactions: the first for the desired article based solely on price and quality of the primary sales agreement and the second for the article or service that would be delivered as a result of the offset agreement.

Another area of controversy includes the negative effects on employment. While work (i.e., jobs) may be gained in the selling country by winning a foreign contract, the seller may transfer certain jobs or skills to industries in the buying country to satisfy foreign government offset demands. Coupled with this employment controversy is the concern raised by some economists pertaining to the negative effect of offsets on the economy. These take the form of distorted trade patterns and uneconomic price increases, particularly within the aerospace sector. Finally, many within selling countries are concerned with the level of technology transfer that results from offsets and the potentially deleterious effects such transfer may have on national security.

In 1990, the USG instituted a “hands off” policy regarding offsets, particularly with respect to government-to-government transactions. Prior to this, the USG was directly involved in a number of offset transactions. However, since 1990, indirect USG involvement has increased significantly: US businesses that provide offsets to foreign governments must report certain information to the USG for inclusion in an annual report to Congress; USG agencies involved in government-to-government transactions must notify Congress and provide information pertaining to the inclusion of potential sales

including offsets; the Department of Defense (DOD) has determined in the defense supplement to the Federal Acquisition Regulations (FAR) that the costs to implement offset transactions are allowable and may be passed on to foreign governments as part of these government-to-government agreements; DOD contracting officers working with businesses must determine whether offset implementation costs are allocable and reasonable; finally, USG personnel, though allowed to acknowledge that offset costs are embedded in a government-to-government agreement if asked, are prohibited from discussing specific offset information with foreign governments.

C. THESIS OBJECTIVES

The objective of this research is to identify the determinants of USG policy and practice towards offsets in international trade. This study will discuss the early development of offset-related practices shortly after World War II and the introduction of offsets as a burden-sharing tool used by the US to help maintain a positive balance of payments with West Germany during the 1960s to mid-1970s. This research traces the initial appearance of offset within the US as a trade practice in the mid-1970s and continues by examining DOD involvement with offset agreements and subsequent development of offset-related policy and regulations within DOD through 1980. This thesis traces the development of a US offset policy, along with the emergence of congressional involvement with offsets through 1990. Finally, this study examines the refinement of offset related policies through 2003.

D. RESEARCH QUESTIONS

1. Principal Research Question

What are the determinants of USG policy and practice towards offsets in international trade?

2. Secondary Research Questions

- What are offsets?
- How do offsets “fit” within the context of international trade?
- When, why, how, and where are offsets employed?
- What is the history of USG participation in offsets?

- What statutes, policies, and regulations govern USG involvement regarding offsets?
- Which USG offices participate in offsets and what is the nature of their participation?

E. SCOPE

This thesis establishes a framework for understanding offsets in the context of international trade. It uses the areas of defense preparedness, industrial competitiveness, economics, trade, employment, technology transfer, and national security to explore the reasons for the formulation of USG policy and practice towards offsets in international trade since post World War II. The thesis will largely confine discussion of offsets to those occurring as part of a sale of defense-related materials. Offsets may take place outside the realm of defense sales; however, the principal US policy and practices involving offsets are related to the export of military goods.

This research does not attempt to analyze the effect of offsets on the areas of defense preparedness, industrial competitiveness, economy, trade, employment, technology transfer, or national security. Research conducted in 1998 highlights job losses due to offset agreements. (US House, 1998) However, numerous studies published between 1986 and 1992 by the Office of Management and Budget (OMB) and between 1996 and 2003 by the Department of Commerce (DOC) find that the effects of offsets in these areas, though somewhat inconclusive, do not appear to be negative. Also, additional studies on the effect of offsets on employment (Gilman and Shea (1987)) and on the industrial base (Woodward (1995) and McCord (1998)) provide results similar to those published by OMB and DOC.

In identifying the determinants of USG offset policy this thesis will touch on a number of other points relating to offsets, to include identifying countries that participate in offsets, listing advantages and disadvantages of offsets, analysis of various types of offset arrangements, and an understanding of offset transaction costs. However, this thesis does not provide a thorough review of individual country policies and rationale for pursuing offsets. (For further information on country policies, see Verzariu and Mitchell, 1992, and US DOC, BIS, 2003, "Sixth," Appendix E.) Nor does this research provide an

exhaustive analysis of the advantages or disadvantages of offsets. (For further information on advantages and disadvantages, see US GAO, 1984, “Trade Offsets,” and US GAO, 1994, “Military Exports.”) This thesis also does not provide an analysis or example of various types of offset arrangements or a study of transaction costs. (For further information on different types of offset arrangements along with an example, see US DOC, BIS, 2003, “Sixth,” Appendix F. For an analysis of offset transaction costs see Taylor, 2000.)

F. METHODOLOGY

The methodology used in this thesis includes literature reviews and a review of documents produced by the US Government and international organizations related to offsets. These documents will be analyzed to identify and characterize the determinants of US Government policy towards offsets in international trade.

US Government documents include congressional reports and testimony from the General Accounting Office (GAO), the Congressional Record (CR), and reports from various congressional committees. Documents from offices within the executive branch of the US Government include the Federal Register (FR), Code of Federal Regulations (CFR), studies or regulations issued by OMB, the Department of Labor (DOL), DOC, Department of State (DOS) archives, DOD policy and regulations relating to acquisition and foreign sales, and an interim report produced by the US Presidential Commission on Offsets in International Trade [hereinafter referred to as “the Offsets Commission”].

Documents from the World Trade Organization (WTO), North Atlantic Treaty Organization (NATO) and North American Free Trade Agreement (NAFTA) were also consulted.

G. ORGANIZATION OF STUDY

Chapter II establishes a basic framework for understanding offsets in the context of international trade. A working definition of offsets for this thesis is provided, characteristics of offsets are identified, and various terms and definitions applied to offsets are reviewed. The underlying principles of trade are outlined and a model of international trade that includes offset agreements within the global marketplace is introduced.

Chapters III through VI discuss offset-related activities during four separate periods that have been organized around five historical events observed throughout the literature that mark a shift in USG practice and policy towards offset in international trade. The author of this study culled these milestones from the literature and suggests their use as a mechanism to aid understanding of the development of offsets policy and practice within the USG. These milestones include initiation of an offset arrangement with West Germany (1961), establishment of an offset agreement with Australia (1973), publication of the “Duncan Memorandum” regarding DOD participation in offsets (1978), issuance of the President’s Policy on Offsets in Military Exports (1990), and creation of the Offsets Commission (2000). Each chapter examines the economic environment during the periods selected, using data on US Gross Domestic Product (GDP), US employment growth, and, where available, employment data from the aerospace sector². Using data from three separate studies, Chapters IV through VI also offer some perspective on the volume of transactions and the number of countries involved in offsets.³ Finally, each chapter discusses the various USG participants in offsets, examines activities and events that influenced the development of offset-related policy, and details the offset-related statutes, policies and regulations that emerged during each period.

1. Post World War II To Mid-1970: Early Offset Development

Chapter III describes offsets during the period from the end of WW II to the mid-1970s. The term “offset” was not used in a conventional sense during this period. The licensed production and coproduction arrangements between the US and several foreign governments that began in the late 1950s were not referred to as offset arrangements until the 1970s. Within international trade, the initial use of the term “offset” occurred with the establishment of a series of offset arrangements between the US and the Federal Republic of Germany that began in 1961 and extended through the mid-1970s.⁴

² Both academic literature and government documents highlight the effect of offsets on aerospace.

³ During the post World War II to mid-1970s period, offsets were not employed in the conventional sense; therefore, similar data are not provided in Chapter III, which covers that period.

⁴ The earliest reference in the literature to US participation in offsets per se is recorded by Dr. Bernard Udis, a longtime observer of offsets, in a 1994 study conducted for NATO (Udis, 1994). Along with Maskus, Udis also mentions this particular application in a 1996 review of US offsets policy.

2. Developing a Department of Defense Offset Policy (1973-1980)

Chapter IV begins with a description of the 1973 US offset agreement with Australia.⁵ This is the first offset agreement, as defined in this study, in which the US participated. A number of other influential offset agreements in which the DOD participated are reviewed. DOD policies and regulations that emerged from these agreements are further discussed. The final point of discussion during this period, is the decline in direct DOD participation in offset arrangements with the incorporation of the May 1978 Duncan Memorandum as part of defense procurement regulations in 1980.

3. USG Offset Policy Evolution (1981-1990)

By 1981, offsets were used with increasing frequency by foreign governments purchasing defense articles and services. All countries involved in trade as defense exporters incurred offset obligations; however, because the US had the largest share of defense exports, it incurred the largest number of offsets. Concerns within the US about the effect of offsets began to increase as unemployment increased and economic growth declined. The US Congress began to take an active interest in understanding, examining, and countering the negative effects of offsets. Numerous agencies within the USG began to publish reports pertaining to the effects of offsets on the US relating to technology transfer, the economy and employment, particularly aerospace employment. The “Duncan Policy” provided a starting point for developing an offsets policy within the

In July, 1961 the US and West Germany signed the first of seven so-called “offset” agreements, designed to minimize the impact of the American balance-of-payments of maintaining US military forces in Germany. German procurements from the US offset roughly 80 per cent of the balance-of-payments costs of maintaining US forces in Germany. (Udis and Maskus, 1996, p. 358)

The use of the term “offsets” here does not exactly fit the working definition of offsets established in Chapter II. In this instance, the US provided defense services to Germany, and Germany reciprocated by purchasing defense goods from the US. A case closer to the working definition would have had Germany purchasing US defense goods on the condition that the US provide defense services. In any event, this initial use of the term in an international context helps the reader understand another factor contributing to the confusion pertaining to the use of the term “offsets.”

⁵ Matt Schaffer, Senior Vice President for Policy at the US Export-Import Bank in the Carter Administration and a student of offsets writes, “The first consciously structured offset sale took place...with Australia.” The Memorandum of Discussions between Australia and the DOD was signed on 10 April 1973. This transaction was actually a broad agreement by the DOD to “facilitate Australian exports [to the US of] up to 25 percent of the value of military exports from the United States into Australia.” (Schaeffer, 1989, pp. 49-50) This does appear to be the earliest reference to an offset as defined in this study that involves the USG. This agreement sets the stage for future, USG participation in offsets. The author will discuss indications of a US-British offset agreement introduced in the mid-1960s as part of US efforts to sell the F-111 to the UK; however, the sale was never consummated.

USG. Congressional hearings, executive branch reports, legislation, executive orders, and regulations pertaining to offsets emerged. This period culminated during the Bush Administration with publication of the “USG Policy on Offsets in Military Exports” in April 1990.

4. Refining US Offset Policy (1991-2003)

A decade after the Bush policy on offsets in military exports and in response to another statutory mandate, President William J. Clinton formed the Offsets Commission in December 2000 to examine the use of offsets in defense trade and, in parallel, issued an executive order to expand the scope of this commission to include a concurrent review of the use of offsets in commercial trade. The Offsets Commission consisted of 11 members representing industry (from the defense, nondefense, and investment sectors), labor, academia, and USG departments and agencies. After meeting once on 4 December 2000, the Offsets Commission issued an interim status report in January 2001. (US Presidential Commission, 2001) Although the work of the Offsets Commission remains unfinished (US GAO, 2003, p. 2), the status report produced in January 2001 provides a baseline for further understanding of USG offset policy and practices.

Chapter VII provides a summary and conclusions regarding the determinants of US offset policies and practices developed during each period. This chapter will also provide an overall summary of offset policy development. This summary will offer insight into the primary and secondary causes and the roles played by participants in offset policy development. Recommendations regarding changes in USG policy and practices towards offsets are made. This chapter concludes with areas for further research.

II. OFFSETS IN THE CONTEXT OF INTERNATIONAL TRADE

Chapter II establishes a basic framework for understanding offsets in the context of international trade and is subdivided into three sections. The section entitled “Defining Offsets” identifies the characteristics of offsets, reviews various terms and definitions applied to offsets, and develops a working definition of offsets for this thesis. The section entitled “Trade in the Global Marketplace” outlines the underlying principles of trade and introduces a model of international trade within the global marketplace. The section entitled “Offsets in International Trade” demonstrates how offsets “fit” in the context of international trade. This chapter concludes with a summary,

A. DEFINING OFFSETS

Offsets are an international trade practice employed by both buyers (e.g., governments) and sellers (e.g., industry) involved in transactions of goods and services. This section begins by identifying the characteristics of offsets, examines the various definitions applied to offsets, and develops a working definition of offsets for use throughout this thesis.

1. Characteristics of Offsets

According to a 2000 report authored by a long-time observer of offsets, Dr. Pompiliu Verzariu,⁶ three important characteristics distinguish offsets as compensatory transactions: purchasing government involvement, supplier reciprocity, and preferential treatment. (Verzariu, 2000, p. 2) The Offsets Commission also recognized the involvement of the purchasing government as the predominant characteristic pertaining to offsets in its January 2001 Status Report. (US Presidential Commission, 2001, p. ii) These three principal characteristics of offsets are described below.

a. Purchasing Government Involvement

The purchasing government may intervene through laws or public policy as well as seek to scrutinize offset transactions during approval processes. Scrutiny of offset transactions is normally conducted by an agency within the purchasing

⁶ Dr. Verzariu is the Director of the Financial Services and Countertrade Division of the US Department of Commerce’s International Trade Administration. He has written extensively on the subject of offsets since 1985.

government. This may include a review of the offset arrangement to ensure that specific types of offsets (e.g., co-production versus marketing services) are pursued or that particular agreements are made in the case of non-fulfillment (e.g., payment of liquidated damages).

b. Supplier Reciprocity

The purchasing government requires that the supplier contractually provide some form of additional, secondary compensation as a prerequisite to contract award of the primary good or service, per se, which is to be purchased. This reciprocity may be either an explicit statement or implicit understanding by a purchasing government that a contract award for goods or services will be based upon cost, schedule and performance as well as additional factors unrelated to the goods or services that the seller must provide as a condition of sale.

c. Preferential Treatment

The purchasing government extends preferred treatment to the supplier as a result of agreement by the supplier to provide reciprocal compensation. Preferential treatment may appear in a variety of forms, for example, as decreased tariffs, lower taxes, or favorable financing. (Verzariu, 2000, p. 2)

The literature points to other areas such as dollar value threshold and sector of the related primary sale as other defining characteristics of offsets. Regarding dollar value threshold, the DOC requires that US suppliers report offset agreements exceeding a \$5 million threshold; however, the DOC reports that numerous countries either require offset agreements for contracts significantly below this threshold (e.g., Israel requires a 35 percent offset for contracts with a minimum value of \$100 thousand, the Philippines requires a 50 percent offset for contracts with a minimum value of \$1 million) or have unspecified threshold values for requiring offsets. (US DOC, BIS, 2003, “Sixth,” Appendix E)

With regard to characterizing offsets by sector, the Offsets Commission, in examining defense trade, recognized that nearly 90 percent of all offsets involve the aerospace industry. The commission also acknowledged that offsets occur in other areas of commercial trade, but specific data is lacking. (US Presidential Commission, 2001, pp. 14-17) Therefore, using dollar value and industrial sector as identifying characteristics of

offsets, while acceptable in certain circumstances, proves impractical for use in this study.

2. Offsets: Terms and Definitions

Another commentator observed that the field of offsets is “cluttered with a babel of terms” and definitions. (Brauer, 2002, p. 1) This observation applies to the jargon used by those who operate within the realm of offsets, as well as to the use of higher-level terms employed in international trade to describe offsets programs. For example, countries avoid using the word “offsets” by substituting a wide variety of terms (e.g., “benefits,” “cooperation,” “participation,” etc.) to describe their offsets policies and programs. The academic literature and government documents also reveal a variety of meanings to define offsets. Definitional ambiguities and inconsistencies continue to exist in describing what constitutes an “offset,” and the literature lacks a common definition of the various practices that constitute offsets. (Verzariu, 2000) Therefore, a brief examination of the various terms from a government perspective and definitions of offsets from both academic and government perspectives is warranted.

a. Government Terms for Offsets

The DOC reports that countries use a wide-variety of terms to describe their offset programs.⁷ Examples of such terms include “Strategic Industry Development Activities (SIDAs)” (Australia), “Industrial Benefit” (Belgium) “Industrial & Regional Benefits” (Canada), “Industrial Participation” (Finland and the United Kingdom), “Industrial Cooperation Benefits” (Israel), “Industrial Cooperation” (Spain), and “Industrial Cooperation Program” (Taiwan). (US DOC, BIS, 2003, “Sixth,” Appendix E) Understanding that countries employ different terms to describe policies and programs relating to offsets, is important with respect to determining what does and does not constitute an offset in international trade.

b. Academic Definitions of Offsets

Dr. Jurgen Brauer, Professor of Economics at Augusta State University, reviews numerous offset definitions offered in the economic literature, citing Neuman (1985), Udis and Maskus (1991), and Martin and Hartley (1995). His research revealed

⁷ See also Taylor who writes, “Offsets often appear under the guise of *compensation packages, industrial benefits programs, cooperative agreements, and countertrade policy.*” (Emphasis in the original. Taylor, 2002, p. 2)

that each of these definitions implied some degree of coercion by the buyer to enter into offset transactions. However, he offered an opinion, substantiated by Hall and Markowski (1994), that a seller is never forced to sell and therefore chooses to undertake offset transactions voluntarily. He cites Hall and Markowski, to wit, “Offsets are simply goods and services which form elements of complex voluntary transactions negotiated between governments as purchasers and foreign suppliers ... they are those goods and services on which a government chooses to place the label ‘offsets’.” (Hall and Markowski, 1994 in Brauer, 2002)⁸

c. US Government Definitions of Offsets

The views held by offices within the US Government are just as varied as those of the aforementioned academics. As early as October 1985, the GAO testified before Congress, “the concept of offsets lacks a uniform definition.” (US GAO, 1985, “Foreign,” p. 2) In 1998, Representative John F. Tierney directed the minority staff of the House Committee on Government Reform and Oversight to prepare a report on offsets which was entitled “Foreign Offset Demands in Defense and Civil Aerospace Transactions.” (US House, 1998) The staff report provided, *inter alia*, commentary on the evolving definition of offsets, noting that they “differ primarily in the extent to which compensation must be required.” The staff report drew a distinction between offsets offered by US suppliers as a condition of foreign government policy requirements and offsets voluntarily provided by US suppliers as a result of “competitive pressures in the marketplace.” Also, a footnote in this report stated that the GAO definition of offsets had evolved from a 1990 report citing offsets as “required” by the purchasing government to a 1996 report noting that offsets were a “inducements or conditions” of a sale. (US House, 1998, p. 2)

However, the Bureau of Industry and Security (BIS) within the DOC, charged with preparing an annual report to Congress on offsets, narrowly limits its consideration of offsets to purchases related to the defense sector and continues to denote offsets solely from a perspective of a requirement from the purchasing government,

⁸ Dr. Brauer’s September 2002 paper was presented at an International Conference on Defense Offsets and Economic Development in Capetown, South Africa. Cited with permission of Dr. Brauer.

defining offsets as “Industrial compensation practices required as a condition of purchase in sales of defense articles and/or defense services.”

3. Working Definition of Offsets

Given the discussion of characteristics of offsets as well as terms and definitions, the best available working definition for the purpose of this paper is a slightly modified version of what was provided in the Status Report by the Offsets Commission, “The term ‘offset’ means the entire range of industrial and commercial benefits provided to foreign governments as an inducement or condition to purchase ... goods or services.”⁹ (US Presidential Commission, 2001, p. 5)

B. TRADE IN THE GLOBAL MARKETPLACE

This section examines the underlying principles of trade and introduces a model of trade within the global marketplace. The components of this model include external elements that influence trade; the markets, market structure, and trade flows along which transactions occur; and the trade practices employed by governments conducting trade. This section concludes with a description of how the components of this model work together in international trade.

1. Principles of Free Trade

Economists Marc Lieberman and Robert Hall observe that “Over the post-World War II period, there has been a worldwide movement toward a policy of *free trade*—the unhindered movement of goods and services across national boundaries.” (Emphasis in the original, Lieberman, 2000, p. 490) These authors define the underlying principles of free trade theory as comparative advantage, opportunity cost and specialization and exchange. (Lieberman and Hall, 2000, pp. 490-510)

⁹ The original language in the Offset Commission Status Report states, “This report uses the broad definition of defense offset set out in the statute establishing the Commission: ‘The term ‘offset’ means the entire range of industrial and commercial benefits provided to foreign governments as an inducement or condition to purchase *military* goods or services, including benefits such as co-production, licensed production, subcontracting, technology transfer, in-country procurement, marketing and financial assistance, and joint ventures.’ [italics added]” The report continues, “This report uses an analogous definition of commercial offset, which tracks the above language but substitutes the word ‘non-military’ for ‘military’ (see italicized term above). Thus, commercial offsets apply to the purchase by other nations of such non-military items as communications equipment, civil aircraft, and nuclear power plants.”

a. Comparative Advantage and Opportunity Cost

Comparative advantage is “the ability to produce a good at a lower opportunity cost than elsewhere.” (Lieberman and Hall, 2000, p. 492) Opportunity cost is determined by assessing the value of what is sacrificed (i.e., not produced) in order to produce another good. A nation gains comparative advantage by producing a particular good with a lower opportunity costs than another nation.

b. Specialization and Exchange

Specialization is a “method of production in which each person concentrates on a limited number of activities.” Exchange is the “act of trading with others to obtain what we desire.” Though defined for an individual person, these same principles apply to all entities engaged in international trade when gains are made “from specializing according to comparative advantage.” (Lieberman and Hall, 2000, p. 25)

2. Model and Basic Description of Trade

Trade involves the exchange of goods or services between two parties, a buyer and a seller. Each party seeks to derive maximum value and benefit from this exchange. The buyer strives to pay the lowest possible price to obtain a particular quality good or service at a specified time and place. The seller, in turn, works to attain the highest possible profit: the difference between the price the buyer will pay and the cost the seller will incur for providing a particular good or service. Trade happens between and among various types of entities, including individuals, businesses, governments, etc. International trade is a subset of trade that occurs when the entities involved in a particular transaction are located in different nations. (Lieberman and Hall, 2000, pp. 491-492) The specific components of the model are outlined below.

a. External Elements

For domestic trade these include types of economic system, i.e., determinations of resource ownership and resource allocation. The particular environment, or economic system, is determined by the structure of resource ownership (either the individual, the state, or some combination thereof) and the mechanism by which those resources are allocated (either markets driven by consumer choice or governments which use command). Table 1 illustrates various combinations of resource allocation and ownership within contemporary economic systems. Trade within a

particular system operates according to the economic rules established by the entity that governs the system. According to Lieberman, “different laws must be dealt with.” (Lieberman and Hall, 2000, p. 498) For example, individuals trading within the economic sphere controlled by United States follow the rules of market capitalism as well as the laws of the United States; individuals trading within Cuba follow the rules of command socialism and the laws of Cuba.

		Resource Allocation	
		Market	Command
Resource Ownership	Individuals	Market Capitalism	Centrally Planned Capitalism
	State	Market Socialism	Command Socialism

Table 1: Economic Systems (From Lieberman, 2000, p. 36)

For international trade, external elements include international and regional forums to reduce and remove trade barriers and thereby enhance free trade. International forums include the WTO (successor organization to the GATT regime) and specific WTO arrangements such as the Agreement on Government Procurement (GPA) and the Agreement on Trade in Civil Aircraft (TCA). Significantly, the GATT, which originally instituted free trade as a basic principle for world commerce, states that GATT parties (now WTO members) may not take measures that cause discrimination against or among competitors based on noncommercial factors. This principle was intended to eliminate government interference that distorts commercial transactions otherwise governed by market forces. Two substantive provisions within the GATT further this goal. Article 1 requires members to treat products from all other members equally (most favored nation or MFN treatment), and Article 3 requires that members treat foreign products at least as well as their own (national treatment). (US House, 1998, p. 18)

Regional trade agreements provide forms of governance within particular regions. Examples of these types of agreements include the NAFTA, European Union (EU), and ASEAN¹⁰ Free Trade Agreement (AFTA). Also, two countries or regional blocs may choose to establish on a bilateral basis reciprocal trade agreements to further

¹⁰ ASEAN is the Association of South East Asian Nations and includes the following countries: Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. (www.aseansec.org accessed 3 August 2003)

control trade flows of specified goods and services. (Lieberman and Hall, 2000, pp. 504-506)

b. Markets and Market Structures

A market is simply defined as a “group of buyers and sellers with the potential to trade.” (Lieberman and Hall, 2000, p. 523) A market where trade occurs within a national economy or economic sphere is regarded as a domestic market. The market in which trade occurs and crosses national economic boundaries is referred to as an international market.

A market structure refers to unique features that have an effect on how trade occurs within a particular market. Market competition exists under certain conditions that primarily depend upon the numbers of buyers and sellers, type of product (standardized or differentiated), ease of market entry or exit and degree of independence. Other market conditions include the level of information that is available to participants (e.g., perfect information) as well as presence or lack of “benefit spillovers among activities.” (Markowski and Hall, 1998, p. 25)

Three basic market structures exist based on competition: perfect, monopolistic, and oligopolistic. In the case of perfect competition, no buyer or seller is able to influence price by changing the quantity it buys or sells. Additionally, standardized products and sellers may easily enter or exit perfect markets. Information is assumed to be nearly perfect or at least available and buyers obtain the benefits of the purchased good with few, if any, residual benefits other than those directly offered by the purchased good. With perfect competition, economic profit in the long run is minimized.

Similarly, monopolistic competition has many buyers and sellers who easily enter and exit the market. However, in monopolistic competition, information provided to the seller is less than perfect, but additional benefits may accrue. Unlike the perfectly competitive scenario, a differentiated product permits the monopoly competitor to earn economic profits in the long run.

Finally, oligopolistic competition may or may not have a differentiated product, normally has few sellers, and limits to market entry. Information is imperfect which may result in additional benefits, particularly to the seller. A unique feature of

oligopolies is that they are marked by a “small number of strategically interdependent firms” that must take into account their competitors’ actions and reactions. In this case, profits reach an equilibrium depending on decisions made by the firms involved. (Lieberman and Hall, 2000, pp. 216-217, Markowski and Hall, 1998, p. 17)

c. Trade Flows

Trade is the transfer or flow of goods and services between people. Those goods and services produced domestically, but sold abroad are labeled as exports. Those goods and services produced abroad, but consumed domestically are labeled imports. Imports and exports occur independently of one another. The marketplace provides the environment within which trade occurs, but “it is individual consumers and firms [and governments] who decide to buy things—at home or abroad.” (Lieberman and Hall, 2000, p. 496)

d. Trade Practices/Barriers

Governments enact laws, make policies, and establish regulations that result in practices that affect both domestic and international trade. Domestically, these include practices such as providing subsidies to specific suppliers, establishing set-asides that provide preference to specified companies (e.g., small, disadvantaged businesses, etc.) for award of designated contracts, and zoning which restricts the location where certain trade activities may occur. Internationally, governments adopt practices to protect domestic interests by establishing laws, policies, and regulations intended to protect or promote national interests. Most countries regulate international trade by establishing tariffs which tax imports and quotas which limit imports. Governments may also enact protectionist legislation (e.g., buy national provisions) or establish various forms of non-tariff trade barriers (NTBs) to protect domestic industry interests.¹¹ (Mikic, 1998, p. 324).

The components of the international trade model described here consist of the following major components: external elements (economic system determinants and international trade agreements), markets (international and domestic) and their trade flows (exports and imports), buyers and sellers, and trade practices/barriers (domestically

¹¹ Mikic lists such items as quasi-non tariff measures, quantitative trade restrictions, price-cost trade measures, standards and regulations, government purchasing policies, arbitrary customs procedures, tied-aid programs, competitive and industrial policies.

to include set-asides, subsidies, and zoning; internationally to include tariffs, quotas, protectionist legislation, and NTBs). This model is a synthesis based upon the work of Lieberman and Hall (2000) and Mikic (1998). Figure 1 introduces a visualization of this model of international trade and will be updated with additional elements in this chapter.

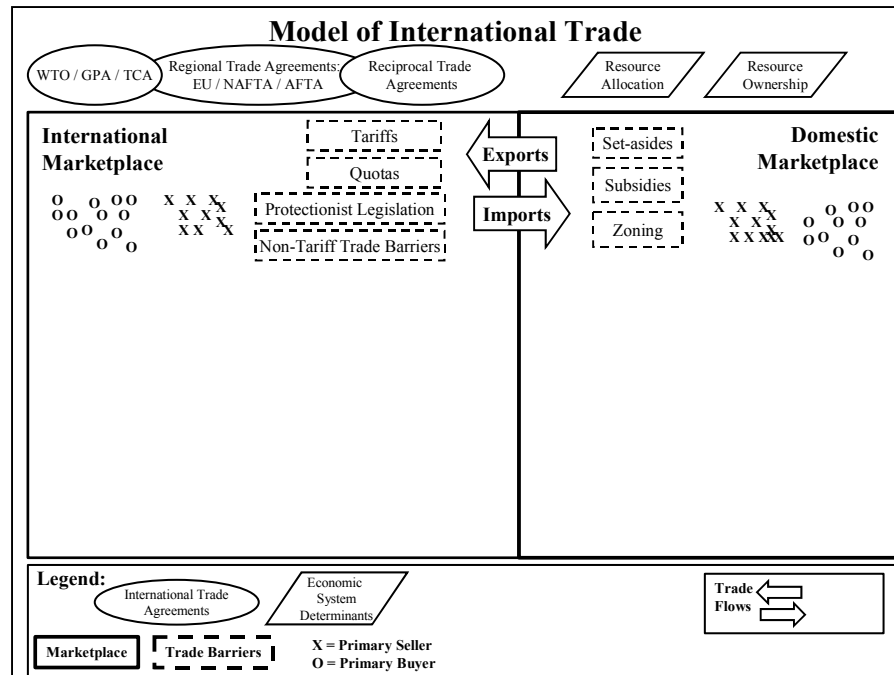


Figure 1: Model of International Trade – Basic Model (After Lieberman and Hall, 2003 and Mikic, 1998)

C. OFFSETS IN INTERNATIONAL TRADE

From the above working definition and trade discussion, it is apparent that offsets are another mechanism through which governments seek to manage or control trade in certain international transactions. Therefore, offsets exist as trade barriers under the proper conditions. This section places offsets in the context of international trade by, first, discussing why offsets challenge the principles of free trade; second, reviewing the role of offsets in various international trade agreements; and third, examining market structures and trade flows resulting from offsets. This section concludes by establishing the contextual “fit” of offsets in international trade and updating the model.

1. Offsets and Free Trade Principles

As trade barriers, offsets run counter to and are the result of rejecting free trade principles. Rejection of these principles occurs in specific sectors, primarily government and defense procurement. For example, “Public officials have rejected competition and comparative advantage as the basis for military industrialization.” (Kapstein, 1991, p. 660) Free trade principles are rejected in other areas as well. For example, some industries such as civil aerospace, which the US regards as a commercial concern, may have a connection to the government of the country in which it operates. Therefore, purchases for these entities are regarded by some nations as government procurement and therefore exempt from rules in GATT and other international agreements against discriminatory trade practices. (US House, 1998, p. 25)

2. Offsets in International Trade Agreements

The purpose of the various international trade agreements and forums is to reduce and remove trade barriers which, it has been argued, now include offsets. The US House minority staff wrote, “Generally, the theory underlying free trade agreements is that [trade barriers to include] offsets are ‘economically inefficient and market distorting.’” (US House, 1998, p. 16) Despite this, various international agreements permit offsets in certain circumstances.

a. The General Agreement on Tariffs and Trade (GATT) and World Trade Organization (WTO)

The GATT does not specifically mention offsets, presumably, according to the writers of the US House study on offsets, “because the use of offsets accelerated after the GATT was established.” The GATT requirements for MFN and national treatment would seem to preclude practices similar to offsets; however, GATT Article 3.8(a) “explicitly exempts from its nondiscrimination rules any procurement for governmental purposes.” (US House, 1998, p. 19) Therefore, offsets and other discriminatory trade practices are permitted in government trade.

b. Agreement on Government Procurement (GPA)

First entered into force in 1981, the GPA was most recently amended in 1996. The purpose of the GPA was to continue to open government business to international competition by increasing transparency in “laws, regulations, procedures, and practices” pertaining to government procurement and further reduce barriers to trade.

Article XVI specifically addresses and excludes offsets from government procurement stating, “Entities shall not, in the qualification and selection of suppliers, products or services, or in the evaluation of tenders and award of contracts, impose, seek or consider offsets.” (WTO, 1996)

However, several factors limit the effectiveness of the GPA in reducing and removing offsets and related barriers to trade. First, the GPA is considered a “plurilateral” agreement and nations are not required to participate prior to joining the GATT/WTO. Therefore, the only nations bound by the GPA are those that choose to sign the agreement. (Fewer than 30 nations have acceded to the GPA compared to more than 130 countries that have acceded to the WTO.)¹² Second, the GPA permits nations to determine which types of government procurement are covered by the agreement. Third, the GPA establishes different monetary thresholds for various types of government purchases. Fourth, the same GPA Article XVI that excludes offsets explicitly states that developing countries wishing to join the GPA may negotiate “conditions for the use of offsets” as part of their accession agreements. Finally, and most significantly, GPA Article XXIII permits exceptions for “procurement indispensable for national security or for national defence purposes.” (WTO, 1996) As a result, offsets and other discriminatory trade practices are permitted in defense trade.

c. Agreement on Trade in Civil Aircraft (TCA)

Entered into force in 1980, the TCA was last updated in 1987 and, like the GPA, undertook action to enhance transparency and reduce trade restrictions for products relating to civil aviation. TCA Article 4.3 states, “the purchase of products covered by this Agreement should be made only on a competitive price, quality and delivery basis.” (WTO, 1987) In a separate 1992 agreement between the US and the EU entitled

¹² According to the WTO, parties to the GPA (committee members) include the following: Austria, Belgium, Canada, Denmark, European Communities, Finland, France, Germany, Greece, Hong Kong, China, Iceland, Ireland, Israel, Italy, Japan, Korea, Liechtenstein, Luxembourg, Netherlands, Netherlands with respect to Aruba, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, United Kingdom, United States. As of 2003, countries negotiating accession include: Bulgaria, Estonia, Jordan, Kyrgyz Republic, Latvia, Panama, Chinese Taipei. Observer governments include: Argentina, Australia, Bulgaria, Cameroon, Czech Republic, Chile, Colombia, Croatia, Estonia, Georgia, Jordan, Kyrgyz Republic, Latvia, Lithuania, Malta, Moldova, Mongolia, Oman, Panama, Poland, Slovak Republic, Slovenia, Turkey. (www.wto.org accessed 10 July 2003.)

“Agreement Between the Government of the United States of America and the European Economic Community Concerning the Application of the GATT Agreement on Trade in Civil Aircraft on Trade in Large Civil Aircraft,” the parties agreed to interpret Article 4.3 as prohibiting offsets:

the signatories agree that Article 4.3 does not permit Government-mandated offsets. Further, they will not require that other factors, such as subcontracting, be made a condition or consideration of sale. Specifically, a signatory may not require that a vendor must provide offset, specific types or volumes of business opportunities, or other types of industrial compensation. Signatories shall not therefore impose conditions requiring subcontractors or suppliers to be of a particular national origin. (Verzariu, 2000, p. 22)

Like the GPA, TCA accession is voluntary and currently limited to 26 member nations. The TCA does not address military aircraft.

d. North American Free Trade Agreement (NAFTA)

Entered into force in 1994, NAFTA created a free trade area between Canada, Mexico, and the US. A primary purpose behind NAFTA and similar free trade agreements (e.g. EU, AFTA, etc.) is to eliminate tariffs in substantially all trade between the parties. This is encouraged by the GATT/WTO and extends WTO objectives beyond simply identifying and lowering tariffs. However, like the GATT and GPA, NAFTA permits offsets for purposes of defense and national security. (US House, 1998, p. 21)

3. Market Structures and Trade Flows

Market structure may also influence the use of offsets along with other trade barriers and practices. Markowski and Hall argue that results from market competition result in “best outcomes” if certain necessary and sufficient conditions are met (e.g., “well informed agents; no barriers to entry or exit; no cost or benefit spillovers”), but that these “often do not apply in markets for major items of defense equipment.” since suppliers experience barriers to market entry. (Markowski and Hall, 1998, p. 25) Brauer and Taylor as well as Markowski and Hall also note that markets operate imperfectly, particularly defense markets which typically have few buyers and sellers and operate within an oligopolistic structure where transactions are complex and information is

asymmetric. According to Taylor, these conditions allow “for moral hazard and adverse selection.”¹³ (Taylor, 2002, 12, Brauer, 2002, p. 6)

Offsets alter trade flows. Imports and exports are no longer regarded as independent events, but are “linked” or “bundled” together. In tracing the history of offsets and related compensatory transactions, Verzariu writes of this concept of “linked import/export exchanges,” Noting that “[m]anaged or conditioned trade involving contractually-enforced reciprocity commitments has always existed in international commerce,” he refers to the time following World War I as the “modern era of compensatory trade” which “began when *linked import/export exchanges* helped the German economy.” This type of compensatory trade continued after World War II to aid the European economies with such devices as “bilateral clearing arrangements” which provided “for the exchange of goods under government-to-government arrangements.” In 1961, the term offsets first appeared in usage as a tool whereby the US “pressed West Germany to *offset* the foreign exchange costs of keeping U.S. troops in Germany by buying American weapons.” (Emphasis added, Verzariu, 2000, p. 2)

4. Contextual Fit of Offsets in International Trade

Brauer, Taylor, and others argue that offsets may have a role in promoting welfare for buyers¹⁴ particularly given the oligopolistic market structures and imperfect information that exist within many government and defense transactions. Figure 2 identifies separate sectors for government and defense trade sectors and highlights offsets as occurring internationally within some parts of these two sectors as well as in some

¹³ Hazards to exchange or simply “exchange hazards” are practices that impede free and open exchanges. Exchange hazards include imperfect information as well as “moral hazards” and “adverse selection.” In this context, a “moral hazard” occurs when a seller exerts less effort after a buyer agrees to a transaction and results from the seller misleading a decision maker with distorted information. “Adverse selection” entails the buyer making a less than optimum choice due to seller misrepresentations or information that is hidden either intentionally or unintentionally. According to Taylor, “Exchange hazards tend to increase as the market structure approaches oligopoly. Oligopoly and monopoly markets are more susceptible to exchange hazards because many of the goods and services in these markets embody high technology and tacit information.” (Taylor, 2002, p. 11)

¹⁴ Taylor cites Singer, “When oligopolistic multinational firms are key decisionmakers, it would be foolhardy for a developing country to proceed with policy on the basis of traditional models of pure competition, perfect markets, and comparative advantage.” (Singer and Tandon. 1991. p. 142 in Taylor 2002, p. 2) Brauer quotes Martin and Hartley, “in a world of imperfect markets, oligopoly rents, complex transactions and asymmetrical information, offsets might enhance the welfare of the purchaser.” (Martin and Hartley, 1995, p. 127 in Brauer, 2002, p. 6)

segments of the non-governmental sector. Additionally, in contrasting many sellers and many buyers outside of the realm of offsets, primary sellers on the domestic side are portrayed as limited and interdependent; the primary buyer is limited in number as well. Also, a linked import/export exchange may be created whereby the primary buyer may involve one or more secondary sellers in the transaction and the primary seller may involve one or more secondary buyers.

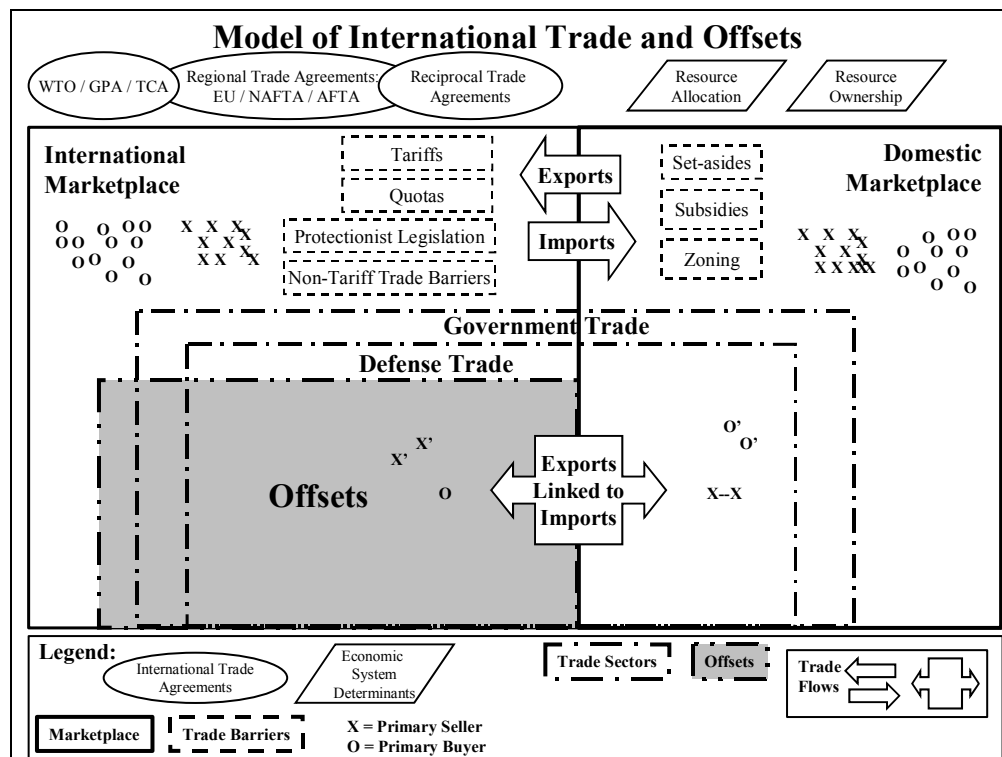


Figure 2: Model of International Trade and Offsets – Placing Offsets in Context (After Lieberman and Hall, 2003, Mikic, 1998, and US Presidential Commission, 2001)

D. SUMMARY

Governments participating as buyers in the global marketplace adopt a variety of strategies designed to protect national interests as well as to enhance the transactional value of traded goods or services – particularly within economic sectors related to defense and national security. Offsets are one of the many practices that nations use to protect as well as promote development of domestic, national interests. Industry often

undertakes offsets as “a necessity dictated by market considerations, a competitive advantage, or an alternative to no trade.” (Verzariu, 2000, p. i)

Chapter II has established a basic framework for understanding offsets in the context of international trade by defining offsets, discussing international trade in the global marketplace, and demonstrating how offsets fit. The following chapters examine the early development of offsets (World War II to the mid-1970s), the development of DOD offset policy (1973-1980), the evolution of USG offset policy (1981-1990), and refinement of US offset policy (1991-2003).

III. POST WORLD WAR II TO MID-1970: EARLY OFFSET DEVELOPMENT¹⁵

As discussed in Chapter II of this study, international commerce has “always” included some form of “compensatory trade” or “contractually-enforced reciprocity.” The phrase “linked import/export exchanges” began to appear following World War I to describe “offset-like” practices that provided aid to the ailing German economy. These types of compensatory practices were also employed following World War II to assist in the economic recovery of Europe. (Verzariu, 2000, p. 2)

The GAO reported in 1984 that offsets, particularly in the form of co-production, “began in the late 1950s and early 1960s in Europe and Japan.” (US GAO, 1984, “Trade Offsets,” Appendix I, p. 2) In June 1999 testimony before the Subcommittee on Criminal Justice, Drug Policy and Human Resources of the House Committee on Government Reform, R. Roger Majak, Assistant Secretary for Export Administration for the DOC, pointed to the importance of these trade practices following World War II, stating that they “were justified on national security grounds -- co-production was needed to rebuild war-damaged defense industrial bases in Europe and Japan to enable them to resist the spread of communism.” (US House, 1999, p. 164)

In an earlier report the GAO provides information on a wide variety of coproduction programs and licensing arrangements undertaken by the military departments from the late 1950s through the mid-1970s. The discussion of advantages and disadvantages in this report parallel the description of offset advantages and disadvantages discussed in Chapter I of this study. (US GAO, 1975, “Coproduction,” Appendix I, pp. 7-8) However, the only program referred to in the report as involving an “offset commitment” was the F-16 program that took place in 1975 and is more

¹⁵ In an interesting footnote in his book, Winning the Countertrade War, Schaffer observed that Canada had signed an agreement in 1956 similar to the offset agreements signed in the 1970s. (Schaffer, 1989, p. 56) This US-Canadian agreement is known as the Defence Production Sharing Arrangement (DPSA). Through the DPSA, “Canada agreed to purchase integrated weapons platforms from the United States in return for privileged access to the American defence market.” (Fergusson, 1996, p. 110) An argument could be made that DPSA is similar to an offset arrangement due to the element of reciprocity. However, DPSA lacks the specificity of offset agreements. Fergusson notes that offsets did not become common in Canadian policy until 1976. (Fergusson, 1996, p. 132) For further information on the DPSA, see http://www.dnd.ca/site/Reports/Budget01/Canada_US_b_e.htm. (Canada, 2001)

thoroughly treated in this chapter at Section D. (US GAO, 1975, “Coproduction,” Appendix I, pp. 13-18)

Finally, the term “offset” was first applied as a specific practice in international trade in 1961, and each US administration between 1961 and 1975 employed offset “arrangements” with allies as one of a number of tools to help correct balance of payment problems. The principal offset arrangement was between the US and the Federal Republic of Germany. The US attempted, with varying degrees of success, to structure similar agreements with France, Italy, Japan, and Spain. Also, State Department records during this period indicate the early emergence of the employment of offsets, albeit without success, as a tool to enhance the United Kingdom (UK) purchase of the F-111 aircraft. A 1974 DOD report also referred to the existence of unspecified offset arrangements that various elements within the DOD had concluded with Germany (1968), Norway (1968), and the UK (1971 and 1972). (Welsch, 1974, p. 1)

A. THE GLOBAL ECONOMIC ENVIRONMENT

In the 1950s, the US economy was strong and growing. Between 1950 and 1960, US GDP¹⁶ grew from \$1,687 billion to \$2,378 billion at an average real growth rate of 3.17 percent (US DOC, BEA, 2003, “GDP”), while unemployment averaged 4.6 percent. (US DOL, BLS, 2003) During this period, the USG aggressively opposed Soviet expansion and undertook several measures to strengthen involvement with Western European governments. Among these efforts was the establishment of a massive Military Assistance Program (MAP). Under MAP, the US transferred more than \$10 billion in military equipment and services to Western European nations. As European economies recovered from World War II during the late 1950s, the direct transfers provided under MAP were replaced by licensed production of US military hardware, including different types of fighter aircraft, armored personnel carriers, and helicopters.¹⁷ (Udis and Maskus, 1996, p. 358)

¹⁶ All US GDP figures used in this study are based on 1996 dollars unless otherwise stated.

¹⁷ Some authors refer to these licensed production arrangements between the US and various allies as early offset agreements. However, these early licensed production arrangements were not “consciously structured” as offsets. Therefore, the author of this study has opted to note the existence of these early licensed production arrangements, but not as offsets per se.

By the early 1960s, with the Soviet Union leading one sphere (the Warsaw Pact) and the US leading another (NATO), the world remained economically bi-polar in outlook. Between 1961 and 1972, US GDP grew from \$2,432 billion to \$3,898 billion, with real growth of 4.38 percent. (US DOC, BEA, 2003, “GDP”) During this same period, unemployment averaged 4.9 percent. (US DOL, BLS, 2003) Economies throughout the world, particularly Europe, had gained strength at the expense and through the assistance of the US. However, one of the greatest problems faced by the US was how to pay for growing commitments and share burdens for these commitments with its allies while maintaining a proper balance of payments.

This issue of balance of payments between the US and foreign nations became a significant preoccupation for USG policymakers.¹⁸ Until 1972, the US dollar was tied to gold (one ounce of gold was equal to \$35) and foreign exchange rates were largely fixed to the US dollar. This placed a tremendous burden upon US domestic and international economic policy. As economist Robert Schenk points out, “Throughout the 1950s and 1960s the U.S. lost gold, and by the end of 1967 it had only one half of what it had had in mid-1949.” (Schenk, 1997) US policy makers demanded these early offsets arrangements as a result of concerns regarding deficits in the balance of payments and outflow of gold from the US economy. (Gavin, undated, p. 6)

An editorial note in the State Department archives provides an interesting observation of this period.

By 1969 the United States, the unipolar economic and military power in the early postwar world, now shared economic power, and to a degree military power, with Western Europe and Japan. The Nixon administration believed, however, that the members of the European Community, Japan, and the other industrial democracies in the G-10 and the OECD were not bearing their share of the responsibility for managing adjustments to economic imbalances and for providing international assistance and international security. (US State, 1969-1972 Volume IV, No. 279)¹⁹

¹⁸ A thorough discussion of balance of payments is considered beyond the scope of this study. However, at <http://wueconb.wustl.edu/E1043S00/schenk/TitlePage.html>, Professor Robert Schenk, an economist at Saint Joseph's College-Indiana, provides an overview of economics that includes relevant subjects such as the 1944 Bretton Woods Agreement, fixed versus floating exchange rates, and balance of payments.

¹⁹ According to the Bank for International Settlements (BIS), “The Group of Ten is made up of eleven industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) which consult and co-operate on economic,

B. US GOVERNMENT PARTICIPANTS AND THEIR ROLES

During this period in offset development, members of the executive branch dominated USG participation. State Department records indicate active involvement of the President, Secretary of State, Secretary of Defense, Secretary of the Treasury, and Special Assistant for National Security Affairs. Additionally, the US Ambassadors to the UK and Germany participated in discussions relating to offsets with their host nations. Records indicate the formation of a Cabinet Committee on Balance of Payments (Cabinet Committee) which addressed, *inter alia*, offset issues. Also referred to in State Department documents were the Bureau of Budget (BOB, forerunner of the OMB) and the Council of Economic Advisors (CEA). Both offices had limited involvement regarding Germany's offsets, with the BOB coordinating reports with Treasury and the CEA concurring in recommended plans (US State, 1961-1963; 1964-1968 Volume VIII; 1964-1968 Volume XII; 1969-1972 Volume III)

In the US Congress, a few senators led by Senator Mike Mansfield approached solving the problem of balance of payments from another angle, urging reductions in numbers of troops stationed in Europe. (Bare, 1976, pp. 425-427) The Jackson-Nunn Amendment to the 1974 Defense Appropriations Authorization Act which became section 812 of Public Law 155 (P.L. 93-155 Section 812) required a reduction in the numbers of troops stationed in Europe if the 1974 balance of payment deficit remained uncorrected.²⁰ (US GAO, 1984, "Reductions," pp. 1-2)

The principal focus for all participants was to engage in discussions and negotiations with foreign counterparts to further offset arrangements in order to obtain a positive position regarding US balance of payments. Treasury and the BOB were involved with monitoring and reporting to the President and others progress made in achieving a positive balance of payments. (US State, 1961-1963)

monetary and financial matters." (<http://www.bis.org/about/gten.htm>) Also, the OECD is the Organization for Economic Cooperation and Development. (<http://www.oecd.org>)

²⁰ In May 1975, the President reported that the balance of payment deficit had been met. Therefore, no US troop reductions were necessary. (US GAO, 1984, "Reductions," p. 2)

In a 27 July 1962 report to President Kennedy on balance of payments, the aforementioned Cabinet Committee clearly stated the import of military offset arrangements over other forms of development assistance in achieving a proper balance of payments.

United States objectives with respect to the other industrialized countries of the Free World include (a) arrangements for offsetting the dollar costs of United States military expenditures in such countries; and (b) an increase in, and improvement in the terms of, development assistance from other industrialized countries to the developing areas. Both these objectives are important to our foreign economic policy. However, it should be understood that under present circumstances military offset arrangements enjoy a clear priority over increased development assistance because of the immediate and direct benefits which this objective can bring to our balance of payments. Appropriate United States missions should be instructed accordingly. (US State, 1961-1963, No. 17)

C. ACTIVITIES DURING THIS PERIOD

Activities related to offsets during this period were, according to Udis and Maskus, confined primarily to the seven “offset” agreements between the US and Federal Republic of Germany. However, government records also demonstrate similar initiatives with France, Italy, Japan, and Spain. Government records also mention offset arrangements with the British government in relation to the proposed sale by the US to the UK of the F-111, as well as unspecified offset agreements with Germany, Norway, and the UK.

1. German Offset Arrangement

According to US State Department records the seven offset agreements signed between the US and Germany were initiated during the Kennedy administration in 1961 as part of a larger plan to help balance of payment problems faced by the United States. These agreements were re-negotiated at approximately two-year intervals until the economic environment shifted in 1975 by the US decision to sever the link between the dollar and gold and “float” the dollar.²¹ Under these agreements, the US essentially paid for and provided a service, i.e., military security in Europe with the placement of six

²¹ Data on these agreements is available at various locations at <http://www.state.gov/r/pa/ho/frus/> and was accessed 30 August 2003. This US State Department website provides a gateway to obtain many declassified documents from the Truman through Ford administrations. The topic of “German Offsets” is discussed throughout documents in the Kennedy, Johnson, and Nixon administrations.

divisions in Germany. (Gavin, undated, p. 7, US State, 1964-1968 Volume VIII, No. 6) To mitigate the full burden borne by US taxpayers, Germany agreed to purchase US goods equal to some percentage (generally regarded to be 70-80 percent) of the cost of providing the six divisions.²²

An internal State Department memorandum from 24 March 1965 outlined some of the specific offset arrangements made with Germany in attempting to achieve “full offset of US defense expenditures of \$1.35 billion for CY 1965-1966.” (US State, 1964-1968 Volume VIII, No. 55) The primary goal was to obtain offsets by having Germany purchase US defense goods. Another memorandum stated, “military purchases are conventionally accepted as true offsets.” (US State, 1969-1972 Volume III, No. 13) This 24 March 1965 memorandum continued to spell out details that indicated that the German Government wanted the US to “accept as offsets German purchases in other fields (e.g., Boeing aircraft sales to Lufthansa).” (US State, 1964-1968 Volume VIII, No. 55)

Another notable activity during the Johnson Administration involved a “complicated, 3-cornered deal” in March 1967, transferring from the US to the UK \$100 million in offset obligations owed by Germany. Again, this transfer was made to cover a shift in receipts between fiscal quarters to cover a balance of payment shortfall. (US State, 1964-1968 Volume VIII, No. 118) What makes this transaction noteworthy is the introduction of trading in offset credits, a practice now prevalent in private industry.

The total cost to Germany for these seven offsets arrangements exceeded \$11 billion, primarily involving procurement of US military equipment. In July 1976, President Ford and German Chancellor Schmidt declared an end to these offset arrangements with a Joint Statement on Mutual Defense Issues.

Given the recently introduced changes in the international monetary area, specifically flexible exchange rates, as well as the notably improved strength of the dollar and a more acceptable U.S. balance-of-payments position, the President and the Chancellor consider that the traditional

²² Interestingly, a “Record of Conversation” of a 30 June 1965 meeting between US and British officials indicated Germany had a similar offset arrangement with the UK to maintain the British Army of the Rhine (BAOR) for related security services. (US State, 1964-1968 Volume XII, No. 244)

offset arrangements approach has lost its relevance. (US GAO, 1984, “Reductions,” p. 11)

Arguably different than present day “offset arrangements,” the usage of this term does not equate to the working definition of offsets and is really a burden-sharing arrangement. Nonetheless, these activities introduced the modern quid pro quo arrangements that emerged in 1973 as offsets in international trade.

2. Offset Arrangements with France, Italy, Japan, and Spain

Brief mention is made in State Department records of similar arrangements with France, Italy, Japan and Spain. In 1962, USG negotiators attempted to establish an arrangement with the French for additional purchases of US military equipment, but were rebuffed by French officials who “stated that major increases in purchases from the U.S. will not occur, as long as the U.S. remains unwilling to sell equipment in the nuclear and missile fields.” (US State, 1961-1963, No. 18)

With Italy, negotiators did meet with modest success. In October 1962, Secretary of the Treasury Dillon reported to President Kennedy that “Negotiations for an offset arrangement with Italy resulted in an Understanding, reached on 19 September 1962, that Italy will place initial orders for military equipment, approximating \$100 million, with the U.S. Department of Defense within 30 days and that the U.S. will guarantee the availability of \$100 million in credit assistance repayable over five years.” (US State, 1961-1963, No. 18)

By January 1963, the President’s National Security Affairs staff opined that pursuing negotiations on offsets was “running into diminishing returns,” however recommended proceeding into negotiations for offset arrangements with Spain and Japan. (US State, 1961-1963, No. 19) No further records of Spanish offset negotiations during this period were found. Negotiations with Japan resulted in a less than anticipated outcome. The Japanese proposed pursuing cooperative actions to help reduce balance of payments. (US State, 1964-1968 Volume VIII, No. 179)

3. Offsets as a Trade Tool with the United Kingdom

In a 14 September 1967 telegram, Dean Rusk, the Secretary of State, cautioned the US Ambassador to the United Kingdom, about the negative legislative impacts due to the Byrne Amendment which was incorporated into the 1968 Defense Appropriations

Bill. Rusk warned that the law would not permit the use of appropriated funds for foreign construction of naval vessels. He wrote, “This threatens right of HMG [Her Majesty’s Government] to bid on 16 minesweepers which Navy had previously selected as appropriate for HMG competition **offset arrangement**.” He also seeks to reassure the Ambassador of USG commitments to fulfill already established offset arrangements. Rusk continues, “Further, we can convey assurance that nothing in Byrnes Amendment will prevent USG fulfilling the \$325 million and supplementary **offset** targets.” (Emphasis added. US State, 1964-1968, Volume XII, No. 276)

On 16 January 1968, the British government notified the USG that the planned purchase of 50 F-111 aircraft from the US was cancelled. The US Embassy and State Department officials as well as President Johnson used offsets as a principal tool during last minute communiqués as a mechanism to try and persuade the British government to sustain the purchase. In discussions between staff officials from the US Embassy and British Ministry of Defense (MOD), offsets were mentioned as a key to helping Defense Minister Healey “materially ... in holding the line.” (US State, 1964-1968 Volume XII, No. 283) On 9 January 1968, Defense Minister Healey noted to US Embassy officials the helpfulness of earlier talks whereby USG officials agreed the “UK could keep Jetstream order, present offset arrangements.” (US State, 1964-1968 Volume XII, No. 287) Finally, President Johnson in a 15 January 1968 message to Prime Minister Harold Wilson addressing the consequences if the F-111 order was canceled wrote, “Retention of the present **offset arrangements** would become out of the question.” (Emphasis added. US State, 1964-1968 Volume XII, No. 290)

D. STATUTES, POLICIES, AND REGULATIONS DEVELOPED

Other than the aforementioned reference to the 1974 Jackson-Nunn Amendment no other mention of offset related legislation was found in the literature. Other than the aforementioned agreements, the brief discussion pertaining to possible offsets with the UK and notation of unspecified offset arrangements with Germany, Norway, and the UK, a review of the academic and government literature results in a negative finding of specific policies or regulations that pertain to offsets.

E. SUMMARY

For the early part of this period, the US was the primary economic power in the West. The world was on the gold standard with most currencies fixed to the dollar and the dollar fixed to gold. The US economy was strong. US GDP growth was steady and unemployment was decreasing. Throughout this period, the USG used offsets as one of a number of mechanisms to help keep the US economy strong by countering balance of payment problems with its allies. Various offices and agencies within the executive branch concerned with the balance of trade were involved in employing offsets. The US Congress attempted to exert some control with respect to balance of payment deficits through the 1974 Jackson-Nunn Amendment, but at this point Congress had not exhibited concern about the issue of “trade offsets.” The concept of using offsets within defense trade, as defined in this study, surfaced in 1968; however the UK opted not to buy the F-111 from the US.

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IV. DEVELOPING A DEPARTMENT OF DEFENSE OFFSET POLICY (1973-1980)

The first part of this period overlaps with the prior period, but focuses on the emergence of offsets as defined in this study and as the term is used in the conventional sense. In the early 1970s, the US abandoned the gold standard and the link between the dollar and gold was broken. Although economists continue to monitor this issue, the rationale for using offset agreements as an aid in resolving balance of payments issues was largely abandoned by the US. For a number of years, Australia had been seeking innovative approaches to use its power as a defense equipment purchaser as a lever to influence the USG and US prime manufacturers to enhance Australian industry. The 1973 offset arrangement between Australia and the US opened the door to a number of offset transactions in which the USG actively participated alongside US industry. However, these transactions primarily affected DOD, with little USG involvement from other agencies during this eight-year period.

However, DOD involvement in offsets was extensive and included negotiation of at least three major offset arrangements, participation as a guarantor for offset commitments, and development of policy and regulations pertaining to offsets. Annual estimates of US offset obligations incurred during this period ranged from \$1.5 to \$5 billion.²³ (Neuman, 1985, pp. 197-198) Direct DOD participation in offset arrangements declined at the end of this period with the incorporation of the Duncan Memorandum as part of defense procurement regulations in 1980.

The US Trade Representative (USTR) also played a role during this period, attempting to address “problems caused by new trade practices, such as demands for

²³ Neuman cites the lower figure from a Department of the Treasury report, “*Offset/Coproduction Requirements in Aerospace and Electronics Trade*.” She writes, “The Treasury study reports on the findings of a survey of the Aerospace Industries Association and the Electronics Industries Association. Twenty-six companies reported a total of 143 contracts involving compensation trade agreements with a face value of \$15.2 billion, signed between January 1, 1975, and the summer of 1981. The twenty-six responding firms included most of the largest and most diversified manufacturers in the fields of aerospace and electronics. Of these contracts, 120 (84 percent) valued at \$14.2 billion were in the military sector of which offsets totaled \$8.94 billion. On the higher figure, Congressman Bruce F. Vento used this data to extrapolate and testify in 1984 that he believed annual offset commitments approached \$5 billion.” (Neuman, 1985, pp. 197-198)

offsets.” According to Charles H. Blum, Acting Assistant USTR for Industrial Trade Policy, US trade negotiators achieved some success in two agreements resulting from “the Tokyo Round of Multilateral Trade Negotiations (MTN) during the 1970s [that] dealt with offsets.” The GPA and TCA, along with their appropriate offset provisions, were previously addressed in this study (Chapter II.C.2). Blum argues that these agreements established “some discipline on demands for offsets” and “represented a first step toward establishing controls over demands for offsets.” (US House, 1984, “Impact,” pp. 45-46) Although further discussion of these agreements is beyond the scope of this study, it is important to place these negotiations within the offset policy development context. The Tokyo Ministerial meetings occurred in September 1973, and, as already indicated, the TCA and GPA entered into force in January 1980 and January 1981, respectively.

A. THE ENVIRONMENT

The beginning of this period was marked by tremendous change in the economic environment. The US had abandoned the gold standard and shifted the dollar from a fixed to a floating exchange rate. One offsets observer wrote that this period was marked by, “Disturbances in the international economy since 1973—rising oil prices, high rates of inflation and slow economic growth and trade.” (Neuman, 1985, p. 191) US GDP grew from \$4,123 billion (1973) to \$4,901 billion (1980) with a real growth rate of 2.50 percent largely due to a recession in 1974-1975. (US DOC, BEA, 2003, “GDP”) During this same period, unemployment averaged 6.6 percent. (US DOL, BLS, 2003) Some observers have provided retrospective analyses beginning with this period that examine specific economic sectors to determine factors affecting employment. Dr. Robert Scott, an economist with the Economic Policy Institute (EPI), testified before the House Subcommittee on Criminal Justice, Drug Policy and Human Resources that US aerospace employment grew by more than 16 percent during this period, from 666,000 jobs (1974) to 775,000 (1979). (US House, 1999, p. 109)

In 1983, the Department of the Treasury, with the assistance of the Aerospace Industries Association (AIA) and the Electronic Industries Association (EIA), conducted a survey of 26 aerospace and electronics companies involved in offsets. This study, cited by GAO, reported offset obligations of \$9.6 billion with 23 different countries resulting

from military sales totaling \$14.3 billion between 1975 and 1981. (US GAO, 1984, "Trade Offsets," Appendix I, p. 2) Offset value accounted for slightly more than 67 percent of the contract value. Annually the average value of these offsets for this seven-year period approached \$1.4 billion.

B. US GOVERNMENT PARTICIPANTS AND THEIR ROLES

The number of USG participants in offsets during this period was limited, including significant executive branch involvement by various elements of the DOD and minor involvement by the legislative branch. Offsets, per se, did not become a matter in which Congress engaged until 1981. However, in December 1975, GAO reported to the House Committee on International Relations on "coproduction offsets" in conjunction with the F-16 aircraft purchase made by the four-nation consortium known as the European Participating Governments (EPG): Belgium, Denmark, the Netherlands, and Norway. This report, entitled "Coproduction Programs and Licensing Arrangement in Foreign Countries," discussed a broad range of coproduction and licensing arrangements between the DOD and numerous foreign governments beginning in the 1950s through the mid-1970s. The sole mention of offsets in this report was the discussion pertaining to the F-16 program. (US GAO, 1975, "Coproduction," Appendix I, pp. 13-18) Two further US GAO reports addressing the F-16 coproduction program that touched upon related offset commitments with the EPG were published in 1979.²⁴

Within the executive branch, DOD participants were particularly active in developing offsets policy and procedures. In January 1973, the Defense Security Assistance Agency (DSAA), the DOD organization charged with oversight of the Foreign Military Sales (FMS) program, published guidance on responding to requests for offset procurement. The Secretary or Deputy Secretary of Defense signed three major offset agreements with Australia (1973), Switzerland (1975), and the EPG (1975). The DOD Comptroller issued an audit report on offsets in 1974. DOD procurement regulations were updated beginning in 1976 to include a discussion of procurements involving offsets. Prior to publication of the Duncan Memorandum, Deputy Secretary of Defense

²⁴ See "The Multinational F-16 Aircraft Program: Its Progress and Concerns." June 1979. GAO/PSAD-79-63 and "A New Approach is Needed for Weapons System Coproduction Programs Between the United States and Its Allies." April 1979. GAO/PSAD-79-24.

(DEPSECDEF) Clements issued an offsets policy in 1976. Also, the role of DOD as guarantor of US industry commitments for certain sales involving offsets led to changes in US offsets policy.²⁵

C. ACTIVITIES DURING THIS PERIOD

US DOD efforts were largely focused on “accommodating our allies’ need to develop their own defense industries.” (Schaffer, 1989, p. 53) That this aided US industry in obtaining sales of US produced equipment to foreign nations was important, but secondary. The literature highlights a number of different offset arrangements involving the USG that related to sales of major defense equipment. A number of these transactions that led to significant offset arrangements involved the sale of guided-missile frigates (FFG) to Australia, F-16 aircraft to the EPG, and F-5 aircraft to Switzerland. These sales were important because they were linked to offset agreements. Australia, Switzerland, and the EPG nations were the only countries listed in defense procurement regulations as having offsets with the USG. The offset agreements with Australia and Switzerland were included in these regulations “for information purposes.” The Swiss F-5 aircraft deal, in particular, had implications for USG policy towards offsets. (Udis and Maskus, 1996, p. 359)

1. Australian Offsets

The first significant²⁶ offset agreement in which the USG became involved was with Australia. (Schaffer, 1989, p. 49) Throughout the 1950s and 1960s, Australia purchased “substantial quantities of defence materiel” from the US. During this period, Australia pursued “some form of reciprocal purchasing” with the US in order to support

²⁵ Regarding other executive branch involvement, Schaffer writes that, “In 1977, an offset department was established in the Pentagon Office of International Acquisitions, now an agency of the Deputy Secretary of Defense for Procurement. Its purpose was to review offset proposals being negotiated by U.S. firms.” (Schaffer, 1989, p. 51) This office is not discussed elsewhere in the literature. Also, in 1981 testimony before the House Subcommittee on Economic Stabilization, John D. Lange, Jr., Director, Office of Trade Finance for the US Treasury, testified that “About three years ago when the Treasury staff began to get concerned about this issue, President Carter directed the Department of State to look into the notion of doing a multilateral agreement.” However, during this period no other references were located in the literature pertaining to Treasury involvement in offsets. (US House, 1981, “Revitalization,” p. 555) In providing oversight of the FMS program the State Department had an implicit role in monitoring offset activity and was provided brief mention in the Military Assistance and Sales Manual (MASM).

²⁶ According to a 1974 DOD Comptroller report, the offset target with Australia was \$175 million (based on a \$700 million sale) and surpassed offset targets set for other countries listed in this report. Those targets included \$125 million for Germany, \$50 million for Norway, and \$45 million for the UK in two separate offset agreements. (Welsch, 1974, p. 2)

“development of Australia’s defence-related industries.” Australian missions visited the US in 1968 and 1969 to investigate possibilities for involving “Australian industry in US defence procurement.” (Markowski and Hall, 1996, p. 51) In 1973, Australia concluded an offsets agreement with the USG to purchase three FFGs from the US. DEPSECDEF Wayne P. Clements signed the offset agreement reflected in the 10 April 1973 Memorandum of Discussion. This memorandum stated that “the US DOD and industry agreed to meet an offset objective of up to 25 percent” on a “best efforts” basis. (32 CFR 6-1310, 1 August 1981)

The agreement established a hierarchy of preferred approaches to satisfying the offset agreement. First, DOD would “look to those US firms benefiting substantially from an Australian order to carry the initial and primary burden of offset implementation.” Second, if US firms were not able to meet these offset commitments then DOD would next offer Australian industry the opportunity to bid on selected Government Furnished Equipment (GFE) or other defense-related supplies and equipment that Australian sources could provide on a competitive basis. (32 CFR 6-1310, 1 August 1981) The Australian sources had to be competitive from the perspective of performance, quality and delivery and costs were not allowed to exceed comparable costs for producing the item in the US.²⁷

²⁷ In the mid-1970s timeframe, Australia initiated a competition for a New Tactical Fighter (NTF). As part of the NTF, the Australian DOD revised offset guidelines and published a “Guidance Paper” for NTF competitors. This guidance increased the offset objective to “30 percent of the imported content of project costs.” (Markowski and Hall, 1996, pp. 50-52) In October 1981, Australia selected the F/A-18 aircraft. Australia worked with the USG to structure a government-to-government purchase of 75 aircraft for \$2.36 billion. This program included an offset agreement between the Australia and McDonnell-Douglas, the builder of the F/A-18. (US OMB, 1990, p. 67) DOD officials confirmed that the USG was not a party to the NTF offset agreement, as it was a commercial transaction. (US House, 1982, “To Amend,” p. 72)

2. Swiss Offsets

During the mid-1970s, the Swiss agreed to purchase 72 F-5 aircraft from the US via a \$340 million FMS agreement combined with a “*quid pro quo*” offset arrangement. (Udis, 1996, pp. 322-327) In July 1975, Secretary of Defense James Schlesinger and his Swiss counterpart signed a Memorandum of Understanding (MOU) whereby the US agreed to sell F-5 aircraft to Switzerland and to place “contracts on a competitive basis with Swiss industries” that would provide offsets of no less than 30 percent. Similar to the agreement with the Australians, this MOU looked to those companies that would benefit the most from the sale to fulfill the offset commitment. However, the MOU stated that the burden of meeting the offset was placed upon US contractors during the first two years and that every two years the agreement would be reviewed. DOD agreed to “augment industry efforts” if the contractors did not meet their commitments during the first two years. (32 CFR 6-1310, 1 August 1981) In effect, DOD “agreed to act as guarantor for the offset commitments entered into by the major US prime contractors.” (Udis and Maskus, 1996, p. 359) Although the US contractors involved eventually met their offset obligations, the offsets program did not execute as quickly as planned and DOD was forced to intervene through direct purchase of Swiss goods and efforts “to encourage other USG acquisitions of Swiss products.” The need for DOD intervention on this program led to the “Duncan Policy,” discussed below.²⁸ (Udis, 1996, pp. 322-329)

3. EPG Offsets

From a French perspective, the “birth of offsets” occurred as a result of a need by “north European NATO countries’ combat air fleets” to replace obsolete aircraft. (Hebert, 1996, p. 139) This occurred at about the same time that the US was deciding between the General Dynamics’ F-16 Fighting Falcon and the Northrop Cobra; the US selected General Dynamics²⁹ and decided to build 650 F-16s in 1975. (Struys, 1996, p. 91) The

²⁸ In 1980, the governments of Switzerland and the US extended the MOU to purchase additional F-5 aircraft. This amendment was effective from mid-1983 to mid-1987. The Swiss eventually purchased 38 aircraft for \$280 million. This version of the MOU “implicitly recognized the impact of the Duncan Memorandum” by not requiring that DOD incur additional offset obligations. However, purchases made by DOD, though not required, were captured as “offset credit.” (Udis, 1996, pp. 327-328) See also 51 FR 46052 (23 December 1986) for specifics of this amendment and 53 FR 38171 (29 September 1988) for documentation on the removal of the Swiss MOU from defense procurement regulations.

²⁹ Lockheed-Martin is now the prime contractor for the F-16.

consortium also agreed to purchase “for \$2.8 billion” (Schaffer, 1989, p. 50) 348 F-16 aircraft in 1975. (Struys, 1996, p. 92) This five-nation MOU signed by Secretary of Defense Schlesinger on 10 June 1975 (US GAO, 1975, “Coproduction,” Appendix I, p. 13) adopted a different approach from that undertaken in the Swiss F-5 sale. Instead of acting as a guarantor as in case of the Swiss F-5, the USG negotiated a multilateral coproduction³⁰ agreement that obligated the F-16 prime contractor, “to establish offset projects in these countries.”³¹ These obligations [consisted of] direct offsets relating to F-16 components and parts to be sourced to these countries.” (Marvel, April 2001, p. 23) Specifically, the USG guaranteed participation by industry within the consortium of 10 percent of the value of 650 F-16 aircraft³² purchased by the US Air Force, 40 percent of the value of all F-16 aircraft purchased by the consortium, and 15 percent of the value of all F-16 purchases by third countries. (Struys, 1996, pp. 91-95)

D. POLICIES AND REGULATIONS

During this period, two offsets policies were articulated at the highest levels within DOD. DEPSECDEF Clements issued the first policy in November 1976 highlighting the “present practice of discouraging offset procurement arrangements.” DEPSECDEF Charles Duncan issued the second policy in May 1978 stating, “DOD shall not normally enter into such [offset] agreements.” (DSAA, 1980, pp. C-12-13) Both policies provided explicit guidance for entering into offset agreements if needed.

Additionally, DOD put offset policies and procedures into place as part of the FMS program as early as January 1973 in the Military Assistance and Sales Manual (MASM). The MASM preceded the Clements policy in discouraging offsets, but also listed a number of difficulties faced by foreign customers in pursuing offset arrangements

³⁰ Economist and offsets observer Costas Alexandrides writes, “In USG administrative usage, coproduction is not an offset.” (Alexandrides, 1987, p. 40) Nonetheless, a number of offset observers including Stephanie Neuman argue that coproduction constitutes “government-sponsored offsets.” She writes, “The term *coproduction*, however, itself implies some sort of government participation in offsets.” (Neuman, 1985, p. 203) Nonetheless, these EPG nations were listed in defense procurement regulations as having offset agreements with the USG. (32 CFR 6-1310, 1 August 1981)

³¹ An interesting argument that Secretary of Defense Schlesinger used with the EPG was that the production approach “would offset a large share of balance-of-payment costs through production within their own countries.” (US GAO, 1975, “Coproduction,” Appendix I, pp. 13-18)

³² US GAO reported that the US would “maintain an autonomous capability” to eliminate “dependence on Consortium contractors.” (US GAO, 1975, “Coproduction,” Appendix I, p. 16)

and established guidelines and conditions to follow if a foreign government wished to pursue an offset.

Procurement regulations play a critical role in contracting. Since offsets were linked to defense systems contracts, incorporating information on offsets as part of DOD procurement regulations was a natural evolution. During this period, these procurement regulations evolved from the Armed Services Procurement Regulations (ASPR) to the Defense Acquisition Regulations (DAR) in 1978. The ASPR and DAR were listed under Title 32, Chapter I, parts 1 through 39 of the CFR. This thesis provides background on the inclusion of offsets within DOD procurement regulations and explores the development of offset-related provisions in these regulations. The ASPR were amended in 1976 to include language on “Implementation of Offset Arrangements Negotiated Pursuant to Foreign Military Sales Agreements.”

1. Deputy Secretary of Defense Offset Policies

a. The Clements Policy³³

DEPSECDEF Clements was familiar with offset arrangements. He was a signatory to the 1973 Australian offset agreement and received a 1 November 1974 letter from the AIA that addressed offsets. The letter was sent by Karl J. Harr, Jr., the head of AIA, requesting that the DEPSECDEF review a number of policies and practices relating to US industry participation in FMS, including the impact of offsets. Mr. Harr wrote in the supporting statement that accompanied his letter, “Perhaps the most important development has been the impact of foreign competition and foreign government demands for offset procurement.” (Harr, 1974, p. 2) DEPSECDEF Clements tasked the ASPR Council to examine defense procurement regulations. Also, as Mr. Schelsinger’s deputy, DEPSECDEF Clements was likely involved in the 1975 Swiss MOU. Therefore, it is not surprising that he would issue policy on this topic. On 15 November 1976, he signed a memo entitled, “General Policy on Purchases by DOD from Foreign Sources in Furtherance of Government-to-Government Offset Agreements.” The provisions of this

³³ The author would like to express his appreciation to Mr. John J. Marini, Technical Director for the Security Assistance Directorate within the Navy International Programs Office for pointing to the “Clements Memorandum” as the first DOD policy pertaining to offsets.

memorandum were incorporated into FMS guidance issued by DSAA in the MASM. (DSAA, 1977, pp. C-11-12)

Drawing upon language in the Australian Memorandum of Discussion, the Clements memorandum clarified that “offset agreements included any agreement by DOD to purchase items from a foreign country in order to offset some specific amount or percentage of the foreign country’s expenditures in the US for US defense items.” Key provisions included designation of the Secretary (or Deputy Secretary) of Defense as the sole approving authority for DOD offset agreements, a requirement for negotiation prior to final acceptance of the government-to-government agreement, a statement that contractors benefiting from the sale are to assume the primary responsibility for offset fulfillment, assigning responsibility for marketing products within the US to foreign firms, and use of the International Traffic in Arms Regulations (ITAR) if an offset involved export of US technology or technical data. (DSAA, 1977, pp. C-11-14)

b. The Duncan Policy

As part of the Swiss MOU, DOD was forced to intervene in fulfilling offset obligations as a result of slower than anticipated performance of US contractors. The result was a memorandum issued on 4 May 1978 by DEPSECDEF Charles Duncan addressed to the Secretaries of the Military Departments titled “General Policy on Compensatory Coproduction and Offset Agreements with Other Nations.” This policy severely limited the role of DOD in offsets allowing exceptions “of significant importance to [US] national security interests.” (DSAA, 1980, p. C-13) As Udis and Maskus wrote, “This significant change in US offset policy was a direct consequence of the Swiss F-5 program.” (Udis and Maskus, 1996, p. 360)

The Duncan Memorandum³⁴ notes that offsets have “led to friction between allies when specified [offset] goals are not met or even approached.” As a result of this “friction” and “the inherent difficulties in negotiating and implementing compensatory coproduction and offset agreements,” DEPSECDEF Duncan decided that “DOD shall not normally enter into such agreements.” The memorandum also assigned responsibility to various DOD offices for reviewing any proposed agreements and

³⁴ The Duncan Memorandum is included as enclosure 4 to DOD Directive 2010.6 of 5 March 1980. As of November 2003, this directive was active.

required a semi-annual report providing “the status of all existing and proposed compensatory coproduction and offset agreements” in order to “highlight the US financial obligation.” (US DOD, 1980, p. 27)

In one of its earliest reports on offsets, GAO provided a summary of the policies and rationale for the Duncan Memorandum.

Reasons for adopting the existing policy [the Duncan Policy] included (1) management complexities and resource drain on DOD in negotiating and implementing compensatory coproduction/offset agreements (2) such agreements had the effect, or created the impression, of obligating the USG to place orders for systems or components in foreign countries or of requiring DOD to force U.S. contractors to do so (3) a conviction that offset commitments were business judgments which should not involve DOD, and (4) once commitments were made by industry, the U.S. defense contractors, not DOD should assume responsibility to the foreign government for fulfilling the promised offset. (US GAO, 1984, “Trade Offsets,” Appendix I, p. 1)

2. Foreign Military Sales (FMS) Policies

Since 1970, DSAA³⁵ has provided policy, direction, and oversight for the USG Security Assistance Program to include FMS. DSAA published procedures for conducting FMS in the MASM between 1970 and 1984 and the Security Assistance Management Manual (SAMM) since 1 April 1984. The January 1973 MASM was the oldest document in the government literature addressing defense offsets. The MASM defined offset procurement as “the offering, on a selective case-by-case basis to foreign governments of opportunities to respond to selected DOD procurement requirements.” (DSAA, 1973, p. F-7)

The MASM detailed a number of difficulties that foreign industry faced when competing for US business. First, DOD did not believe that it had the need for a system that would make procurement from a foreign source economically beneficial. Second, logistical considerations mandated that DOD retain the ability to mobilize the defense industrial base, an arrangement at odds with foreign sourcing. Third, DOD was concerned about obtaining assurance of proper quality from foreign sources. Fourth, the

³⁵ In September 1998 DSAA was assigned additional mission areas (e.g., demining, humanitarian aid, etc.) and was redesignated as the Defense Security Cooperation Agency (DSCA).

process by which DOD identified items suitable for procurement from foreign sources was cumbersome. Fifth, DOD was required to apply “bid differentials” when considering bids for items DOD wanted to purchase from foreign sources. The MASM stated that obtaining waivers to these bid differentials was difficult. Finally, the MASM indicated that foreign producers faced “political and other pressures” from domestic competitors. (DSAA, 1973, pp. F-7-8)

The MASM also contained three guidelines, two conditions, and a hierarchical approach when undertaking an offset arrangement. As the MASM policy was signed during the same year as the Australian Memorandum of Discussion, the similarity of the guidelines, conditions, and approach is not surprising. However, the MASM hierarchical approach added that the least preferred alternative to fulfill offset commitments was through “items not directly related to the equipment being sold,” more commonly referred to as indirect offsets. The MASM also suggested foreign participation in Interdependent Research and Development projects as another approach to fulfilling offset obligations. (DSAA, 1973, pp. F-8-9)

In June 1977, DSAA added a significant section to a chapter entitled “DOD Procedures in Offset Agreements” incorporating the provisions of the Clements Memorandum, and, in December 1980, DSAA updated this section of the MASM to reflect the contents of the Duncan Memorandum.

3. Procurement Regulations

The introduction of offsets as part of defense procurement regulations in 1976 was partially influenced by a May 1974 DOD Comptroller report on offset arrangements and by a November 1974 AIA letter to DEPSECDEF. On 29 May 1974, DOD Comptroller sent a report on offset arrangements to the Assistant Secretary of Defense (Installations and Logistics) and DSAA. This document reported numerous findings relevant to the formulation of offset policies and practices within the USG. The report stated that no single activity in DOD was responsible for engaging in offsets and that DOD lacked a standard system to track and report on progress against fulfilling offset obligations.

The report also cited concern regarding the ability of DOD to effectively implement offset arrangements. For example, the report stated that the participants in offset arrangements lacked criteria for obtaining credit for offset transactions. The report found that the Naval Air Systems Command had implemented an offset arrangement with Germany and directed relevant industries to report progress as offset obligations were met; DSAA³⁶ implemented the offset arrangement with Norway, but required quarterly progress reports from the US Military Departments involved in these transactions; and no procedures existed “in final form” for offsets with the UK. (Welsch, 1974, pp. 2-3)

The report provided three recommended actions. First, the report stated that appropriate offices within DOD should develop policies and procedures for implementation of all future offset agreements. Second, the report recommended that DOD develop a complete and standard system to identify, record, and report purchases under offset arrangements. Third, the report recommended that DOD establish criteria to negotiate offset parameters. The report noted that offices within DOD were staffing a draft instruction to implement these recommended actions. (Welsch, 1974, pp. 3-4) According to DAR Council records, this draft instruction resulted in a 12 December 1974 memorandum requesting that the ASPR Council establish a new section in the ASPR to address offsets.

During this same timeframe, the aforementioned AIA letter was sent to DEPSECDEF Clements. This letter was sent to the ASPR Council for further investigation and action. In response to the DEPSECDEF tasking and the DOD Comptroller report, the ASPR Council proceeded to develop procurement policy and regulations pertaining to offsets between December 1974 and September 1976. The ASPR Council obtained numerous comments from various US government agencies and industrial associations. The development of these regulations was extended in order to provide sufficient time to address industry concerns as well as accommodate anticipated changes in the law as a result of the Arms Export Control Act (AECA), enacted as P.L. 94-329 on 30 June 1976. To address offsets and other aspects of foreign procurement, the ASPR Council issued Defense Procurement Circular (DPC) 76-4 and added a new

³⁶ The author notes that DSAA was not established until 1970. According to DOD Comptroller report, the Norwegian agreement was signed with DOD prior to the establishment of DSAA in 1968.

section VI, part 13 to the 1976 version of the ASPR on 7 September 1976. The updated 1976 version of the ASPR articulated DOD policy, as follows:

The policy of the DOD is that the U.S. contractor involved in the FMS and the foreign customer will make suitable arrangements to fulfill an offset agreement. Only if it is determined that the offset agreement cannot be fulfilled in this fashion will the Department of Defense seek to fulfill the offset commitment from other defense procurements. When practical, the U.S. prime contract shall be contacted and coordination obtained prior to the Government committing the U.S. prime contractor's participation. (Section 6-1310.2(b))

On 23 March 1978, the ASPR was redesignated as the DAR. The section of the ASPR/DAR on offsets experienced little revision until Defense Acquisition Circular (DAC) 76-25 was issued on 31 October 1980. DAC 76-25 added another section to the DAR (6-1315) containing an informational copy of USG offset agreements with Australia and Switzerland. This version of the DAR now contained three principal sections that specifically addressed offsets: a policy and procedures section (6-1310), a section containing offset agreements (6-1315), and a section on similar agreements with NATO allies (6-1406). Most of these NATO agreements contained statements noting the existence of offset arrangements in the broader context of an overall cooperative relationship. Another significant part of the DAR (6-1304.2(a)(iii)) indicated that "costs associated with the implementation of DOD offset arrangements" were recoverable as a cost of doing business with a foreign government. (32 CFR 6-1310, 6-1315, 6-1406, 6-1304, 1 August 1981)

E. SUMMARY

A number of situations influenced the development of US policies and procedures relating to offsets from 1973 to 1980 when the Duncan Memorandum was incorporated into the MASM and the DAR. First, the US economy had moved from the gold standard; the exchange rate for the dollar was no longer fixed and was permitted to float. As a result, ensuring that the US was able to maintain a strong dollar through a positive balance of payments was no longer of paramount importance. Foreign governments desiring indigenous defense capabilities and recognizing this situation pressed for greater consideration of and participation by their industries in the US procurement system,

particularly when the foreign government made major purchases of US defense goods and services.

Second, oil prices and inflation increased, unemployment was high, and the US experienced a recession in 1974-1975. The US sought approaches to support international sales and reinvigorate trade that would help counter slow economic growth. Trade offsets provided an approach that responded to both situations. Offsets provided the US with a mechanism to positively respond to allied needs for building a domestic defense infrastructure while at the same time supporting US industry. Offsets also offered US industry a competitive advantage in international competitions throughout the world. And, although some smaller areas of the labor force were immediately affected (e.g., the US machine tool industry was negatively affected due to the influx of Swiss competition resulting from the Swiss F-5 offsets), overall employment in the aerospace sector where the effects of offsets were concentrated (and later were linked most clearly) increased between 1974 and 1979 by more than 16 percent.

Although the three GAO reports published in 1975 and 1979 mentioned offsets in conjunction with defense trade, legislators remained largely unaware of the effects of offsets on their constituents and, thus, were not yet inclined to address offsets as an issue. Similarly, most agencies in the executive branch were not engaged in offsets. By contrast, DOD was intensely involved with offsets throughout this period, particularly at the Secretary and Deputy Secretary of Defense levels. DOD offset policies and procedures developed concurrently and evolved with the establishment of various offset agreements. Additionally, contractors involved in fulfilling offsets as well as industry associations such as AIA influenced the development of DOD offset policies and procedures.

Despite statements that the USG “encouraged the use of offsets” (US House, 1998, p. 10) during this period, a review of the policies and regulations between 1973 and 1980 suggests a differed picture. Direct DOD involvement in offset agreements was discouraged as a consequence of the MASM (1973), the Clements Policy (1976), the Duncan Policy (1978), and, finally, inclusion of the Duncan Policy provisions in the MASM in December 1980.

V. USG OFFSET POLICY EVOLUTION (1981-1990)

By 1981, offsets were used with increasing frequency by foreign governments purchasing defense articles and services. All countries involved in trade as defense exporters incurred offset obligations; however, the US had the largest share of defense exports and therefore the largest number of offsets. Concerns about the effect of offsets began to increase as unemployment increased and economic growth declined. The US Congress began to take an active interest in understanding, examining and countering the negative effects of offsets. Numerous agencies within the USG began to publish reports pertaining to the effects of offsets on the US relating to technology transfer, the economy and employment, particularly aerospace employment. The “Duncan Policy” provided a starting point for developing an offsets policy within the USG. Congressional hearings, executive branch reports, legislation, executive orders, and regulations pertaining to offsets emerged. This period culminated with publication of the “USG Policy on Offsets in Military Exports” in April 1990.

A. THE ENVIRONMENT

Between 1981 and 1990, US GDP grew from \$5,021 billion to \$6,708 billion, with the growth rate fluctuating widely from -2.03 (1982) to 7.27 percent (1984), but with a real growth of 3.52 percent. (US DOC, BEA, 2003, “GDP”) During this same period, unemployment ranged between 9.7 (1982) and 5.3 (1989) percent, averaging 7.1 percent, slightly worse than the 6.6 percent unemployment for the previous period. (US DOL, BLS, 2003) In contrast, the EPI reported growth in US aerospace employment of more than 22, percent from 775,000 jobs (1979) to almost a million aerospace jobs (1989) before settling at 946,000 (1990) jobs at the end of this period. (US House, 1999, p. 109)

The US International Trade Commission (USITC) conducted an industry survey in 1985 that captured information on offset agreements between 1980 and 1984. OMB used this data in its first report on offsets, published in 1986. OMB, in conjunction with the Bureau of Economic Analysis (BEA) within the DOC, initiated a more comprehensive survey, with industry of military exports and related offset agreements between 1980 and 1987. This second survey reported offset obligations of \$20 billion

with 30 different countries resulting from military sales totaling \$35 billion between 1980 and 1987. (US OMB, 1990, pp. 121-123) Offset value accounted for slightly more than 58 percent of the contract value. The average annual value of these offsets for this eight-year period increased from \$1.4 billion during an eight-year timeframe in the previous period to \$2.5 billion.

B. US GOVERNMENT PARTICIPANTS AND THEIR ROLES

Offset policy development expanded significantly between 1981 and 1990, with five major participants emerging from the legislative and executive branches of the USG. From the legislative branch, Congress and GAO began to earnestly engage in offset policy in the early 1980s. From the executive branch, DOD continued its involvement in offsets as modified in 1978. However, as a result of legislation, the President and the OMB were also thrust into the middle of offset discussions, while a number of other executive branch participants played minor, but important supporting roles relating to offsets. These participants included the DOS, DOC, Department of Treasury (Treasury), USITC, and USTR.^{37 38} During this period, the President designated OMB to lead a Coordinating Committee to examine and provide a report on offsets with principal members from DOC, DOD, DOL, and Treasury. (US GAO, 1986, “Military Exports: Analysis,” p. 5) However, GAO observed “little joint coordination” on offsets among these agencies: “There is little coordination among the agencies studying offsets, and no single federal agency has taken the lead to ensure that the various U.S. interests are served when a U.S. firm makes an offset commitment with a foreign government.” (US GAO, 1984, “Trade Offsets,” Appendix I, pp. 2-3)

1. Congress

Together, the Senate and House considered a number of offset-related bills and eventually passed legislation that mandated gathering, monitoring, reporting and studying information on the impact of offsets in defense trade. Congress also passed legislation directing the President to develop an offsets policy and to negotiate with US trading

³⁷ Some sources refer to the US Trade Representative as the Special Trade Representative (STR).

³⁸ Other participants mentioned infrequently in offsets literature include the DOL, Federal Emergency Management Agency (FEMA), Arms Control and Disarmament Agency (ACDA), Central Intelligence Agency (CIA), CEA, and National Security Council (NSC). (US GAO, 1986, “Military Exports: Analysis,” p. 5)

partners to identify multilateral solutions on offsets. Throughout this period, Congress received a number of GAO reports and conducted hearings that pertained to offsets. The first GAO product to provide a substantive treatment of offsets was contained in a June 1982 report to the Subcommittee on International Trade, Finance, and Security Economics of the Joint Economic Committee, entitled, “U.S. Security and Military Assistance: Programs and Related Activities.” This report included offsets as a type of activity that supports foreign governments and addressed USG offsets, US industry offsets, and current governmental activities regarding offsets. (US GAO, 1982, pp. 82-84) GAO updated the report in September 1985 and December 1988. GAO also provided the US Senate Committee on Foreign Relations and US House Committee on Foreign Affairs a June 1983 report titled “Assistance to Israel” which contained some general information pertaining to offsets. (US GAO, 1983)

Within the House, five different subcommittees received two reports and one briefing from GAO and conducted eleven hearings that included substantial discussions pertaining to offsets. The Subcommittee on Economic Stabilization of the Committee on Banking, Financing, and Urban Affairs was particularly active throughout this period. In addition to holding the first hearing within Congress to address offsets, this subcommittee conducted five additional hearings on this topic between 1981 and 1989. This subcommittee conducted a hearing on offsets in September 1981 as part of a larger series of hearings on “Revitalization and the US Economy,” received an April 1984 GAO report titled “Trade Offsets in Foreign Military Sales,” conducted hearings on the “Impact of Countertrade and Offset Agreements on the US Economy” in May 1984, held hearings on offsets in July 1985 as part of a series of hearings related to “US Trade and Competitiveness,” conducted hearings in June 1986 on “Offset Agreements,” and included discussion of offsets in May 1989 hearings on the “Defense Production Act Amendments of 1989 (H.R. 486).”

The Subcommittee on Oversight and Investigation of the Committee on Energy and Commerce conducted a series of four hearings in October 1985 on “Foreign Military Sales and Offsets” and obtained a GAO Briefing Report entitled “Military Exports: Analysis of an Interagency Study on Trade Offsets” in April 1986. Two Subcommittees of the Committee on Foreign Affairs – International Economic Policy and Trade and

Arms Control, International Security and Science – held two hearings during June and July 1987 regarding “Countertrade and Offsets in International Trade.” Finally, the Subcommittee on Legislation and National Security of the Committee on Government Operations requested a review of a 1988 OMB Offsets Report as part of an overall review of the US Defense Industrial Base. GAO responded with a subcommittee briefing on offsets in April 1989. (US GAO, 1990, “Defense Production,” p.11)

The Senate requested and received few reports on offset related matters. Testimony before the Senate on offsets was confined to hearings in November 1989, March 1990, and July 1990 before the Committee on Banking, Housing, and Urban Affairs involving the reauthorization of the Defense Production Act (DPA). Also, in April 1990, Senator Alan J. Dixon (D-IL) requested and received a GAO report entitled, "Defense Production Act: Offsets in Military Exports and Proposed Amendments to the Act."

2. General Accounting Office (GAO)

GAO conducted investigations into offsets and related areas as requested by congressional committees and subcommittees as well as individual members of Congress. During this period, GAO produced the three aforementioned reports directly relating to offsets in 1984, 1986, and 1990 and provided testimony on offsets at six different congressional hearings. In general, GAO findings were similar, albeit at a federal level, to the 1974 findings of the DOD Comptroller, i.e., the USG lacked a comprehensive policy, a central focal point, and a database to gather information on offsets. Additionally, GAO was critical of the practice of using grant funds to pay for offsets in the sale of US defense goods.

3. The President

President Reagan issued three Executive Orders (EO) to implement offset related provisions in the law. These included signing EO 12521 in June 1985 and EO 12649 in August 1988 which implemented offset-related provisions of the DPA enacted in April 1984 and October 1986, respectively. These orders delegated to OMB responsibility for preparing the DPA 309 report and for collection of offsets data, first, by the USITC, and, second, by the BEA. EO 12661 implemented the Omnibus Trade and Competitiveness Act (OTCA) of 1988 and trade-related provisions found in other laws including the

National Defense Authorization Act (NDAA) of 1989. Interestingly, no mention of offsets was made with respect to the OTCA, but certain offset-related negotiating functions were jointly delegated to the Secretary of Defense and the USTR. Additionally, President Bush issued the USG policy pertaining to offsets in military exports.

4. Department of Defense (DOD)

DOD published a report on International Cooperation and Industrial Participation Arrangements in August 1983 and the Defense Policy and Advisory Committee on Trade (DPACT) provided a report in December 1983. DOD updated the DAR which became the Defense FAR Supplement (DFARS) in April 1984 and other offset-related changes evolved in the DFARS through November 1990. DSAA published revised guidance for the Security Assistance Program in April 1984 which replaced many of the specific procedures with a simple policy statement that echoed the Duncan Policy. Also, in 1984, DOD entered into an offset agreement with the Netherlands. Finally, in 1989, DSAA imposed limitations on the use of offsets during competition for the Korean Fighter Program (KFP).

5. Office of Management and Budget (OMB) and Other Executive Branch Agencies

a. Office of Management and Budget (OMB)

OMB was responsible for producing reports on offsets in response to presidential direction and, in this regard, coordinated the efforts of various departments within the Executive Branch. Some confusion exists regarding the dating and sequencing of the six reports that OMB produced in response to Section 309 of the DPA between 1985 and 1990. The first report, dated December 1985, was published in February 1986, the second report, dated December 1986, was published in February 1987, and the third report, dated December 1987, was published in January 1988. A summary of the first three reports was published in December 1987, the fourth report, dated December 1988, was published in January 1989, and the fifth report, dated April 1990, was published in July 1990. The fourth and fifth reports also responded to reporting requirements found in Section 825(d) of the NDAA of 1989. According to Udis and Maskus, these OMB reports concluded “that the impact of offsets on the US economy and defense technology base had been relatively minor.” (Udis and Maskus, 1996, p. 361)

b. Other Executive Branch Agencies

A number of other agencies, including the USTR, DOS, DOL, and DOC participated in studies. However, the only other specific offset policy products were a May 1983 report by Treasury, an analysis on offsets conducted in 1982 by the USITC, and an initial survey of industry regarding offsets that was conducted by USITC between 1984 and 1985.

C. LEGISLATION AND EXECUTIVE ORDERS

Prior to 1981, provisions pertaining to trade offsets were not included in legislation or reports from Congress. However, between May 1981 and November 1989, several bills containing offset provisions were introduced and five were enacted into law. These provisions affected laws contained in three different titles of the US Code (U.S.C.): Title 50 (War and National Defense), Title 10 (Armed Forces), and Title 15 (Commerce and International Trade).

Of the five offset-related bills that became law, two are significant. Offset reporting requirements were introduced in the DPA Amendments of 1984 in Section 4 of P.L. 98-265 which added Section 309 of the DPA (referred to as 50 U.S.C. Appendix (App.) 2099). Also, P.L. 100-456, the NDAA for FY89, in Section 825 added requirements to 10 U.S.C. Section 2505 for the US President to develop an offset policy and open negotiations with other countries to reduce adverse affects of offsets and for industry to report on contracts containing offset arrangements.³⁹ Both of these laws were further amended during this period. It is also worth noting that Section 2205 of P.L. 100-418 OTCA of 1988 amended 15 U.S.C. App. 4712 to establish a requirement for an interagency group on countertrade. Congress required that the executive branch form this group to make recommendations on countertrade and offsets.

1. Title 50 and Defense Production Act (DPA) Amendments of 1984 and 1986 (P.L. 98-265 and P.L. 99-441)

The purpose of the DPA is to enhance the defense industrial base and ensure that the industrial base is prepared for defense mobilization in the case of national emergency. In May 1981, the President signed P.L. 87-47 which extended the DPA through 30

³⁹ On 23 October 1992, offset provisions under 10 U.S.C. Section 2505 were redesignated as 10 U.S.C. Section 2532.

September 1982. The report (No. 97-48) that accompanied the legislation put in place an important reporting requirement.

Representative Bruce F. Vento of Minnesota proposed that the Subcommittee [on Economic Stabilization of the US House Committee on Banking, Financing, and Urban Affairs] also examine the effect of “offset” demands from other countries purchasing U.S. military equipment and other items. He said that foreign countries are increasingly insisting that as a condition of such sales American firms compensate by subcontracting overseas, setting up production facilities, transferring technology, licensing manufacturers and other actions. The effects of such “offsets” on the U.S. economy and national security are not clear and may well be adverse to U.S. defense production. For this reason, the Committee believes the Department of the Treasury should continue its present effort to collect all available data from government and industry to evaluate this potential problem. (US House, 1981, “Extension,” p. 5)

Four months later, in September 1981, the Subcommittee on Economic Stabilization of the Committee on Banking, Financing, and Urban Affairs resumed a series of hearings on “Revitalization and the US Economy.” A single hearing was set aside to address the topic of offsets and on 24 September 1981, John D. Lange, Jr. (Director, Office of Trade Finance, US Treasury) and Colonel Ronald L. Carlberg (Director, International Acquisitions, Office of the Undersecretary of Defense) provided testimony before the subcommittee. This was the first hearing held within the US Congress directly addressing offsets. The chair was Representative Vento (D-MN). In opening the hearings, Congressman Vento observed that “Apart from the instructions to the Department of the Treasury in the subcommittee report on the Defense Production Act in 1981, this is the first Congressional attention to the problem of offsets and foreign military sales that I am aware of.” (US House, 1981, “Revitalization,” p. 483)

These hearings were significant in opening to public debate the subject of offsets in defense trade. In particular this hearing provided insight into the varying positions held by different agencies within the USG. For example, Lange noted the Treasury position that offsets were a concern that needed examination. “We at Treasury are concerned that the United States has paid inadequate attention to this phenomenon, and has too little information on what its economic effects may be or what, if anything, should be done about it.” (US House, 1981, “Revitalization,” p. 490) On the other hand, Carlberg stated that the main concern for DOD was to protect its right to require domestic

production of equipment designs procured abroad. “We will want to retain our prerogatives to require defense production of foreign-designed equipment in the United States.” (US House, 1981, “Revitalization,” p. 493)

During the next legislative session (97th Congress, 2nd Session), the House initiated efforts to extend the DPA. The Subcommittee on Economic Stabilization discussed the proposed legislation, H.R. 5540, at hearings on 23 March 1982. As reported at these hearings, the text of the bill did not contain provisions relating to offsets; however, Congressman Vento raised the issue of the impacts of offsets on “foreign source dependency” and the effect of offset agreements on production capacity. (US House, 1982, “To Amend,” pp. 59-60) On 17 May 1982, H.R. 5540 was committed to the Committee of the Whole House with amended language to include offset provisions inserted by Congressman Vento. The language proposed by Congressman Vento for insertion into 50 U.S.C. is provided below.

(e)(1)(A)(i) Any person signing a contract which involves the sale of any defense article or service for use by a nation other than the United States and which includes an offset agreement in excess of \$5,000,000 shall file an annual report with the Secretary of the Treasury. Each report shall include the total of all offsets, classified by the category of the defense material or defense services involved, entered into by such person during the three calendar years preceding the year in which such report is filed. The first such annual report shall be filed with the Secretary of the Treasury not later than June 1, 1983. Subsequent annual reports shall be filed not later than June 1 of each year.

(ii) Except as provided in subparagraph (B) and notwithstanding any other provision of law, including section 552 of title 5 United States Code (commonly known as the Freedom of Information Act), the Secretary of the Treasury shall not disclose, except to the Congress, any information required to be reported pursuant to this subparagraph.

(B) Not later than the first October 1 occurring more than ninety days after the date of the enactment of this subsection and not later than each October 1 occurring after such October 1, the Secretary of the Treasury shall submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and to the Committee on Banking Finance and Urban Affairs of the House of Representatives a report on the total number of contracts reported pursuant to subparagraph (A) and the total amount of offsets required by such contracts. Such report shall contain a breakdown of offsets by category of defense material or defense services involved by recipient country.

(2) For purposes of this subsection –

(A) the term ‘offset’ means any international transaction between a buyer that provides nonmonetary compensation which may include, but not be limited to, the transfer of production or technology to the buyer as a consideration for the purchase of a particular item or service; and
(B) the term ‘person’ means any individual, sole proprietorship, partnership, or corporation.
(3) This subsection shall cease to be effective five years after the date of the enactment of this subsection.” (US House, 1982, “Defense,” pp. 8-10)

On 1 October 1982 the House considered, amended and passed the senate version of the bill extending the DPA, S. 2375. (The House did amend S. 2375 by extending DPA expiration to 31 March 1983.) S. 2375 was enacted as P.L. 97-336 on 14 October 1982. (US House, 1983, “Summary,” pp. 90, 103-104) In late March 1983, the Congress decided by voice vote to extend the DPA expiration date to 30 September 1983 and the President signed H.R. 2112 as P.L. 98-12 on 29 March 1983. (US House, 1985, “Summary,” p. 30) The language proposed by Congressman Vento was not included in the DPA.

In mid-April 1983, the Subcommittee on Economic Stabilization conducted hearings entitled “The Defense Industrial Base Revitalization Act” in order to amend the DPA. In May 1983, the Committee on Banking, Finance, and Urban Affairs sent H.R. 2782 to the Committee of the Whole House. H.R. 2782⁴⁰ which contained the same offset provision found in H.R. 5540, the language proposed by Congressman Vento the previous year. It added a further amendment to include language requiring that the Secretary of Defense report to the US Congress within 30 days of signing any document that pertained to “actual, planned, or potential offsets in defense sales contracts” that totaled more than \$5 million. (US House, 1983, “Defense,” Report 98-110 Part 2, p. 10) However, H.R. 2782 did not reach the floor for a vote and DPA authorities lapsed on 1 October 1983. In November 1983, Congress included an amendment to H.R. 3959, the

⁴⁰ The bill number used during hearings and referred to in the report (No. 98-24) refers to H.R. 2057. Except for the new reporting requirement for the Secretary of Defense, H.R. 2782 contained the identical offsets language. Interestingly, the “Summary of Activities” includes H.R. 2782, but not H.R. 2057 in its “Summary of legislation reported but not enacted.” (US House, 1985, “Summary,” p. ix) However, the Legislative History of the law that was eventually enacted that included offset provisions (P.L. 98-265) lists both H.R. 2057 and H.R. 2782. (CIS, 1984, P.L. 98-265)

supplemental appropriations bill enacted as P.L. 98-181 extending the DPA through 30 March 1984.

Finally, since language relating to offsets and a number of other provisions was not included in the Senate version of the 1984 DPA reauthorization bill, S. 1852, the Senate and House convened a conference committee to discuss and reach agreement regarding differences between their versions of the DPA in early 1984. Congressman Vento, whose support for offset reporting language had been critical during the previous two years, participated in this Conference. The Conference Report (No. 98-651) reflected agreement between the Senate and House on the DPA to include language pertaining to offsets and S. 1852 as amended was enacted into law (P.L. 98-265) on 17 April 1984 with the first offset provisions included.⁴¹

SEC. 309. Not later than 18 months after the date of the enactment of the Defense Production Act Amendments of 1984, and annually thereafter, the President shall submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing and Urban Affairs of the Senate, a report on the impact of offsets on the defense preparedness, industrial competitiveness, employment, and trade of the United States. Each such report shall include a discussion of bilateral and multilateral negotiations on offsets in international procurement and provide information on the types, terms, and magnitude of the offsets. (USCAN, 1985, Vol. 1, P.L. 98-265, 98 Stat. 152)

The “Joint Explanatory Statement of the Committee of the Conference” stated that the offset language was a “House-offered provision” and clarified the intent of the conferees regarding the specific information to be provided by the executive branch in the report on impacts of offsets. (USCAN, 1985, pp. 348-350) The final language in P.L. 98-265 retained an annual reporting requirement that included a requirement for reporting offset-related negotiations. The \$5,000,000 threshold and reporting requirements pertaining to the Secretaries of the Treasury and Defense were removed.

⁴¹ In 1985 Neuman observed, “Congressman Vento wrote the amendment to the Defense Production Act (section 309), April 1984, directing the president to submit a formal report of its (sic) findings to these questions. The survey currently being conducted by the coordinating committee is in response to this mandate. An earlier study on offsets requested by the committee appeared as: General Accounting Office, *Trade Offsets in Foreign Military Sales*, Report to the Chairman, Subcommittee on Economic Stabilization, Committee on Banking Finance, and Urban Affairs, House of Representatives, April 13, 1984 (GAO/NSIAD-84-102). According to one observer, this report was used by Congressman Vento to persuade Congress to pass his amendment to the Defense Production Act.” (Neuman, 1985, p. 204)

Those changes notwithstanding, P.L. 98-265 put offsets in the public eye and made them a part of the lexicon of the Congress. The Subcommittee on Economic Stabilization followed up this legislation with hearings on 22 May 1984 entitled “The Impact of Countertrade and Offset Agreements on the U.S. Economy” to more fully investigate these agreements with witnesses from the DOC, Treasury, and USTR. Again, Congressman Vento expressed concern regarding offsets, “The lack of rational policy, data, and coordination on an issue which will affect what trade, defense, and industrial paths will be available to us in the future.” (US House, 1984, “Impact,” p. 9)

By 1986, certain members of Congress had become dissatisfied with the “total inadequacy” of the response by the administration to the offset provisions in P.L. 98-265 and the Subcommittee on Economic Stabilization re-energized offset-related hearings on 18 June 1986 with a broad range of experts from government and industry. These hearings, entitled “Offset Agreements,” included a report from GAO that roundly chastised the executive branch for the poor quality of the first “Section 309 Report” produced by OMB. GAO recommended that Congress make specific additions to the offset provisions in the DPA requiring that the OMB report include interagency studies and that these studies contain particular information. (US House, 1986, “Offset”) This same subcommittee later referenced these June hearings during its 24 July 1986 hearings to discuss “Reauthorization of the Defense Production Act.” The subcommittee chair, Congressman Jim LaFalce noted that the Reagan administration opposed the offsets reporting requirement and sought to have it repealed. In the end, however, Congress adopted GAO’s recommendations and expanded the DPA to include a new section within Section 309 (50 U.S.C. App. 2099(b)) requiring that future “Section 309 Reports” be based upon interagency studies and further delineated the specific content of these reports. (US House, 1986, “Reauthorization,” p. 2)

The provisions of Section 309 of the DPA added as part of P.L. 98-265 and amended as part of P.L. 99-441 required that the executive branch initiate action to produce these required offset reports. In response to Section 6 of P.L. 98-265, the President signed EO 12521 on 24 June 1985. EO 12521 amended EO 10480 of 14 August 1953 by adding subparagraph 602(d)(1) which delegated to OMB the preparation and submission of the offsets reports to Congress. In response to P.L. 99-441 Section 4,

the President signed EO 12649 on 11 August 1988, further amending EO 10480 by adding subparagraph 602(d)(2) to authorize the BEA to collect information in order to build a database of information for the Section 309 report. (50 FR 26337, 26 June 1985, 53 FR 30639, 15 August 1988)

2. Title 15 and the Omnibus Trade and Competitiveness Act (OTCA) of 1988 (P.L. 100-418)

The purpose of the OTCA of 1988 (P.L. 100-418, 102 Stat. 1107 et. seq.) is to enhance the competitiveness of American industry. Title II of this law addresses several measures relating to export enhancement including a brief mention of offsets under Section 2205(a) “Barter and Countertrade.” This section amended 15 U.S.C. App. 4712 by establishing an interagency group on countertrade to make recommendations to the President and Congress regarding countertrade and offsets. Specifically, this interagency group is charged with reviewing and evaluating the policy and use as well as the need for and feasibility of negotiating agreements with others on the use of countertrade and offsets. Section 2205(b) established an office of barter within the DOC. (USCAN, 1989, Vol. 1, 102 Stat. 1332-1333)

The rather lengthy legislative history of P.L. 100-418 includes offset-related hearings that helped to shape the OTCA. (CIS, 1988, P.L. 100-418) These include three hearings by House subcommittees. The Subcommittee on Economic Stabilization held hearings on “US Trade and Competitiveness” in July 1985 and “Offset Agreements” in June 1986. Two subcommittees of the Committee on Foreign Affairs conducted hearings on “Countertrade and Offsets in International Trade” in June 1987. Significantly, Congresswoman Barbara Kennelly (D-CT) provided testimony as part of the June 1987 hearings. Congresswoman Kennelly discussed a bill that she had sponsored (H.R. 1652) that impacted offsets. This bill, though not enacted, was referred to in the legislative history of P.L. 100-418. As described in the report of her testimony, H.R. 1652 directed the President to enter into negotiations with foreign governments to limit defense and commercial offsets. (US House, 1987, “Countertrade,” pp. 1-8)

The conference report for P.L. 100-418 provides further background on the development of Section 2205.⁴² The conference report cited Section 309 of the DPA (50 U.S.C. App. 2099) as germane because of its requirement for a “report on the impact of defense-related offsets on U.S. exports” and “an interagency group [that] meets infrequently on offset issues.” This portion of the conference report also discussed two sections in the House bill (H.R. 3) and the Senate amendment to this bill. Section 345 of H.R. 3 established an interagency group on countertrade. Section 912 of H.R. 3 required that US exporters provide a report to the DOC on foreign sales exceeding \$2 million that “pursuant to the authority of the foreign government involved, requires countertrade or offsets as a condition for sale.” Section 4501 of the Senate amendment to H.R. 3 proposed establishment of an office within the DOC to monitor countertrade and publish “information on countertrade and barter opportunities.” The conference committee dropped the proposed reporting requirement, but agreed to establish and expand the interagency group for both countertrade and offsets. (USCAN, 1989, Vol. 5, p. 1825)

The OTCA had little impact on offsets. While the conference committee agreed to establish an interagency group on countertrade and offsets, language in the OTCA established an interagency group on countertrade only. However, the hearings that preceded passage of this law sustained offsets as a relevant issue before Congress. Furthermore, two offset-related legislative initiatives proposed but not enacted as part of the OTCA introduced ideas that became important in other legislation. Section 912 of the bill introduced a provision to require that US exporters provide reports on foreign sales involving offsets. Provisions requiring US exporters to report foreign sales involving offsets were eventually enacted into law. Additionally, H.R. 1652 directed the President to enter into negotiations pertaining to offsets. Although not reflected in the relevant legislative history, H.R. 1652 served as a rough draft for similar legislative language in the NDAA of FY89 that directed the President to conduct negotiations on offsets.

⁴² Although P.L. 100-418 enacted H.R. 4848, H.R. 4848 was derived from H.R. 3, the predecessor bill vetoed by President Reagan on 24 May 1988. Conference Report 100-576, which accompanies H.R. 3, provides the legislative history for P.L. 100-418. (USCAN, 1989, Vol. 4, p. 1547)

The President implemented P.L. 100-418 Section 2205(a) by issuing EO 12661 Section 2-101 on “Countertrade and Barter” on 27 December 1988. This order established an Interagency Group on Countertrade “composed of the Secretaries of Commerce, State, Defense, Treasury, Labor, Agriculture, and Energy, the Attorney General, the Administrator of the Agency for International Development, the Director of the Federal Emergency Management Agency, the United States Trade Representative and the Director of the Office of Management and Budget, or their respective representatives.” The Secretary of Commerce or a representative was designated to chair this group. (54 FR 779, 9 January 1989) The absence of offsets from this Executive Order is noteworthy. GAO commented in 1990 that review and evaluation of offsets was included as part of P.L. 100-418. However, GAO found that, “Commerce determined that the interagency group would focus on commercial counter-trade issues, not offsets in military exports.” (US GAO, 1990, “Military Exports,” p. 2)

3. Title 10 and National Defense Authorization Acts (NDAA) of FY 1989 and FY 1990-FY 1991 (P.L. 100-456 and P.L. 101-189)

The NDAA of 1989 (P.L. 100-456, 102 Stat. 1918 et. seq.) was enacted during the same legislative session as the OTCA of 1988. The purpose of the NDAA of 1989 was to authorize appropriations for military activities of the Department of Defense “and for other purposes.” Section 825, which addressed “Department of Defense Offsets Policy” and amended Title 10⁴³, was among the numerous “other purposes” included in this legislation under “Part B – Defense Industrial Base.” (USCAN, 1989, Vol. 2) This section had significant effects on US offset policy and practice, adding several significant offset-related requirements to both the US Code and notes within the US Code.⁴⁴

The US Code listed three requirements. First, the President was required to establish “a comprehensive policy with respect to contractual offset arrangements in connection with the purchase of defense equipment or supplies.” Second, US officials were prohibited from entering into an agreement requiring the transfer of US defense

⁴³ P.L. 100-456 Section 825 (102 Stat. 2020-2022) originally amended 10 U.S.C. 2505. In October 1992, P.L. 102-484 Section 4202(a) renumbered 10 U.S.C. 2505 as 10 U.S.C. 2532. (10 U.S.C.A. 2505)

⁴⁴ Mr. John Miller of the Office of Law Revision Council, US House of Representatives, stated that notes carry the same force of law, but are entered into the US Code as notes for a variety of reasons. For example, Congress may not have assigned a provision from the law to a specific section or chapter in the US Code or the note may be of limited interest or duration.

technology to a foreign country or firm as part of an offset arrangement if the agreement would “significantly and adversely affect” the US defense industrial base and lead to a significant financial loss for a US company. Third, US contractors incurring obligations as a result of offset arrangements that exceeded \$50 million were required to notify the Secretary of Defense.

The notes to the US Code also listed three provisions. First, the President was directed to enter into negotiations with foreign governments to curb the negative aspects of offsets. Second, the President was directed to submit a “comprehensive report on contractual offset arrangements” to the US Congress by 15 November 1988 that provided analysis, assessment, and recommendations regarding offsets. Third, the President was directed to submit to the US Congress by 15 March 1990 and at least annually thereafter for four years a report discussing the appropriate actions to take with foreign countries regarding offsets and the progress of negotiations.

Senator Dixon authored an earlier version of Section 825. In November 1987, he had introduced S. 1892 as a starting point for conducting legislative discussions to address maintaining and improving the US defense industrial base. (Dixon, 1988, 1 March) He requested and obtained comments on his proposed legislation and spoke from the floor of the Senate on the topic of offsets. During two separate hearings on the NDAA (29-30 March 1988), he heard testimony from numerous government and private sector witnesses on the topic of offsets. Furthermore, Senator Dixon discussed with these witnesses a further modification to S. 1892 as a result of his study of offset related issues. (US Senate, 1988, pp. 267-268) On 31 March 1988 the day following these two hearings, Senator Dixon submitted the Dixon Amendment No. 1926 to S. 1892, the “Defense Base Preservation Act.” Title III of the modified version of S. 1892 was labeled “Department of Defense Offsets Policy” and consisted of numerous offset provisions beyond what was eventually enacted into law. This proposed legislation included provisions on a reciprocal offset requirement, prohibition on offsets, and exceptions for coproduction contracts. (Dixon, 1988, 31 March) Although S. 1892 itself, was never enacted it was influential in forming offset provisions that were eventually placed into law.

Slightly more than one month after the introduction of the Dixon amendment, the Senate began deliberating the defense authorization bill for FY89. Section 806 of this bill closely paralleled a number of the provisions of S. 1892, Senator Dixon's defense industrial base bill. The House version of this bill, H.R. 4264, introduced on 26 April 1988, did not contain similar provisions on offsets, either when introduced or during House consideration. (CIS, 1988, P.L. 100-418) However, as reflected in the conference report, the offset provisions proposed in Section 806 of S. 2355 were incorporated into Section 825 of H.R. 4481 as amended and agreed to by the conference committee. It should be noted that Senator Dixon participated as a member of the conference committee. The report shows that the conferees noted the existence of offset reporting requirements already contained in Section 309 of the DPA. Finally, the conferees stated that "certain offset arrangements with non-industrialized countries may be of less concern." (USCAN, 1989, Vol. 5, pp. 2560-2561)

A year later, section 816 of P.L. 101-189, the NDAA for fiscal years 1990 and 1991, included a minor modification to the statutory note pertaining to negotiations. This modification enjoined the President to undertake positive efforts to reach an agreement with the country or countries involved in international agreements to limit the adverse effects of offset arrangements.

The offset-related legislation provisions in the NDAA were significant for a number of reasons. First and most importantly, this legislation prompted the President to formulate the USG Policy on Offsets in Military Exports. Second, it directed the President to enter into negotiations on offsets. According to GAO, this action raised a constitutional question whether the Congress could direct the President to enter into negotiations with foreign governments. (US GAO, 1990, "Military Exports," p. 5) However, the President did agree to consult with nations regarding the negative aspects of offset arrangements. Third, this legislation was the first to mandate industry reporting of offset arrangements exceeding a specified threshold (\$50 million). This particular reporting requirement had been included in at least two earlier pieces of legislation that were never enacted. (H.R. 5540 introduced by Congressman Vento in 1982 specified a contract reporting threshold of \$5 million, and H.R. 3 Section 912, considered during

deliberations on the OTCA of 1988 specified a contract reporting threshold of \$2 million.)

D. POLICIES, REGULATIONS, AND OTHER ACTIVITIES

The only significant policy change pertaining to offsets articulated during this period was the introduction of the USG Policy on Offsets in Military Exports in April 1990 in response to the congressional mandate in the NDAA of 1989. FMS policies and defense procurement regulations underwent structural changes during this period, but were not significantly different from the 1980 version of those policies and regulations. Other activities during this period included DOD participation in an offset agreement relating to sale of the Patriot to the Netherlands. Additionally, Udis and Maskus record an interesting attempt in 1989 by a DOD agency to regulate offsets demands during the Korean Fighter Program competition.

1. USG Policy on Offsets in Military Exports

Fifteen months after enactment of the NDAA of 1989, President Bush issued the USG policy on offsets in military exports (see Figure 3 below). According to Udis and Maskus, this statement provided a restatement of the Duncan Memorandum, in that the USG would not act as “guarantor” of offset commitments made by US industry. (Udis and Maskus, 1996, p. 363) John H. Eisenhour, a long-time observer of offsets and former OMB official involved with producing the offset reports, observed that the language in this policy statement really did not alter current practices within the DOD particularly with regard to using US grant financing to pay for offset costs since this was already an established procedure. (Eisenhour, 2003) The Bush policy statement did elevate the approval authority for USG participation in offsets to the President through the National Security Council (NSC). Additionally, this policy called for consultations (vice negotiations as already discussed) with allies regarding the use of offsets in defense procurement.

Shortly after publication of this policy, Senator Dixon, a longtime proponent of greater offset controls, roundly criticized the President from the floor of the Senate. He stated that the President’s policy did not meet the requirements mandated by Congress. He argued that the policy of noninvolvement in offsets was actually a “non-policy” and

that the President had failed to enter into negotiations with allies to reduce the negative effects of offsets. (Dixon, 1990)

U.S. Government Policy on Offsets in Military Exports

On April 16, 1990, the White House issued the following statement:

STATEMENT BY THE PRESS SECRETARY

The President announced today his Policy on Offsets in Military Exports. This responds to the requirement under the FY 1989 National Defense Authorization Act, Section 825, 10 U.S.C. Sec. 2505.

The President stated that the United States Government is committed to the principles of free and fair trade. Consequently, the United States Government views certain offsets for military exports as economically inefficient and market distorting.

Mindful of the need to minimize the adverse effects of offsets in military exports, while ensuring that the ability of U.S. firms to compete for military export sales is not undermined, the President has established the following policy:

- No agency of the U.S. Government shall encourage, enter directly into, or commit U.S. firms to any offset arrangement in connection with the sale of defense goods or services to foreign governments.
- U.S. Government funds shall not be used to finance offsets in security assistance transactions except in accordance with currently established policies and procedures.
- Nothing in this policy shall prevent agencies of the U.S. Government from fulfilling obligations incurred through international agreements entered into prior to the issuance of this policy.
- The decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved.
- Any exceptions to this policy must be approved by the President through the National Security Council.

The President also noted that the time has come to consult with our friends and allies regarding the use of offsets in defense procurement. He has, therefore, directed the Secretary of Defense, in coordination with the Secretary of State, to lead an interagency team to consult with foreign nations with a view to limiting the adverse effects of offsets in defense procurement. This interagency team will report periodically on the results of these consultations and forward any recommendations to the National Security Council.

Figure 3: USG Policy on Offsets in Military Exports (From Verzariu, 2000, p. 27)

2. Foreign Military Sales (FMS) Policies

The substantive provisions concerning offsets that were contained in the MASM were replaced during the initial publication of the SAMM in April 1984 with a brief statement outlining the semi-annual offsets reporting requirement along with a very brief statement of the DOD policy regarding offsets.

It is DOD policy not to enter into government-to-government offset arrangements because of the inherent difficulties in negotiating and implementing such arrangements. Any foreign government requesting offset should be informed that the responsibility for negotiating any offset arrangements resides with the US contractor involved. The US Government will not commit a US contractor to an offset commitment without having its prior concurrence. (DSAA, 1984, p. “14-17”)

The SAMM was renumbered in 1988, but the information on offsets remained substantively the same until 1992.

3. Procurement Regulations

Similar to the MASM-SAMM change, on 1 April 1984, the DAR became the DFARS and except for minor, non-substantive changes, the DAR sections relating to offsets remained intact in subsequent DFARS revisions through 1989.⁴⁵ (49 FR 38549, 1 October 1984) However, certain DFARS subparts, including subpart 225.73 which included information on offsets, were targeted for streamlining as the result of the Defense Management Review initiative to eliminate unneeded text and clauses and reduce or modify unnecessary burdens placed upon contracting officers. By the end of 1990, changes to the offset related portions of the DFARS eliminated the distinction between FMS/offset and defense cooperation countries, deleted mention of countries with which the USG had offsets, removed detailed procedures for offset procurements, and deleted reference to the appendix which contained the offset agreements to which the USG had agreed. (This appendix was eventually deleted in July 1991 as part of the overarching structural changes to the DFARS.) (55 FR 48730, 21 November 1990)

4. Other Activities

DOD directly intervened in international defense sales on two occasions during this period, significantly influencing offset policy. In the first instance, DOD made an exception to the Duncan Memorandum by agreeing to accept a \$70 million offset as part of a \$305 million sale of the Patriot Air and Missile Defense System to the Netherlands in 1984. Although not a standard practice, DOD agreed to this arrangement as “necessary for foreign policy and national security reasons.” As part of this offset, the US Army purchased over 1,900 Patriot missile canisters. (US OMB, 1987, “Second,” p. II-27-28)

⁴⁵ The DFARS 1984 version referred to the subparts 25.7310, 25.7314, and 25.7304. The DFARS 1988 versions renumbered these subparts as 225.7310, 225.7314, and 225.7304. The DFARS 1988 numbering is employed to reduce confusion.

In the second instance, DOD attempted to control the level of offsets during efforts by the Republic of Korea (ROK) to purchase new fighter aircraft. By mid-1989, the competition had narrowed to two US-built fighters: the F-16 built by General Dynamics and the F/A-18 built by McDonnell-Douglas. At first, the ROK demanded that the winning company provide 30 percent offsets, but then raised offset demands to nearly 60 percent. “In an unprecedented and somewhat puzzling step,” DSAA intervened with the two companies involved and attempted to restrict offsets to the 30 percent level. Some observers commenting upon this intervention have indicated that as a result of the USG intervention in the quantity of offsets the ROK was able to demand greater quality (e.g., technology transfer) of offsets. Udis and Maskus observe that while the ROK agreed to the 30 percent offset level, it could “extract a level of purchases by the seller” beyond this level. (Udis and Maskus, 1996, pp. 363-364)

The purchase of missile canisters from the Dutch was clearly an exception to the Duncan policy. The intervention in the KFP, while not a departure from established policy, did represent an unprecedented intrusion by DOD into industry offset arrangements which has not been repeated since that time.

E. SUMMARY

Despite a flurry of activity between 1981 and 1990, little changed with respect to USG policy and practices towards offsets in international trade. The legislative branch, which had little engagement in offsets prior to 1981, emerged as the primary catalyst in efforts to formulate US offset policy during this period. The executive branch responded to new offset-related legislation with Executive Orders and OMB reports. Interestingly, DOD involvement, though still noteworthy, was rather limited during this period.

In the legislative branch, members of Congress conducted more than ten subcommittee hearings in which offset discussions played a prominent part. These members, principally House Democrats, represented states and districts with strong unionized, working class constituents: Minnesota (Representative Vento), Illinois (Senator Dixon), Ohio (Representative Mary Rose Oaker), and Connecticut (Representative Kennelly). Additionally, four GAO reports published between 1984 and 1990 provided members with ample information on offset practices. Members in both the House and Senate used these subcommittee hearings and GAO reports to sponsor

numerous offset-related bills. Several of these bills were enacted into law which helped to further shape offset-related debate and ultimately led to the formulation by President Bush of the USG policy on offsets in military exports in 1990.

Within the executive branch, the President responded to congressional reporting requirements found in Section 309 of the Defense Production Act (50 U.S.C. App. 2099) and Section 825 of the National Defense Authorization Act of 1989 (10 U.S.C. 2505) with Executive Orders directing OMB to conduct studies and provide reports on the effects of offsets. OMB sponsored two surveys to collect offset information from industry and published six offset-related reports during this period.

DOD curtailed what had been active involvement in offsets engagement and policy formulation with the Duncan policy. Between 1981 and 1990, DOD provided offset-related reports and non-substantive modifications to acquisition regulations and procedures for conducting foreign military sales. However, during this period, DOD made two exceptions to the Duncan policy, involving itself in two offset arrangements. In 1984, DOD agreed to an offset arrangement with the Netherlands in conjunction with the Dutch purchase of the Patriot missile defense system. In 1989, DOD intervened in the sale of US fighter aircraft to Korea by attempting to limit offsets to a 30 percent threshold.

Constituents concerned about employment brought offsets as a potential area of concern to the attention of certain members of Congress. These members, in turn, conducted hearings, collected reports, and proposed legislation to curb the potentially negative effects of offsets on the US defense industrial base, national security, economy, trade and employment. Legislation was enacted which led to a number of studies and reports, and, ultimately, establishment of US policy on offsets in military exports. The policy issued by President Bush in 1990 recognized offsets as economically inefficient and market distorting, restricted US government agency involvement in offsets, and made industry responsible for offset arrangements. This policy also called for consultations with allies regarding offsets. However, the activities undertaken during this period continued the policy of noninvolvement in offsets first articulated in the 1978 Duncan

Policy. Thus, little real change occurred during this period with respect to US policy or practice towards offsets in international trade.

VI. REFINING US OFFSET POLICY (1991-2003)

Following the establishment of the US Policy on Offsets in Military Exports, legislators continued to change different parts of the law to further modify US offset policy through the end of this period. These laws shifted responsibility for offset reporting from OMB to the DOC, provided penalties for making incentive payments related to offsets, added reporting requirements for industry, and mandated offset notification requirements for government agencies. Although only two congressional hearings directly relating to offsets were held, numerous individuals who provided testimony before a broad range of congressional subcommittees raised offset issues. Additionally, GAO reports continued to maintain offsets as a relevant issue. Most significantly, during this period, a decade after the Bush policy on offsets in military exports and in response to a statutory mandate, President William J. Clinton formed a Presidential Commission in December 2000 to examine the use of offsets in defense trade and, in parallel, issued an executive order to expand the scope of this commission to include a concurrent review of the use of offsets in commercial trade. Although the work of the Commission remains unfinished (US GAO, 2003, p. 2), the status report it produced provides a baseline for further understanding of USG offset policy and practices.

A. THE ENVIRONMENT

Between 1991 and 2002, US GDP grew from \$6,676 to \$9,440 billion, with growth rates ranging from -0.47 (1991) to 4.43 percent (1997). The real growth of the GDP was 3.20 percent. (US DOC, BEA, 2003, "GDP") During this same period, unemployment ranged between 7.5 (1992) and 4.0 (2000) percent, averaging 5.5 percent. (US DOL, BLS, 2003) The EPI reported that worldwide aerospace employment fell by one-third, with US aerospace employment declining significantly during this period, by more than 37 percent from 946,000 (1990) jobs to 580,000 (1995) jobs. (US House, 1999, p. 109)

Since 1994, the DOC has collected data directly from industry on the value of offset agreements entered into as part of international military sales. DOC data shows that between 1993 and 2000, US industry signed offsets for close to \$30 billion with 37

different countries for military exports valued at almost \$49 billion. Additional countries with which US industry entered into offset agreements included, in Europe, Austria, Czech Republic, Finland, and Slovenia; in the Middle East and Africa, Kuwait, South Africa, and UAE; and in Asia, Malaysia, Thailand, and Taiwan. (US DOC, BIS, 2003, “Seventh,” p. 6) Offset value accounted for slightly more than 61 percent of the contract value. The average annual value of these offsets for this eight-year period increased from \$2.5 billion during an eight-year timeframe in the previous period to \$3.7 billion.

B. US GOVERNMENT PARTICIPANTS AND THEIR ROLES

At any one time during this period, as many as five major governmental participants were involved in offset policy development. Within the legislative branch, the Congress and the GAO continued their engagement in offsets. Congress conducted two hearings, and GAO produced six offset related reports. DOD continued as the most active participant from the executive branch and focused primarily on updating regulations and policy. The President continued to issue Executive Orders as necessary to implement legislation. Additionally, the President issued a signing statement in response to the DPA Amendments of 1992 which disputed reporting different views from the administration on offsets to Congress. Also, for the first two years of this period, the OMB was involved in providing reports in response to section 825 of the NDAA of 1989, but changes to Section 309 of the DPA in 1992 resulted in designation of the DOC as the lead agency in preparing these reports. Finally, another agency within the DOC, the International Trade Agency (ITA), issued several documents for use by practitioners of countertrade and offsets.

1. Congress

Much of the important offsets policy work completed by Congress during this period was the direct result of bills considered or enacted, GAO reports received, and subcommittee hearings held during the previous period. Between 1991 and 2003, Congress focused its activities on refining previously enacted legislation by adjusting the focus of reports and changing specific offset-related practices such as the use of nonrepayable financing and incentive payments as part of offset transactions. Congress also initiated action to incorporate a number of different offset policies and definitions into law. Most of the work of the Congress resulted from efforts expended by

subcommittees. Despite the fact that subcommittees convened only two formal hearings to address offsets between 1991 and 2003, these proved critical in forming policy relating to offsets.

The Subcommittee on Commerce, Consumer Protection, and Competitiveness of the House Committee on Energy and Commerce convened a hearing on 24 June 1994 to receive testimony from the Frank C. Conahan, from GAO's National Security and International Affairs Division (NSIAD). In her opening statement, the subcommittee chair, Congresswoman Cardiss Collins (D-IL), said that she understood the positions of foreign governments and US defense contractors regarding offsets, but viewed the current offset policy as a "failure" of the USG. She believed that this policy needed to be changed and viewed this hearing as a step toward making that change. (US House, 1994) Mr. Conahan's testimony was a verbal summary of the June 1994 GAO report entitled, "Military Exports: Concerns Over Offsets Generated with U.S. Foreign Military Financing Program Funds." (In addition to delivering this report to the aforementioned subcommittee, GAO also addressed the report to Senator Russell D. Feingold (D-WI) who played a significant role in shaping offset-related legislation during this period.) The testimony and report highlighted the absence of legislative restrictions regarding the use of nonrepayable funds to pay for offset costs and made recommendations to amend various laws to restrict the use of these funds. Although this hearing was not listed in the legislative history of P.L. 104-107, together with the GAO report, it did help to frame discussions regarding the use of nonrepayable funds to finance offsets. (US GAO, 1994, "Military Exports")

On 29 June 1999, the Subcommittee on Criminal Justice, Drug Policy, and Human Resources of the Committee on Government Reform conducted hearings titled, "Defense Offsets: Are They Taking Away Our Jobs?" Congressman John F. Tierney (D-MA) requested these hearings after reading a report on offsets that he had requested from the Minority Staff of the Committee on Government Reform entitled, "Foreign Offset Demands in Defense and Civil Aerospace Transactions." This report was incorporated as part of these hearings. Congressman Tierney became interested in the topic after learning that much of the work to build jet engines under a foreign military sales contract with Korea would be done by industry in that country as a result of offsets.

He viewed offsets as “sweeteners” to induce a buyer’s purchasing decision. (US House, 1999, p. 5) The subcommittee also received a statement from Senator Feingold and testimony from a number of witnesses representing industry, labor, the DOD and the DOC. This hearing served to highlight the contrasting views from industry that offsets are a nuisance to cope with and from labor that offsets are a threat to American jobs. This hearing was listed in the legislative history of P.L. 106-113 which provided for the Defense Offsets Disclosure Act (DODA) of 1999.

Although the two hearings discussed above were the only two opportunities formally designated for a discussion of offset matters, a scan of other congressional testimony demonstrates that offsets were discussed in a wide variety of other hearings throughout this period. For example, offsets were described in the context of conventional arms transfer as a threat to US employment. Also, labor representatives discussed the negative aspects of offsets in the context of US trade policies and trade relations with China.⁴⁶

2. General Accounting Office (GAO)

GAO produced six reports between 1994 and 2003 that continued to explore offsets from a broad perspective as well as address specific issues. In June 1994, GAO produced the aforementioned report pertaining to “Military Exports” which led to changes to Section 22 of the AECA in 1996 and the prohibition of the use of nonrepayable funds to pay offset costs. In April 1996, GAO published a broad, balanced overview of offsets in a report entitled, “Military Exports: Offset Demands Continue to Grow.” This report was provided to the Senate Armed Services Committee and the House Small Business Committee. Also included in this report was information on selected foreign government offset policies and practices. (US GAO, 1996, “Military Exports”) In August 1997, a GAO report entitled “Military Offsets: Regulations Needed to Implement Prohibition on Incentive Payments” stated that the DOS had failed to

⁴⁶ See for example, 9 November 1993 testimony by Dr. Caleb S. Rossiter, Direct, Project on Demilitarization before the House Foreign Affairs Committee (Federal Document Clearing House (FDCH), 1993); 23 May 1995 testimony by Ms. Lora Lumpe, Director, Arms Sales Monitoring Project for the Federation of American Scientists before the Subcommittee on Foreign Operations of the Senate Appropriations Committee (Federal News Service (FNS), 1995); and, 28 January 1999 testimony of Mr. John J. Sweeney, President, American Federation of Labor and Congress of Industrial Organizations before the Senate Finance Committee (FNS, 1999).

implement any regulations to address provisions in P.L. 103-236 and codified in Section 39A of the AECA at 22 U.S.C. 2279A that related to the prohibition against making incentive payments. (US GAO, 1997, “Military Offsets”) In December 1998, GAO provided another report to Senator Feingold. This report, entitled “Defense Trade: US Contractors Employ Diverse Activities to Meet Offset Obligations,” provided additional insight as to the particular practices that contractors employ to meet offset commitments. Among the report’s conclusions was this statement: “It is difficult to accurately measure the impact of offsets on the overall U.S. economy and on specific industry sectors.” (US GAO, 1998, “Defense Trade”)

As a result of the aforementioned June 1999 hearings, Congressman John Mica (R-FL), requested a review of data collection and policy coordination efforts. In October 2000, GAO responded with a report entitled, “Defense Trade: Data Collection and Coordination on Offsets.” This report indicated that per the DPA of 1950, the DOC is the primary agency responsible to collect offset information and that the DOD and DOS also collect and report certain information as required by the AECA. GAO criticized both the DOD and DOS for not having published specific implementing regulations for the type of data needed from industry. (US GAO, 2000, “Defense Trade: Data Collection”)

In this and its 1998 report, GAO also pointed to an office within the DOD known as the Office of Foreign Contracting that collects information subject to 10 U.S.C. 2410g on contracts that exceed \$10 million when more than \$500,000 worth of work will be performed outside of the US. (US GAO, 1998, “Defense Trade,” p. 10) However, the Office of Foreign Contracting, while concerned with foreign sourcing issues similar to offsets, does not collect information applicable to a study of offsets.

Finally, in May 2003, GAO reported in “Defense Trade: Report and Recommendations of the Defense Offsets Commission Still Pending” that after almost three years that the Offset Commission had not completed its work.

3. The President

Prior to the November 1992 elections and the close of his term in office, President Bush issued a statement upon signing the DPA Amendments of 1992 into law that expressed concern regarding the desire of Congress to obtain differing views from within

the administration regarding offsets. President Bush wrote as President he would retain the constitutional authority to protect the executive branch deliberative process.

President Clinton issued a total of four Executive Orders to implement offset related provisions in the law. The first three of these were simple delegations of the authority provided to the President as part of amendments to the DPA and AECA. Finally at the end of his second term with the controversial election of 2000 still undecided, President Clinton signed EO 13177 to establish the National Commission on the Use of Offsets in Defense Trade and the President's Council on the Use of Offsets in Commercial Trade.

4. Department of Defense (DOD)

Throughout this period, DOD continued to refine policies and regulations that pertained to offsets. DOD updated the offset provisions in the DFARS nine times. These DFARS changes principally focused on the ability of US firms to recover offset costs. Also, senior officials involved in defense procurement published policy letters in 1999 and 2000 that addressed pricing issues, including the treatment of offset costs as allowable, in FMS. Finally, DOD updated the SAMM three times during this period to parallel the DFARS changes regarding cost recovery and to implement reporting requirements on offsets to Congress.

5. Other Executive Branch Agencies: The Office of Management and Budget (OMB), Department of Commerce (DOC), and International Trade Administration (ITA)

a. OMB Participation and Roles

Through 1992, OMB retained the lead role for the executive branch with respect to offsets. OMB did not provide an offset report for either 1990 or 1991 because Section 309 authorities had lapsed with the expiration of the DPA on 20 October 1990, and offset reporting under Section 309 authority was not required.⁴⁷ Although it did not provide reports under Section 309, OMB continued to provide reports to Congress in response to the requirement of Section 825(d)(3) of the NDAA of 1989 which required reports on the progress of efforts with foreign countries to negotiate agreements to curb

⁴⁷ P.L. 102-193 reauthorized the DPA between 6 December 1991 and 1 March 1992. Although authority technically existed to provide a report, time was insufficient to gather data and write a report during this time frame. (Eisenhour, 2003)

the adverse effects of offsets. These two reports, “Negotiations Concerning Offsets in Military Exports: December 1990” and “Negotiations Concerning Offsets in Military Exports: December 1992,” were published in June 1991 and December 1992, respectively.⁴⁸ (Eisenhour, 1995, App. XVI) Following publication of these reports and with the enactment of P.L. 102-558, OMB no longer had the responsibility to produce offset-related reports, but has retained involvement, reviewing reports prior to delivery to Congress.

b. Department of Commerce (DOC) Participation and Roles

Section 124 of P.L. 102-558 established the DOC as the President’s Executive Agent for offset-related matters under Section 309 of the DPA, to include preparation of the annual report. Within the DOC, the Bureau of Export Administration (BXA) was provided the authority to collect data and prepare the Section 309 report. In April and December 1994, the DOC published proposed and final regulations, respectively, in the Federal Register in order to begin the process of collecting offset data from industry. (59 FR 21678, 26 April 1994; 59 FR 61796, 2 December 1994) BXA published its first report in May 1996 and provided subsequent reports in August 1997, August 1998, December 1999, May 2001, and February and July 2003. Early reports drew on the OMB reports for background information. Additionally, these reports used the data collected by the DOC to provide statistical information on the quantity and types of offsets in defense trade.

c. International Trade Administration (ITA) Participation and Roles

Within the DOC, the ITA was designated to oversee the implementation of Section 2205 the OTCA of 1988, which involved countertrade practices including offsets. In accord with the OTCA, the ITA published several documents throughout this period to educate those involved with international trade on these types of practices. In 1992 the ITA published two documents that provided information on offset and offset practices,

⁴⁸ Section 825(d)(3) of P.L. 100-456 required annual reports over a four-year period. The first report was published on 16 July 1990 as part of OMB report, “Offsets in Military Exports: April 16, 1990.” (OMB, 1990) Also, in discussing this reporting requirement, Udis and Maskus observe that these reports were provided during 1990, 1991, and 1992 and remarked that these reports were “very much abbreviated compared to the economic impact reports” that OMB had previously provided. (Udis and Maskus, 1996, p. 362)

“International Countertrade: A Guide for Managers and Executives” and *“International Countertrade: Individual Country Practices.”* Additionally, in 2000, the ITA published an update to the “Guide” that was entitled, “The Evolution Of International Barter, Countertrade, and Offset Practices: A Survey Of The 1970s Through The 1990s.” These publications provided comprehensive, historical overviews of offset and countertrade practices. Their purpose was “to focus the awareness of readers on the areas of knowledge they will need to further develop as practitioners.” (Verzariu, 2000, p. ii)

C. LEGISLATION AND EXECUTIVE ORDERS

By 1991, provisions pertaining to trade offsets were included in numerous pieces of proposed legislation and codified principally in 50 U.S.C. App. 2099 (Section 309 of the DPA) and 10 U.S.C. 2505 Section and, to a lesser degree, in 15 U.S.C. 4712. The authorities under Title 10 and Title 15 remained in force and unchanged throughout this period. After a lapse that began in October 1990, the DPA was reauthorized in October 1992 and Section 309 underwent significant revision, including changes to the responsibility for, purpose of, and content in the reports, new reporting requirements for US industry, and direction on the use of reports in negotiations. Additionally, the notes to Section 309 were modified to include an uncodified statement of policy pertaining to offsets. Although the text of Section 309 remained unchanged during the remainder of this period, the notes were again modified in 1999 to add provisions of the DODA.

During this period, the AECA of 1976 as amended emerged as a new legislative tool to monitor offsets. The AECA provides the authority and general rules for conducting foreign sales of defense articles and services, and training on a government-to-government and industry-to-government basis. Prior to this period, the AECA did not address offsets. However, beginning in 1994 four separate laws with offset provisions amended the AECA during this period.

1. Amendments to the Defense Production Act (DPA)

The offset provisions in DPA Section 309 (50 U.S.C. App. 2099) underwent substantial modification in 1992. That same year, an uncodified declaration of congressional policy was added to the notes of Section 309. In 1999, the provisions of the DODA, except for those applicable solely to the AECA, were also incorporated in the notes of Section 309.

a. Defense Production Act Amendments of 1992 (P.L. 102-558)

The offset-related amendments that became part of P.L. 102-558 (106 Stat. 4198 et. seq.) originated with efforts beginning in 1988 during the second session of the 100th Congress and continuing through both sessions of the 101st Congress. The most vocal proponent of a need to modify offset legislation was Senator Dixon. In 1989, Senator Dixon had introduced S. 1379, containing substantially the same offset provisions eventually enacted into law in 1992. (135 CR 8599 S8604, 24 July 1989) However, despite efforts by Senator Dixon and others to enact legislation that would extend the DPA, it expired on 20 October 1990.

During the next two years, the DPA was briefly reauthorized for two brief periods, from 17 August to 30 September 1991 (P.L. 102-99) and then again from 6 December 1991 to 1 March 1992 (P.L. 102-193). These two 1991 laws that reauthorized the DPA made some technical changes, but neither had any effect on offset provisions. And, though the reasons for DPA expiration were unrelated to the provisions in Section 309, offset reporting requirements lapsed. Finally, on 28 October 1992, P.L. 102-558 was enacted with two sections of this law containing offset-related provisions, Sections 123 and 124.

Section 124 (106 Stat. 4207-4208) completely revised DPA Section 309 “Annual Report on Impact of Offsets.” This section made significant changes to the responsibility for, purpose of, and content in the reports; added reporting requirements for US industry; and provided direction on the use of reports in negotiations. The Secretary of Commerce was designated as the “President’s Executive Agent for carrying out this section” and given the responsibility for preparing the DPA Section 309 Report. The legislation also specifically required that, in preparing the report, the Secretary of Commerce must consult with the Secretaries of Defense, Treasury, and State and the USTR.

The purpose of the interagency report (50 U.S.C. App. 2099(b)) narrowed from a broad examination of the “long-term as well as the short-term effects of offsets,” to a more focused review to “identify the cumulative effects of offset agreements.” The revised language in this subsection expanded the scope of reports beyond the effects of

offsets on lower tier defense subcontractors” to address “domestic defense productive capability” and “the domestic defense technology base.” The revised language removed a requirement to examine the effects of offsets on “nondefense industry sectors.”

Regarding content, the statute had previously required “a discussion of bilateral and multilateral negotiations on offsets in international procurement and provide information on the types, terms, and magnitude of offsets.” The revised language laid out specific content requirements pertaining to the offset report, including a “net assessment of the elements of the industrial base and technology base,” “recommendations for remedial action,” and summaries of any interagency studies, offset arrangements, and completed negotiations.

The most significant change to DPA Section 309 involved a new requirement for US firms to notify the DOC of certain offset agreements. Specifically, US contracts now had to report to the DOC any sale to a foreign government or firm of a “weapon system or defense-related item” if that sale involved an offset agreement exceeding \$5 million. Senator Donald Riegle (D-MI) inserted a statement in the Congressional Record explaining the need for “a continuous data collection and analysis system” to “better identify and analyze areas of growing US dependence on foreign suppliers.” (137 CR 1571, 5 February 1991)

Finally, the legislation required US negotiators to use the findings and recommendations contained in the DPA Section 309 reports during bilateral or multilateral negotiations to reduce the negative effects of offsets.

Section 123 (106 Stat. 4206-4207) included an uncodified “Declaration of Offset Policy” that has been incorporated as a note in Section 309 of the DPA (50 U.S.C. App. 2099). This section duplicates the policy provided by President Bush in April 1990, but did change the periodicity and recipient of reports on offset consultations with foreign nations. The Bush policy required periodic reporting to the NSC. The legislative policy required annual reporting to the Congress as part of the annual DPA Section 309 Reports. Also, the language in this section tacitly acknowledged that the President would conduct “consultations” instead of “negotiations” directed by Section 825 of the NDAA of FY 1989.

The legislative history of P.L. 102-558 highlights differences between committees of the House involved in reviewing matters related to the DPA. In Report No. 102-208(II) submitted on 25 September 1992 to accompany the House version of the DPA legislation (H.R. 3039), the Armed Services Committee noted that it had amended the Offset Policy in Section 123 of the proposed legislation to conform with Title 10 language passed as part of the NDAA of 1989. The Armed Services Committee found the language proposed by the “Banking Committee” as overly restrictive and made the change to provide flexibility to the President in discussing offset-related matters with allies. The Armed Services Committee also noted that this legislation goes beyond the scope of the DPA and was beyond the jurisdiction of the “Banking Committee.” (USCAN, 1993, Vol. 6, p. 3529)

Upon signing S. 347 into law, President Bush enumerated reservations regarding a number of sections, including Section 124. He wrote, “I sign this bill with the understanding that this provision does not detract from my constitutional authority to protect the executive branch deliberative process.” (USCAN, 1993, Vol. 6, p. 3551)

The President also signed Part IV of EO 12919 to enact the revised legislation concerning offsets. This delegated the President’s responsibility and authority relating to offsets to the Secretary of Commerce. The order also stated that the offset report, though prepared by the DOC, remained subject to clearance by OMB prior to submission to Congress. (59 FR 29525, 3 June 1994)

b. The Defense Offsets Disclosure Act (DODA)

The President enacted the Consolidated FY2000 Appropriations Act (P.L. 106-113) on 29 November 1999. The DODA was contained in P.L. 106-113 as Division B, Section 1000(a)(7) [Division B, Title XII, Subtitle D (Sections 1241 to 1248)] (113 Stat. 1536, 1501A-500 to 1501A505). Except for Sections 1245 and 1246 which were incorporated into the AECA, all other sections of the DODA were included, along with the aforementioned “Declaration of Offset Policy” as a note in DPA Section 309. The DODA provided another policy pertaining to offsets, defined offsets, established an offset commission, and mandated reporting pertaining to a multilateral strategy to address offsets. The DODA “Declaration of Policy” stated, “It is the policy of the United States to monitor the use of offsets in international defense trade, to promote fairness in such

trade, and to ensure that foreign participation in the production of United States weapon systems does not harm the economy of the United States.” This policy is an extension of previously articulated statements on offset.

The DODA also defined an offset to mean “the entire range of industrial and commercial benefits provided to foreign governments as an inducement or condition to purchase military goods or services, including benefits such as coproduction, licensed production, subcontracting, technology transfer, in-country procurement, marketing and financial assistance, and joint ventures.” This definition recognized that offsets could be an inducement offered by industry in order to obtain a foreign sale or as a condition imposed by a foreign government. The “benefits” in this definition are actually types of offsets that are described throughout the literature and in government documents.

The review commission was to be established by the President in consultation with the leadership of Congress. The DODA articulated requirements and duties of the commissioners with regard to examining offsets. Additionally, the DODA outlined the requirements for a report once the work of the commission was completed.

The DODA required that the President submit a report on the feasibility of establishing a multilateral treaty on the standards for employing offsets in defense trade. The DODA requires that the President submit this report within 90 days after receiving the final report of the commission.

With EO 13177 (65 FR 76558, 4 December 2000), President Clinton established the “National Commission on the Use of Offsets in Defense Trade” and a parallel “President’s Council on the Use of Offsets in Commercial Trade.” The Commission held hearings on 4 December 2000 and published an interim status report on 18 January 2001. This status report discussed the initial proceedings of the Commission, provided an initial assessment of the extent and nature of offsets in both defense and commercial trade, described the reasons that other countries seek offsets, and identified the goals of US firms that provide offsets. Additionally, the status report placed offsets in the context of larger trends in the US aerospace industry, the US economy, and the world economy, discussed the impacts of offsets on the US economy and US national

security, and described the next steps for the Commission. The Commission, however, never reconvened.

2. Amendments to the Arms Export Control Act (AECA)

In the mid-1990s, the AECA emerged as another policy area affected by offsets. Between 1994 and 1999, four separate laws with offset-related provisions were enacted that modified three different portions of the AECA. AECA Section 36 (22 U.S.C. 2776) pertained to reports of foreign sales, Section 39A (22 U.S.C. 2779A) focused on incentive payments and Section 22 (22 U.S.C. 2762) addressed financing for foreign military sales.

a. AECA Section 36 (22 U.S.C. 2776)

This section of the AECA pertains to “Reports and certifications to Congress on military exports.” Under this section, DOD (for government-to-government military sales) and DOS (for industry-to-government military sales) provide specified information in a notification to Congress of potential foreign sales of military articles that exceed specified dollar thresholds.⁴⁹ On 30 April 1994, Section 732 of P.L. 103-236 (108 Stat. 503-504) amended AECA Section 36 to add a requirement for offset information as part of this pre-sale notification. This offset information included a certification that offsets either were or were not proposed in connection with the sale, and, if proposed, a description of the offset was required. Along with this new offset notification requirement, Section 732 added a subsection that provided a definition of “offset agreement.”

The term “offset agreement” means an agreement, arrangement, or understanding between a United States supplier of defense articles or defense services and a foreign country under which the supplier agrees to purchase or acquire, or to promote the purchase or acquisition by other United States persons of, goods or services produced, manufactured, grown, or extracted, in whole or in part, in the foreign country in consideration for the purchase by the foreign country of defense articles or defense service from the supplier. (22 U.S.C. 2776(e))

⁴⁹ At the time the law was passed, notification was required for sales containing major defense equipment (MDE) exceeding \$14 million, for sales not containing MDE exceeding \$50 million, and for construction sales exceeding \$200 million. These thresholds continue to apply to non-treaty Allies, but on 30 September 2002, Section 1405 of P.L. 107-228 (116 Stat. 1456-1458) raised thresholds for treaty Allies (e.g., NATO, Australia, etc.) to \$25 million for sales containing MDE, \$100 million for sales not containing MDE, and for construction sales that exceed \$300 million. (USCA, 2003)

This section was further amended on 21 July 1996 with the enactment of Section 155 of P.L. 104-164 (110 Stat. 1440). This law added a requirement for the administration to publish the unclassified portions of these pre-sale notifications in the Federal Register. A second subsection pertaining to offsets was added to AECA Section 36. A review of the Federal Register database indicates that the DOS has not yet implemented this provision of P.L. 104-164 for commercial sales; however, DOD has complied for government sales since 1996. As part of its notification of potential FMS transactions to Congress, DOD includes an offset certificate and declaration that offsets either are not included or may be included as part of the potential sale. In any case, the details of any proposed offset transaction are included in the classified notification to Congress.

Finally, Section 1245 of the DODA (P.L. 106-113, 113 Stat. 1501A-502) inserted language clarifying the type of information that was to be included in the congressional notifications. Most significantly, the DODA added language pertaining to the confidentiality of offset agreement information. Thus, a third subsection pertaining to offsets was added to AECA Section 36.

EO 11958 (42 FR 4311, 18 January 1977) had already been amended to delegate responsibility for making pre-sale notifications to Congress. However, in response to Section 155 of P.L. 104-164, the President issued EO 13091 to amend Section 1.k. of the executive order to delegate to the Secretaries of Defense and State the responsibility for publishing unclassified information pertaining to these pre-sale notifications in the Federal Register. (63 FR 36153, 29 June 1998)

b. AECA Section 39A (22 U.S.C. 2779A)

This section of the AECA addresses the “Prohibition on incentive payments.” On 30 April 1994, Section 733 of P.L. 103-236 (108 Stat. 504) added Section 39A to the AECA (22 U.S.C. App. 2779A). P.L. 106-113 (113 Stat. 1501A-502) added some clarifying language in 1999. A memorandum signed by President Clinton on 26 July 1994 delegated new functions from this legislation to the Secretary of State. (59 FR 40205, 26 July 1994) Senator Feingold authored what became Section 733 of P.L. 103-236. This legislation was in response to a constituent who had been negatively affected by offsets. In testimony before the House Subcommittee on Criminal Justice,

Drug Policy, and Human Resources on 29 June 1999, Senator Feingold provided insight pertaining to the background on Section 733 of P.L. 103-236.

I first became involved in the offsets issue in February 1993, when I learned that a Wisconsin-based company, the Beloit Corp., a subsidiary of Harnischfeger Industries, Inc., had been negatively affected by an apparent indirect offset arrangement between an aerospace contractor, the Northrop Corp., and the Government of Finland. Beloit was one of only three companies in the world that produce this particular type of large papermaking machine. In its efforts to sell one of these machines to the International Paper Co., Beloit became aware that Northrop had offered International Paper an incentive payment to select, instead the machine offered by a Finnish company, Valmet, not the Wisconsin company. Northrop was promoting the purchase of the Valmet machinery as part of an agreement that would provide dollar-for-dollar offset credit on a deal with Finland to purchase 64 F-18 aircraft.

This type of payment had the flavor of a kickback, distorted the practice of free enterprise, and I think, threatened U.S. jobs. By lowering its bid, and thereby only barely breaking even on the contract, to take into account the incentive payment offered by Northrop, Beloit still did succeed in winning the contract. Nevertheless, for me, the incident demonstrated the potential for offset obligations to have an impact on apparently unrelated domestic industries, as the chairman mentioned. I became concerned that this could happen anywhere, in any industry, in the future without being recognized, much less remedied.

Mr. Chairman, one of the first things I did as a new Member of the Senate in 1993 was to offer an amendment to the Arms Export Control Act to prohibit incentive payments in the provision of an offset credit. I wanted to clarify the congressional disapproval of an activity that appeared to fall through the cracks of various existing acts. Neither the Anti-Kickback Act nor the Foreign Corrupt Practices Act seemed clearly to address the payment being offered to International Paper in the Beloit case. My provision, which was enacted into law in 1994, prohibits the use of third-party incentive payments to secure offset agreements in any sale that is subject to the Arms Export Control Act. The measure also expanded the requirements for congressional notification of the existence and, to the extent possible, the details of any offset agreement at the time of notification of a pending arms sale under the Arms Export Control Act. (US House, 1999, pp. 67-68)

The statement made by Senator Feingold suggests the strong linkage between offsets and US jobs. Offsets are also viewed by some as unfair trade practices that must be eliminated. Senator Feingold worked to enact offset legislation prohibiting incentive

payments and increasing congressional notification requirements that he believed would serve the interests of his constituents.

c. AECA Section 22 (22 U.S.C. 2762)

This section of the AECA addresses “Procurement for Cash Sales.” Section 531A of P.L. 104-107 (110 Stat. 731) stated that pricing of nonrepayable funds for foreign military sales should be done on the same basis as used for DOD-purchased items. Therefore, since DOD does not pay offset costs for its own contracts, offset charges are not allowable costs for FMS contracts paid for with nonrepayable (i.e., grant) funds appropriated from the US Treasury.⁵⁰

3. Department of Defense Appropriations Act of 2004 (P.L. 108-87)

Legislative interest in offsets continued through the end of this period. On 17 July 2003, Senator Christopher Dodd⁵¹ (D-CT) introduced amendment number 1276 to the Defense Appropriations Act of 2004 that added a requirement for the President to review offset arrangements. The amendment required the Secretary of Defense to provide a report to Congress on the result of this review by 1 March 2005. This amendment was incorporated into the Defense Appropriations Bill as Section 8138, enacted on 30 September 2003 as P.L. 108-87 (117 Stat. 1054 et seq.). Senator Dodd cited the sale of F-16 fighters to Poland and associated offset arrangements that transferred jobs overseas as his reason for introducing this amendment. He indicated his view that this amendment would add a measure of government accountability for these offset contracts. (149 CR S9516-9520, 17 July 2003)

⁵⁰ In 1996, the largest recipients of nonrepayable or grant funding, referred to as Foreign Military Financing (FMF), included Israel, Egypt, Greece, and Turkey. (US GAO, 1996, “Military Exports,” p. 4) Eisenhower notes that the US began as early as 1984 to phase out Israeli use of grant funds to pay for “directed offsets.” He writes, “Through a series of negotiations, limitations were place on Israeli use of tax money to pay for offset although the total amount of foreign aid was not affected by this action. The ceilings were \$225 million (1984), \$200 million (1985), \$150 million (1986, 7, 8 and 9), \$100 million (1990), \$50 million (1991), and \$25 million (1992). The so-called ‘directed offsets’ program for Israel ended in September, 1992.” (Eisenhower, 1995, p. 96)

⁵¹ On 8 August 2003, Senator Dodd’s office issued a press release regarding a letter signed by the senator to the Secretary of Commerce regarding the questions on offsets in defense trade. (See <http://www.senate.gov/~dodd/press/Releases/03/0808.htm> accessed 22 October 2003.)

4. Other Legislation Under Consideration

As of December 2003, the DPA was under consideration for a five-year extension to 30 September 2008 by the 108th Congress. Section 7 of this bill, S. 1680, called for offset reporting in addition to that already required in Section 309 of the DPA. This reporting requirement specifically extended studies of offset impacts to “at least the first 3 tiers of domestic subcontractors during the 5-year period beginning on January 1, 1998.” The report would be due one year following enactment of S. 1680. As originally introduced in the Senate, S. 1680 did not include Section 7. It was inserted during consideration by the House as part of an arrangement worked out with Senator Dodd. (149 CR H9416, 15 October 2003) On 8 December 2003, S. 1680 was agreed to by both the House and Senate. (CIS, 2003, S. 1680)

D. PRESIDENTIAL COMMISSION ON OFFSETS

On 4 December 2000, the National Commission on the Use of Offsets in Defense Trade and the President’s Council on the Use of Offsets in Commercial Trade convened. A number of witnesses from industry, labor, academia, and government provided testimony. The Commission approved publication of a status report on 18 January 2001. This report provided an overview of the extent and nature of offsets in both defense and commercial trade; described reasons foreign countries and industry enter into offsets agreements; provided a preliminary assessment of the impact of offsets on the US economy and national security; and listed the next steps for the Commission to undertake. (US President, 2001, p. A) However, as of November 2003, the Commission has not held further meetings.

In 2003, disagreement regarding the status of the Commission emerged between the executive and legislative branches. In February 2003, the DOC reported, “However, because of the change in administration and the resignation of a large number of Commission members, it was decided that the interim report would serve as the final report of the Commission.” (DOC, 2003, “Sixth,” p. 57) In May 2003, GAO, fulfilling its mandate under Section 1248(d) of the DODA of 1999 to “monitor and periodically report to Congress on the progress in reaching a multilateral treaty,” stated that the Commission report and recommendations were pending. GAO explained the reporting delay in terms of the “2001 change in presidential administrations” which “resulted in

vacancies in the five executive branch positions on the Commission, which have yet to be filled.” (US GAO, 2003, p. 2)

GAO indicated that another Presidential Commission, “The Commission on the Future of the United States Aerospace Industry,” called for the President to reactivate the Offset Commission and to pursue “a multilateral solution to curtail offset demands in defense trade.” (US GAO, 2003, p. 1) As of October 2003, no further action had been initiated to either re-establish the Offset Commission or to pursue multilateral solutions.

E. POLICIES, REGULATIONS AND OTHER ACTIVITIES

1. Foreign Military Sales (FMS) Policies

Substantively, the offsets section in the 1984 SAMM remained through March 1992 as a consequence of the introduction of the 1988 version of the SAMM. In 1992, a new paragraph was introduced to address incorporation of a note on “Offset Costs” in “all LOAs⁵² which include industry offset administrative costs.” Furthermore, the current section was expanded to include specific conditions for contractors recovering offset costs. These conditions paralleled those already outlined in DFARS 225.7304(c)(1)(iii)(C)⁵³. (DSAA, 1992, Change 4, pp. 701-11 and 1401-14-15)

In January 1996, DSAA made significant changes to the offset policy section of the SAMM that corresponded to the DFARS by replacing reference to the DOD Policy with the President’s Policy on Military Offsets, adding a restriction on the use of USG funding to finance offsets,⁵⁴ and deleting the semi-annual offset reporting requirement. Procedurally, the specific conditions for recovering offset administrative costs in an LOA were deleted and the requirement to include a note pertaining to offsets was extended to include all LOAs. (DSAA, 1996, pp. 701-9 and 1401-14-15)

In 2000, the renamed Defense Security Cooperation Agency (DSCA) published a letter making extensive modifications throughout the SAMM to incorporate offset-related provisions of legislation, changes to the DFARS, and modification of DOD procurement

⁵² The “LOA” is the common name for the Letter of Offer and Acceptance employed by DOD as the government-to-government agreement employed in FMS.

⁵³ On 2 November 1992, DSAA issued SAMM Change 5 which updated the DFARS reference to 225.7307-2(a)(2)(iii). (DSAA, 1992, Change 5)

⁵⁴ The SAMM restriction on the use of US funds to finance offsets preceded enactment of P.L. 104-107 in April 1996.

policy. (DSCA, 2000) And, in February 2002, DSCA issued additional changes to the various portions of the SAMM relating to offsets to clarify and amplify previously approved DOD policy and legislative requirements. (DSCA, 2002) Finally, the SAMM was revised in October 2003, but no substantive changes were made to offset policies.

2. Procurement Regulations

During the early part of the 1990s, the DFARS underwent substantial modification in an effort to streamline business practices. In February 1991, as part of this DFARS transition, DOD published a proposed rule (56 FR 6056, 14 February 1991) in Subpart 225.7304 addressing “Pricing acquisitions for foreign military sales.” The rule explicitly stated that “Costs associated with the implementation of an offset agreement directly between a contractor and a foreign government are not allowable.” However, on July 15, 1991, the DOD issued Departmental Letter 91-015 enabling defense contractors participating in FMS contracts to recover the costs associated with administering offset agreements between contractors and the foreign government. (56 FR 67208, 30 December 1991)

Until this change, only offset costs associated with a DOD-approved offset agreement were allowable. This change resulted from a recommendation made by the DPACT. (56 FR 34030, 25 July 1991) Finally, a revised and renumbered DFARS that put this interim change into place was published at the end of July with an effective date of 31 December 1991. (56 FR 36280, 31 July 1991)

Two subparts in the revised DFARS pertained to offsets. Subpart 225.7303 addressed “Pricing acquisitions for foreign military sales” and Subpart 225.7307 addressed “Implementation of offset arrangements negotiated pursuant to foreign military sales agreements.” The renumbering and revisions made little difference between the 1991 and 1990 versions. Subpart 225.7303 (1991) had already incorporated the interim rule change that permitted contractors to recover administrative costs of offset arrangements that were part of foreign military sales. Subpart 225.7307 (1991) did not differ substantially from Subpart 225.7310 (1990), except to the extent that the 1991 DFARS referenced the April 1990 Presidential Policy instead of the May 1978 DOD Policy.

Subpart 225.7303 underwent further clarification and revisions in 1994, 1995, 1996 and 1999. The initial Subpart 225.7303-2 revision published in October 1994 emphasized that recovery of offset administrative costs was permitted if “financed wholly with customer cash or repayable foreign military finance credits.” This revision reinforced the notion that the USG would not play a role in satisfying offset arrangements. The point is clearly made in the statement that “The U.S. Government assumes no obligation to satisfy or administer the offset requirement or to bear any of the associated costs.” (59 FR 50511, 4 October 1994)

Between 1994 and 1996, several other changes were made to subpart 225.7303-2. As reflected in the Federal Register on June 5, 1995 (60 FR 29491, 5 June 1995), DOD withdrew the condition that required specific offset information in the DOD Letter of Offer and Acceptance. In September 1995, DOD proposed and removed specific examples of what constitutes an offset administrative cost. (60 FR 49358, 25 September 1995)⁵⁵ In February 1996, DOD changed the operable phrase from “offset administrative costs” to “offset implementation costs.” (61 FR 7739, 29 February 1996)

Finally, and perhaps most significantly, was the addition of subsection 225.7303-5 in April 1996. This subsection addressed the topic of acquisitions wholly paid for from nonrepayable funds (e.g., US appropriated grant funds, etc). Recovery of offset costs was no longer permitted for acquisitions paid for with nonrepayable funds. This April 1996 revision also included a change to 225.7303-2. Both amendments were in response to Section 531A of the Fiscal Year 1996 Foreign Operations, Export Financing, and Related Programs Appropriations Act (P.L. 104-107). (61 FR 18987, 30 April 1996) This law stated that pricing of nonrepayable funds for foreign military sales should be done on the same basis as used for DOD-purchased items. Therefore, since DOD does not incur offset costs for itself, DOD contractors that accept nonrepayable funds as payment for defense sales to foreign customers are not permitted to recover offset costs if these offsets and related costs are required by the foreign government involved. (P.L. 104-107)

⁵⁵ This proposed rule, although incorporated in Subpart 225.7303-2, was never published as a final rule. The author confirmed this situation with members on the staff of the DFARS Council on 29 September 2003.

Pertaining to subpart 225.7307, in June 1997 DOD simplified the title to “Offset Arrangements.” Additionally, the general and procedural information contained in this subpart was replaced with a simple but succinct summary of USG policy on offset arrangements:

In accordance with the Presidential policy statement of April 16, 1990, DoD does not encourage, enter into, or commit U.S. firms to FMS offset arrangements. The decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved. (62 FR 34114, 24 June 1997)

The most recent modification to the DFARS involving offsets occurred in September 1999 when subparts 225.7303-2 and 225.7303-5 were updated to replace “offset implementation costs” with “offset costs.” (64 FR 49683, 14 September 1999) Eliminating the word “implementation” now opened the door for contractors to recover all costs resulting from offset transactions.

3. Procurement Policies

During this same period, Eleanor Spector, the Director for Defense Procurement, issued a memorandum on 13 July 1999 addressing “Pricing Issues in Foreign Military Sales Contracts.” This memorandum was intended to clarify for contracting officers certain pricing issues, particularly those relating to competitive versus noncompetitive procurement and offsets that involved FMS contracts. Significantly, she wrote, “Contracting officers should treat all offset costs as allowable FMS contract costs.” (Spector, 1999) Under Secretary of Defense (Acquisition, Technology, and Logistics) Jacques Gansler reiterated this policy in a 27 September 2000 memorandum. (Gansler, 2000) Both of these memoranda are reflected in language published at DFARS 225-7303(b) and DFARS 225.7303-2(a)(3).

4. Other Activities

During this same period, the USG undertook a number of other significant actions that touched upon offsets. These actions included efforts by the USG to obtain international agreements to limit offsets, to develop a national trade strategy that addressed offsets, and to conduct workshops to gain consensus on managing offsets in defense aerospace trade.

a. *E.C.-US Interpretation*

In July 1992, the US and European Community “agreed to interpret the Civil Aircraft Code as prohibiting offsets.” Under this agreement, the signatories agreed to use price, quality, and delivery terms in making purchase decisions and that government-mandated offsets were not permissible. (US House, 1998, pp. 27-28)

b. *NATO Code of Conduct*

Between 1992 and 1993, the US attempted to further limit defense offsets within the NATO as part of a “Code of Conduct” pertaining to “Principles for Improving Defense Trade Among the Allies.” The language pertaining to offsets stated that “countries will progressively reduce, towards timely elimination, their offset requirements, once they have noted real progress in the opening up of markets.” However, for a variety reasons that transcend offsets policy, the establishment of this Code failed. (US DOC, BXA, 1996, p. 68)

c. *Workshops to Gain Consensus*

In February 1997, the White House National Economic Council (NEC) requested the National Research Council Board on Science, Technology, and Economic Policy (STEP) “to examine the impact of offsets on the US aerospace industry.” In response the STEP Board convened two workshops at the National Academy of Sciences, one on 9 June 1997 and another on 14 January 1998. These workshops brought together experts on offsets from academia, government, industry, and labor. The purpose was to deepen understanding of offset issues, identify areas of consensus, place offsets in context, and “advance...the national dialog on aerospace offsets.” The results of these meetings were published in 1997 and 1999 as “Policy Issues in Aerospace Offsets” and “Trends and Challenges in Aerospace Offsets,” respectively. (Wessner, 1999, pp. xi-xiii)

F. SUMMARY

Between 1991 and 2003, overall activity of the USG remained, as measured by the number of interactions, at the same level as the previous decade with respect to development of USG policy and practice towards offsets. Offset-related activity in Congress declined when compared to the previous decade (e.g., fewer Congressional hearings), but became more directly focused and actually resulted in change to specific offset-related policies and procedures. Executive branch activities increased with

numerous changes to offset-related regulations, particularly within the DOD. Additionally, the executive branch continued to study and report on offsets. The most promising activity during this period was formation in December 2000 of a US Commission to study defense offsets and a parallel Council established by the President to examine commercial offsets.

Within the legislative branch, the House conducted only two hearings during this period (as contrasted to ten between 1981 and 1990), but the GAO published six offset-related reports that maintained the debate on offsets. As in the previous period, those Members exhibiting the most interest in offset issues were Democrats representing states and districts with strong unionized, working class constituents from Wisconsin (Senator Feingold), Illinois (Representative Collins), Massachusetts (Representative Tierney), and Connecticut (Senator Dodd). However, Senators effected the most change to offset-related policies and practices. Most significantly, GAO provided no fewer than three of its six reports on offset practices to Senator Feingold who was responding to concerns raised by one of his constituents with legislation that would curb negative effects of offsets. Specifically, amendments introduced by Senator Feingold were enacted that modified the AECA to prevent third party incentive payments and to eliminate the use of nonrepayable, appropriated funds to finance offset arrangements. Senator Dodd initiated action during 2003 that was enacted into law requiring yet another study of the effect of offset arrangements on specific subsectors of the US industrial base and mandating another report to Congress by March 2005.

In the executive branch, reporting requirements continued to be met. OMB provided reports in 1991 and 1992 in response to earlier requirements from the NDAA of 1989. However, in response to a 1992 amendment to the DPA, executive branch responsibility and reporting transferred from OMB to the DOC. The DOC, which had produced information relating to offsets in 1992 as a result of the OTCA of 1988, produced its first offset report in response to the DPA in 1996. By July 2003, the DOC had produced a total of seven reports. The 1992 amendment to the DPA also caused the DOC to change the National Industrial Base Regulations requiring US industry to provide an annual report on offset agreements and transactions.

DOD had no further direct involvement in actual offset arrangements during this period. However, DOD regulations pertaining to foreign sales were adjusted numerous times to reflect legislative changes. Also, more than ten changes were made in defense procurement regulations via the DFARS and memoranda from senior defense procurement officials. These procurement changes recognized offset costs involving nonrepayable funds as an allowable cost of doing business with a foreign government and enabled US contractors to recover these costs.

As early as the DPA 309 report produced in 1996, the DOC had called for a national dialog to discuss the various impacts of defense offsets. The DOC, along with DOD and the White House National Economic Council, sponsored workshops in June 1997 and January 1998 by the National Research Council that initiated a dialog between government, industry, labor, and academia on issues related to aerospace offsets. This dialog continued in 29 June 1999 hearings before the Subcommittee on Criminal Justice, Drug Policy, and Human Resources of the Committee on Government Reform on the topic, “Defense Offsets: Are They Taking Away Our Jobs?”

The Defense Offsets Disclosure Act of 1999 established a National Commission on the Use of Offsets in Defense Trade that would continue this dialog between government, industry, labor, and academia. President Clinton established the Offset Commission during the last month of his term in office. The Commission met in December 2000 and provided an interim report in January 2001. However, the Commission faded from view, as no executive branch participants were named by the Bush administration to continue the dialog. Further efforts to reconstitute the Offsets Commission have failed.

As in the previous period, constituents concerned about employment continued to bring offsets as a potential area of concern to the attention of Members of Congress. Like the activities in previous periods, the number of studies and reports increased. However, unlike the prior decade, activities between 1991 and 2003 resulted in real changes in offset-related policies and procedures that allowed contractors to recover offset costs, restricted the use of nonrepayable financing, and imposed stiff penalties for making offset-related incentive payments.

VII. CONCLUSION AND SUGGESTIONS FOR FURTHER RESEARCH

This chapter provides a summary and conclusions regarding the determinants of US offset policies and practices developed during each period, as well as an overall summary of offset policy development. It provides a comparison of the economic environment and offsets; reviews principal USG participants and their roles with respect to offsets; and identifies offset-related activities and the development of offset-related legislation, policy and regulations. Table 2 provides a chronology of significant USG offset-related events that occurred from the inception of offsets following World War II through 2003. The summary concludes with insights into the primary and secondary causes of offset policy development and suggestions for further research.

A. SUMMARY AND CONCLUSIONS

Offsets are another mechanism through which governments seek to manage or control trade in certain international transactions. These offset practices challenge the principle of comparative advantage and create barriers to free trade. Offsets can be seen as governmental strategies designed to protect national interests as well as to enhance the transactional value of traded goods or services – particularly within economic sectors related to defense and national security. Offsets are one of the many practices that governments use to protect as well as promote development of domestic interests and one of the tools that industry uses to respond to increasingly competitive markets.

Market structure is one reason that governments choose to use offset mechanisms. Offset use is minimal to nonexistent in market structures that approach perfect competition (i.e., markets with many buyers, many sellers, no barriers to exit or entry, complete information, etc.). Conversely, governments conducting business within imperfect market structures, e.g., those that have few buyers, few sellers, entry/exit barriers or incomplete, asymmetrical information, often employ offset mechanisms.

In addition to market structure, three distinct features mark offset transactions: purchasing government involvement, supplier reciprocity, and preferential treatment of suppliers providing reciprocity. Offsets are also characterized, in certain cases, by dollar value threshold and limited to key sectors of trade.

<u>DATE</u>	<u>EVENT</u>
Post WW II	Licensed production arrangements in Europe and Japan.
1961-1976	US-German “offset” arrangements for maintaining US troops in Europe.
April, 1974	First Offset Agreement signed between DOD and Australian MOD.
June, 1975	Coproduction/Offset Agreement “Deal of the Century” signed between DOD and European Participating Governments for F-16.
July, 1975	Offset Agreement signed between DOD and Swiss Federal Military Department for F-5.
November, 1976	DEPSECDEF Clements Offsets Policy published, discouraging DOD participation in offsets.
May, 1978	DEPSECDEF Duncan Offsets Policy published, withdrawing DOD participation in offsets except in exceptional circumstances.
May, 1981	First mention of offsets in congressional document.
September, 1981	First congressional subcommittee hearings to address offsets.
April, 1984	Section 309 of the Defense Production Act (DPA) enacted (50 U.S.C. App. 2099). First legislation on offsets (required publication of offset reports).
1984	Offset Agreement between DOD and Dutch MOD for Patriot.
October, 1986	Section 309 of the DPA amended, changing content of offset reports.
September, 1988	Section 2505 (subsequently renumbered as 2532) of Title 10 enacted (10 U.S.C. 2505), requiring establishment of US policy on offsets and additional reports.
August, 1989	DOD intervention in offset agreement for Korean Fighter Program.
April 1990	Publication of President’s policy on offsets in military exports.
15 July 1991	DOD interim rule change to DFARS enabled contractors to recover offset costs.
October, 1992	Section 309 of the DPA amended, incorporating President’s policy on offsets as congressional policy. Also changed content of offset reports and made Department of Commerce the executive agent for offsets and offset reports.
April, 1994	The Arms Export Control Act (AECA) was amended to add offset requirements. Section 36 of the AECA (22 U.S.C. 2776) was amended to add a requirement to inform Congress of the existence of offsets via pre-sale notification. Section 39A of the AECA (22 U.S.C. 2776A) was added to prohibit incentive payments resulting from offsets.
February, 1996	Section 22 of the AECA (22 U.S.C. 2762) eliminated the payment of offset costs involving foreign sales wholly involving nonrepayable funds.
July, 1996	Section 36 of the AECA (22 U.S.C. 2776) was amended to require publication of unclassified pre-sale notification data in the <i>Federal Register</i> to include publication of whether an offset sale did or did not exist.
November, 1999	The Defense Offsets Disclosure Act was enacted. • Section 309 of the DPA amended establishing a National Commission on Offsets. • Section 36 of the AECA (22 U.S.C. 2776) was amended to clarify the level of offset information in notifications to Congress.
December, 2000	National Commission on Offsets convened.
September, 2003	Title 10 amended to require additional offset reports from DOD.

Table 2: A Chronology of Significant Events Associated With USG Policy and Practice Relating To Offsets in International Trade

1. Level of Offsets Activity and Summary of the Economic Environment

Level of activity provides a quantifiable characterization of offset policy development, taking into account the number of enacted laws, significant bills, congressional hearings, regulatory or policy changes, and studies and reports associated with offsets. Figure 4 along with Table 3 provides a summary that illustrates the development of USG offset-related activities between 1973 and 2003. To account for the fact that the time periods are not identical, the author divided the number of activities by the number of years in each time period to provide an average number of offset activities for each time period. The author then arbitrarily assigned a valuation of “Low” for periods with fewer than two interactions per year; “Medium” for periods with between two and four interactions per year, and “High” for periods with four or more interactions per year.

For the eight-year period between 1973 and 1980, the USG engaged in at least 14 different offset-related activities, mostly DOD offset agreements or issuance of policy statements or regulations. This period is regarded as “Low” in terms of offset policy development activity. For the ten-year period between 1981 and 1990, offset policy development activity was “High,” with more than 40 interactions. While DOD activity declined to a half-dozen interactions, overall participation by USG agencies in offset-related activities tripled during this period, primarily as a result of direct congressional interaction (mostly hearings) and reports issued in response to congressional demands.

For the thirteen-year period between 1991 and 2003, direct congressional activity declined, but executive branch responses to Congress on offsets increased. Therefore, the activity level remained “High” during this thirteen-year period, with a total 52 interactions.

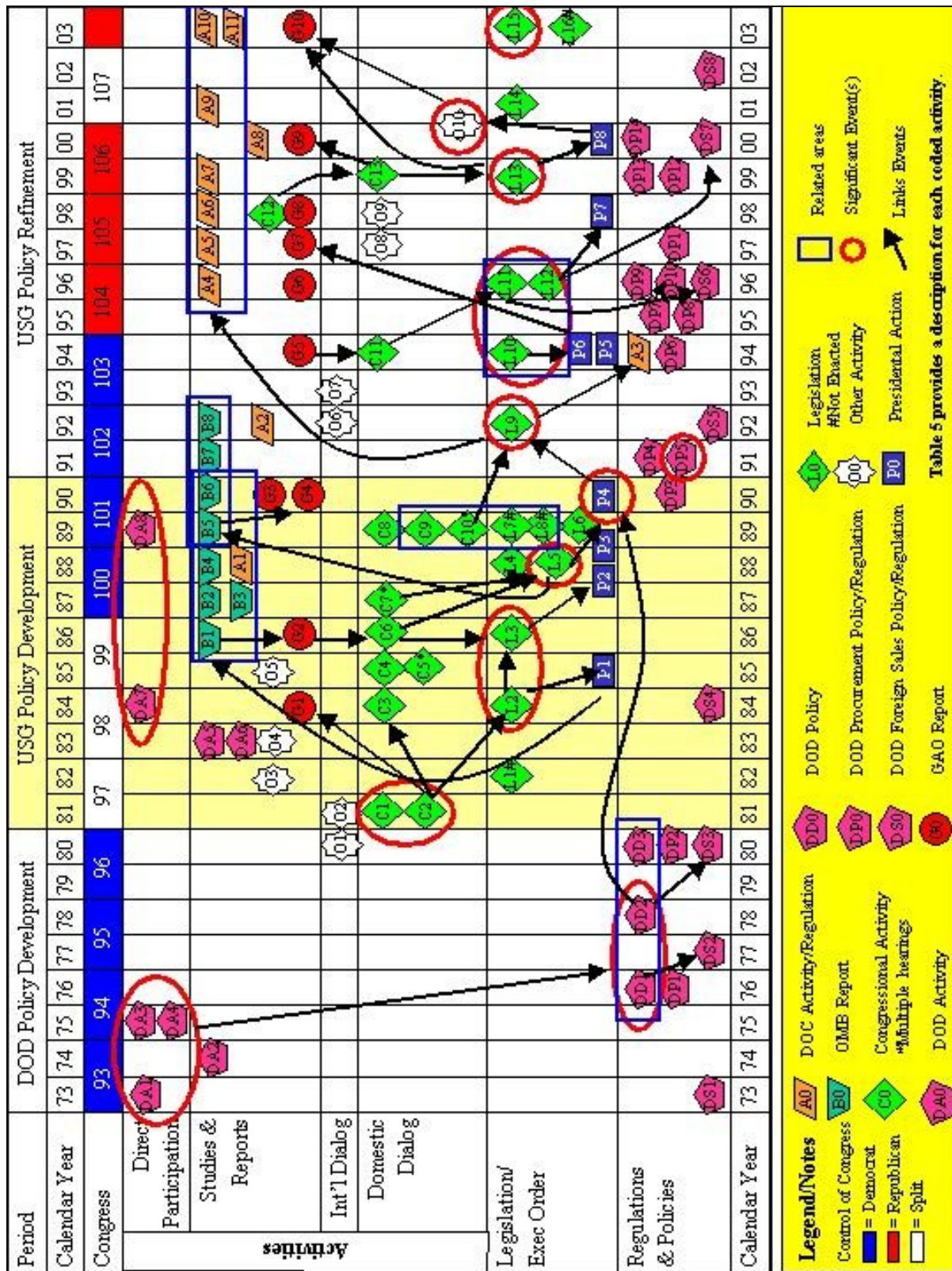


Figure 4: Summary of USG Offset Activities Between 1973 and 2003

Code	Title	Date	Code	Title	Date
A1	BEA Survey	1988	DP12	DFARS Offset Costs	Sep-99
A2	ITA Guide/Practice	Aug-92	DP13	USD(DP) Policy Memo	Jul-99
A3	Offset Regulation	Dec-94	DP14	USD(AT&L) Policy Memo	Sep-00
A4	1st DOC Report	May-96	DS1	Introduction into MASM	Jan-73
A5	2nd DOC Report	Aug-97	DS2	MASM Incorporates Clements Policy	Jun-77
A6	3rd DOC Report	Aug-98	DS3	MASM Incorporates Duncan Policy	Jun-80
A7	4th DOC Report	Dec-99	DS4	MASM becomes SAMM	Apr-84
A8	ITA Evolution	Mar-00	DS5	SAMM: Offset cost recovery allowed	Mar-92
A9	5th DOC Report	May-01	DS6	SAMM: Implement non-use of repayable funds	Jan-96
A10	6th DOC Report	Feb-03	DS7	SAMM: Implement minor changes from DODA	Jan-00
A11	7th DOC Report	Jul-03	DS8	SAMM: Minor, nonsubstantive change	May-02
B1	OMB Report Dec 1985	Feb-86	G1	Trade Offsets	Apr-84
B2	OMB Report Dec 1986	Feb-87	G2	Military Exports	Apr-86
B3	OMB Summary	Dec-87	G3	Defense Authorizations Act	Apr-90
B4	OMB Report Dec 1987	Jan-88	G4	Offset Implementation	Dec-90
B5	OMB Report Dec 1988	Jan-89	G5	FMF Concerns	Jun-94
B6	OMB Report Apr 1990	Jul-90	G6	Demands Grow	Apr-96
B7	OMB Negotiations Report	Jun-91	G7	Incentive Payments	Aug-97
B8	OMB Negotiations Report	Dec-92	G8	Diverse Activities	Dec-98
C1	House Report 97-48	May-81	G9	Data Collection	Oct-00
C2	Revitalization Hearing	Sep-81	G10	Status Report on Offsets Commission	May-03
C3	Trade Offset Hearing	May-84	L1	H.R. 5540#	May-82
C4	US Trade Hearing	Jul-85	L2	P.L. 98-265 (DPA)	Apr-84
C5	FMS Offsets Hearing*	Oct-85	L3	P.L. 99-441 (DPA)	Oct-86
C6	Offsets Agreement Hearing	Jun-86	L4	P.L. 100-418 (OTCA)	Aug-88
C7	Countertrade Hearing*	Jul-87	L5	P.L. 100-456 (NDAA)	Sep-88
C8	GAO Offsets Brief	Apr-89	L6	P.L. 101-189 (NDAA)	Nov-89
C9	House Hearings on DPA	May-89	L7	H.R. 486#	Jan-89
C10	Senate Hearings on DPA*	Nov-89	L8	S. 1379#	Jul-89
C11	Military Sales/FMF Hearing	Jun-94	L9	P.L. 102-558 (DPA)	Oct-92
C12	House Minority Report	Oct-98	L10	P.L. 103-236 (AECA)	Apr-94
C13	Taking Away Jobs Hearing	Jun-99	L11	P.L. 104-107 (AECA)	Feb-96
DA1	Australian Offset Agreement	Apr-73	L12	P.L. 104-164 (AECA)	Jul-96
DA2	DOD Audit Report	May-74	L13	P.L. 106-113 (DODA amended: DPA and AECA)	Nov-99
DA3	EPG Agreement	Jun-75	L14	P.L. 107-47 (DPA)	Oct-03
DA4	Swiss Offset Agreement	Jul-75	L15	P.L. 108-87 (Defense Appropriation)	Sep-03
DA5	DOD IC/IPA Report	Aug-83	L16	S. 1680#	Dec-03
DA6	DPACT Report	Dec-83	O1	GATT/TCA	Jan-80
DA7	Dutch Patriot Agreement	1984	O2	GATT/GPA	Jan-81
DA8	DSCA KFP Intervention	Aug-89	O3	USITC Analysis	1982
DD1	DOD Policy (Clements)	Nov-76	O4	Treasury/AIA/EIA Report	May-83
DD2	DOD Policy (Duncan)	May-78	O5	USITC Survey	1985
DD3	DOD Instruction 2010.6	Mar-80	O6	E.C.-US Interpretation	Jul-92
DP1	Introduction into ASPR	Sep-76	O7	NATO Code of Conduct	1993
DP2	Initial DAR	Oct-80	O8	NRC Workshop I	Jun-97
DP3	DFARS 225.73 Revision	Nov-90	O9	NRC Workshop II	Jan-98
DP4	DFARS Proposed no offset recovery	Feb-91	O10	Offset Commission Hearing/Report	Jan-01
DP5	DFARS offset cost recovery allowed	Jul-91	P1	EO 12521 (DPA)	Jun-85
DP6	DFARS Offset Admin Costs	Oct-94	P2	EO 12649 (DPA)	Aug-88
DP7	DFARS info not in LOA	Jun-95	P3	EO 12661 (OTCA)	Dec-88
DP8	DFARS examples removed	Sep-95	P4	Offsets Policy	Apr-90
DP9	DFARS Offset Implement Costs	Feb-96	P5	EO 12919 (DPA)	Jun-94
DP10	DFARS no-nonrepayable funds used	Apr-96	P6	Presidential Memo (AECA)	Jul-94
DP11	DFARS offsets data reduced	Jun-97	P7	EO 13091 (AECA)	Jun-98
* Denotes multiple hearings conducted			P8	EO 13177 (DODA)	Dec-00
# Denotes legislation not enacted into law			Bold indicates significant offsets event		

Table 3: List of USG Offset Activities Between 1973 and 2003

Table 4 provides a summary for each time period studied in this thesis, comparing available⁵⁶ economic, employment, and offsets data to the type and level of activity in US offset policy development. For the entire period between 1950 and 2002, the US GDP remained strong, growing from \$1,687 billion to \$9,440 billion, reflecting an annual 3.37 percent rate of real growth. Though the negative impact of offsets on the US economy is frequently cited as a reason for examining them, the available data do not demonstrate a correlation between GDP and offset activity. With an increase in both GDP and offsets, the impact of offsets on the economy is not obviously negative.

Period	US GDP Growth Rate	Avg US Unemployment	US Aerospace Employment (K=1,000 persons)	Annual Average Value of Offsets (\$ billions)	Percent of Offset Value to Contract Value	Number of Countries Engaged with US in Offsets	US Offset Policy Development
1950-1960	3.17%	4.6%	Data either not germane or unavailable				
1961-1972	4.38%	4.9%					
1973-1980	2.50%	6.6%	Growth from 666K (1974) to 775K (1979)	\$1.4 (1975 to 1981)	67%	23	Low – DOD only
1981-1990	3.52%	7.1%	Growth from 775K (1979) to 946K (1990)	\$2.5 (1980 to 1987)	58%	30	High – Congress
1991-2003 ⁵⁷	3.20%	5.5%	Decline from 946K (1990) to 580K (1995)	\$3.7 (1993 to 2000)	61%	37	High – Congress and DOD
Overall Summary	3.37% (Avg.)	5.7% (Avg.)	Overall Decline 666K (1974) to 580K (1995)	Increasing Trend	Slightly Declining Trend	Increasing Trend	High – since 1981

Table 4: Summary Comparison of Economic, Employment, Offsets, and Policy Development

On the other hand, increases in overall unemployment rates and the actual declines in aerospace employment demonstrate a relationship with the high level of activity in US offset policy development. Between 1981 and 1990, overall aerospace

⁵⁶ Between 1950 and 1960, licensed production and coproduction programs were not recognized as offset transactions, per se; therefore, data pertaining to offsets information was unavailable. Similarly, the “offset agreements” during the 1961 through mid-1970 period actually constituted an allied burden-sharing arrangement; therefore available data pertaining to these offset agreements is not included.

⁵⁷ Economic and employment data is for the period 1991-2002; aerospace data is available for 1995; offset values, values of associated contracts, and number of countries is provided for 1993-2000.

employment was high which would logically correlate with a low level of policy development activity; however, overall unemployment for this period was higher than any other period. Since employment was cited as a key congressional concern, this could be pointed to as one reason for the high level of policy development activity. Conversely, between 1991 and 2002, overall unemployment was dramatically reduced, which should have led to decreased offset policy activity. However, the dramatic decline of employment in the aerospace sector helped to maintain a high level of offset policy development.

Regarding offset data, three different studies were conducted by three different agencies using three different methodologies to obtain offset-related data. Recognizing that disparities between different sets of data are highly likely, this data is used to provide a rough comparison of offset activity during the period covered by the studies to develop overall trends. No attempt has been made to normalize the data across the various periods. The value of offsets as a percentage of contract value appeared to decline slightly. Overall, the annual average value of offsets with US companies and the number of countries participating with US companies both increased. There does appear to be a correlation between these two areas and a high level of offset policy development. In other words, as the value of offsets and the number of countries demanding offsets increased, so did the level of offset policy development.

2. Principal USG Participants and Their Roles with Respect to Offsets

From 1973 to 1980, few non-DOD government agencies were involved in offsets. During this time, DOD actively participated in offset agreements, developed policy and regulations relating to offsets, and provided offset-related studies and reports. Principal entities within DOD involved with offsets included offices involved with defense procurement regulations and FMS. Both the Secretary and Deputy Secretary of Defense were engaged in all aspects of offsets and were instrumental in establishing the first high-level offset-related policy determinations.

During the period 1981 to 1990, Congress emerged as the principal protagonist on offset related matters. Legislators representing states and districts where organized labor was strong led efforts to mandate reporting requirements. House legislators were most active, and within the House, members of the Subcommittee on Economic Stabilization

of the Committee on Banking, Financing, and Urban Affairs were the most active, conducting the first offset-related hearing in 1981 and four additional hearings on offsets by 1989. Most importantly, though, an executive branch interagency group formulated the USG policy on offsets in military trade that President Bush signed in April 1990.

From 1991 to 2003, the Senate became active, as certain Senators responding to concerns raised by constituents worked to impose stiff penalties for making incentive payments related to offsets, to restrict appropriated grant funds from use in offset transactions, and to increase offset reporting and study requirements. The legislation involving third-party incentive payments for offsets, while original, was also characterized by ambiguity and the absence of implementing regulations. Legislation to restrict the use of appropriated funds ratified an earlier decision by DOD to phase out use of these types of funds to pay for offset costs in foreign sales transactions.

DOD was also actively involved during this period, adjusting procurement regulations to allow recovery of offset costs incurred by US contractors. The Offsets Commission, which was established and met in 2000, appeared to offer a promising avenue for a robust dialog on US offset policy. However, the Commission was unable to move beyond providing an initial status report due to changes in Presidential Administrations.

3. Activities that Influenced US Offset Policy Development

This subsection provides a summary of the broad array of offset-related activities in which the USG was involved since 1973 that influenced the development of US offset policy. These activities are grouped into four areas: participating in offset arrangements, studying and reporting on offsets, addressing offsets in international forums, and conducting domestic dialog on offset practices.

a. Participating in Offset Arrangements

DOD participated in at least four major offset arrangements between 1973 and 1984 and intervened to limit a commercial offset arrangement in 1989. The early offset arrangements between 1973 and 1975 with Australia for guided-missile frigates, with the EPG for F-16 aircraft, and with Switzerland for F-5 aircraft, led DOD to make exceptions to “Buy America” restrictions allowing industries from these and other countries to bid on DOD procurements. Later, the friction resulting from the failure of

prime contractors to meet Swiss offset obligations in a timely manner led to formulation of the Duncan Policy which stated that DOD would not participate in offsets, but allowed for exceptions limited to US national security interests.

Two activities in the 1980s tested DOD offset policy. In 1984, DOD participated in an offset agreement with the Netherlands to purchase Patriot missile canisters, and, in 1989, DOD intervened with US competitors to limit the level of their offset commitments made as part of the Korean Fighter Competition. Ostensibly, both activities were undertaken in the interest of US national security. Both activities demonstrated that exceptions could be made without wholesale changes to offset policy.

b. Studying and Reporting on Offsets

Studies and reports proved to be the most popular activity to help form offset policy. Executive branch reports prepared by DOD, Treasury, and the USITC were originally self initiated, but subsequent reports prepared by OMB and DOC responded to congressional reporting requirements. Except for a single House study, GAO provided all legislative branch reports. A common finding of these reports was that the use of offsets in international trade was occurring with increasing frequency, expanding to new countries, and growing in terms of dollar value. They also recognized the extreme difficulty of eliminating offsets altogether and that, given a choice, trade without offsets was preferable, but that trade with offsets was preferable to no trade at all. Most government studies also reported that offsets per se did not have a negative effect on national security. Additionally, most government studies concluded that overall US employment and the US economy were stronger because of the use of offsets, but that offsets may have negative effects on the economy and employment in specific subsectors. Interestingly, findings from the first known government report on offsets are echoed throughout subsequent government reports. In particular, this 1974 DOD report stated that no single activity in the US is responsible for engaging in offsets and that no standard system exists to track and report on progress in fulfilling offset obligations.

c. Addressing Offsets in International Forums

Though beyond the scope of this thesis, offset discussions in international forums certainly played a role in helping to shape US offsets policy. These included US efforts in worldwide forums such as the GATT and WTO intended, in a broad sense, to

reduce and eliminate barriers to trade such as offsets. Also, US trade negotiators made efforts to address offsets directly in other GATT/WTO agreements, specifically the GPA and TCA. US trade negotiators achieved some success with the E.C.-US Interpretation of the TCA in eliminating offsets in trade involving civil aircraft. The NATO Code of Conduct served as another opportunity for negotiators to address offsets in a multilateral forum. In regional trade, US negotiators addressed the use of offsets with Mexico and Canada in NAFTA, but allowed offsets for purchases involving defense and national security.

d. Conducting Domestic Dialog on Offset Practices

Within the US, public dialog on offsets began with congressional hearings in 1981. Congressional subcommittees conducted more than ten hearings between 1981 and 1999 to address offset-related matters.⁵⁸ During and since that time, some witnesses have taken the opportunity to decry the use of offsets as part of testimony addressing other issues (e.g., proliferation of US arms sales, unfair practices in world trade etc.). The executive branch also conducted workshops in 1997 and 1998 to continue dialog and gain consensus on the use of offsets. Again, the one group of activities that held the most promise to further offset policy development was the hearings conducted by the Offset Commission, although, as of December 2003, no action has resulted from these particular hearings.

All of these hearings and workshops were used to gain a better understanding of offset-related issues from experts within government, industry, academia, and labor. A common theme emerging from these discussions is the absence of solid data on the impact of offsets to enable decision makers to determine and take appropriate actions. Additionally, this public dialog called for and resulted in further studies, reports, and more discussions on offsets. Of these domestic dialogs, congressional hearings were the most prolific. Legislators, in particular, used congressional hearings to discuss proposed legislation and to demonstrate that they were taking action on matters important to their constituents and the nation. Of the nine laws

⁵⁸ Congress did not hold any hearings to specifically address offsets between 1999 and 2003.

enacted between 1984 and 2003 that directly introduced or amended offset-related provisions, seven had their foundation in subcommittee hearings on offsets.⁵⁹

4. Offset-related Legislation, Policy and Regulations

Numerous pieces of legislation were proposed between 1981 and 2003 that directly or indirectly affected offsets. Offset policy was initiated first at senior levels within DOD and then at the presidential level. Congress adopted the President's offsets policy and added legislation to set some minor policy pertaining to offsets as well. Also, senior procurement officials in DOD affirmed procurement policy relating to offsets.

Except for one regulation published by the DOC, DOD published all offset-related regulations. The regulations addressed offsets relating to defense procurement and foreign sales made via government-to-government channels.

a. Legislation

Because offsets touch upon issues relating to the defense industrial base, armed forces, and foreign military sales, legislation pertaining to offsets is included in a number of different parts of the US Code. Early legislation found in Section 309 of the DPA (50 U.S.C. App. 2099) focused upon a requirement for the executive branch to collect, study and report specific information related to the impact of offsets. Legislative attempts to move beyond reporting failed until September 1988, when Section 825 of the NDAA of 1989 was enacted (10 U.S.C. 2505). In addition to reporting requirements, Section 825 directed the President to develop a US policy on offsets and to begin negotiations with trading partners to limit offsets and required industry to report on offsets that exceeded a specific monetary threshold. With the renewal of the DPA in October 1992, Congress incorporated the President's Offset Policy into law. Various portions of the AECA were also amended to adjust offset reporting and notification requirements (22 U.S.C. 2776), to impose stiff penalties for any contractor engaged in providing third party incentives (22 U.S.C. 2779A) for offset programs and to restrict the use of appropriated funds to pay offset costs as part of a foreign sales (22 U.S.C. 2762). The DODA of 1999 (P.L. 106-113) established the Offsets Commission and inserted new

⁵⁹ The exceptions were the offset provisions included in the 1994 Feingold Amendment P.L. 103-236 and the 2003 Dodd Amendment P.L. 108-87. Additionally, other laws discussed throughout this thesis that had either an indirect or little impact on offsets included 1996 amendments to the AECA resulting from P.L. 104-107 and P.L. 104-164 and a 2001 change to the DPA resulting from P.L. 107-47.

language regarding the policy of the US to monitor offsets, to promote fairness in international trade and to ensure that foreign participation in building US weapon systems does not harm the US economy. In addition to the Commission, the DODA called upon the President to develop a multilateral strategy to address offsets.

On 30 September 2003, the DOD Appropriations Act for 2004 was signed into law (P.L. 108-87). Section 8138 of this law continues to seek solutions to the offsets problem through studies and reports by requiring that the Secretary of Defense issue a report to the President regarding the use or administration of offsets. As of December 2003, Congress continues consideration of additional legislation that further details the level of reporting under DPA Section 309.

b. Policy and Regulations

With the exception of the President Bush's offset policy in 1990, the 1994 DOC change to the National Industrial Base Regulations incorporating industry offset requirements, and the inclusion of offset policies in legislative language, DOD has published all offset-related policies and regulations between 1973 and 2003.⁶⁰

Important offset policies for DOD and the USG emerged in 1976 (Clements Policy) and 1978 (Duncan Policy). The Duncan Policy, in particular, is generally regarded in academic literature and government documents as a point of departure for offset agreements. Prior to this time, DOD actively participated in offset agreements. However, believing that offsets created unnecessary friction with allies and were difficult to implement and negotiate and recognizing that offsets were economically inefficient, Secretary Duncan curtailed DOD involvement in offsets except for interests of national security. His policy also provided for semi-annual reporting on offsets.

Within DOD, FMS policies and procurement regulations were amended to incorporate first DOD and then USG policies on offsets. FMS policies and procurement regulations paralleled one another and incorporated further changes in response to legislation. In 1991, defense procurement regulations instituted a substantive change in response to a DPACT recommendation that recognized offset costs as an allowable

⁶⁰ The DOS has not made required regulatory changes as a result of offset-related provisions in P.L. 103-236.

charge for doing business with a foreign government. Prior to this change, contractors had been unable to easily recover offset costs incurred as part of a contract resulting from FMS. Policy memoranda signed by senior DOD procurement officials in 1999 and 2000 affirmed offsets as allowable costs.

The President's statement on offset policy was essentially a restatement of current practices within the DOD, restricting offset policy considerations to military exports. However, the 1990 Bush policy statement did elevate the approval authority for USG participation in offsets to the President through the NSC. Additionally, this policy called for consultations with allies regarding the use of offsets in defense procurement.

Legislation also incorporated offset policy into the DPA, AECA, and Title 10. Often this policy paralleled executive branch policy; however, different laws established slightly different policies and offered different definitions of what constituted offset practices.

5. Conclusions

Within the executive branch, DOD offset policies first arose from friction with foreign customers, management complexities and resource drains that arose from direct involvement in offsets. DOD recognized economic inefficiencies and had first-hand experience with problems resulting from offsets, but tolerated offsets and similar practices in order to protect its interest in requiring domestic production of equipment designs procured abroad. However, in 1991 as a result of DPACT-recommended changes to defense procurement regulations, DOD accepted responsibility for collecting offset costs from foreign customers and passing these along to contractors involved in FMS contracts.

At the federal level, a similar rationale applies for supporting the President's Offsets Policy. Here, too, the USG recognizes that offsets are inefficient and market distorting. Like the DOD policy, USG policy did not want to undermine industry or relinquish domestic managed trade practices (e.g., set-aside programs, etc.). Hence, similar to DOD, federal officials opted to tolerate, but not participate in offsets, keeping them at "arms length."

While initially articulated in a wide variety of areas (e.g., economy, national security, defense industrial base, etc.), legislative branch concerns with offsets are primarily due to perceived employment impacts. Legislators consistently highlighted concerns for jobs, primarily in the aerospace industry, when investigating the impact of offsets. Legislators added reporting requirements for offsets to the law and later passed legislation to enhance reporting to gain more and better information.

Offsets, themselves, add complexity to international trade. With slightly different offset policies between the executive branch and legislative branch, distinctions between various offset-related statutes and somewhat dissimilar definitions found in these policies, US offset policy is somewhat ambiguous. The laws, policies and practices that developed between 1973 and 2003 are complex and ambiguous because they were developed by different executive agencies with unique missions and by numerous congressional committees having various jurisdictions and varying constituencies. Taken as a whole, these policies are best described as laissez-faire, striking a rough balance between those who want to do away with offsets due to the perceived threat to US employment and those who tolerate offsets as an integral and necessary part of complex business transactions in the global economy.

B. SUGGESTIONS FOR FURTHER RESEARCH

The research conducted for this thesis investigated the determinants of USG policy and practice towards offsets in international trade. Further research in the area of USG involvement in offsets is warranted, particularly with respect to trade involving offsets that are not military exports, both those that are related to government purchases and those that may be commercial in nature. This research would provide insight as to the extent of offset arrangements that exist outside of the defense sector as well as those that exist beyond the bounds of government procurement.

For example, the literature discusses the use of offsets for large projects such as telecommunications systems and power plants. In another example, GAO reported on 18 June 1997 to the Senate Subcommittee on Science, Technology and Space of the Committee on Commerce, Science and Transportation that the National Aeronautical and Space Agency (NASA) was negotiating offset agreements as part of the International Space Station. GAO reported that NASA was working with “foreign partners and

another foreign participant to build hardware for the United States in return for free or reduced costs access to and use of the station, or other consideration.” (US GAO, 1997, “Space Station,” p. 6)

Identifying alternatives to offsets within defense acquisition would also prove valuable. For example, the Subcommittee on National Security, Emerging Threats and International Relations of the House Committee on Government Reform conducted hearings in July 2003 entitled, “Is DOD Meeting Joint Strike Fighter [JSF] International Cooperative Program Goals?” Administration witnesses stated that JSF was pursuing “best value sourcing” as a “fundamental departure from offsets.” (US House, 2003, p. 9) The “best value sourcing” approach for acquisition programs such as JSF could be compared and contrasted with the offset approach taken by programs such as the F-16.

Another important area of offsets worthy of research would be to determine costs associated with implementing offset agreements. This should encompass the magnitude of costs incurred by both the buyer and the seller. Additionally, this research would identify how these costs are paid and identify who pays these costs. This research would serve to clarify perceptions relating to offset costs.

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