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United States General Accounting Office
Washington, DC 20548

October 26, 2000

The Honorable John L. Mica
Chairman, Subcommittee on Criminal Justice, Drug
Policy and Human Resources
Committee on Government Reform
House of Representatives

Subject: Defense Trade: Data Collection and Coordination on Offsets

Dear Mr. Chairman:

Defense offsets have gained increasing attention in recent years because of the potential impact they may have on the U.S. economy and national security. Defense offsets are the full range of industrial and commercial benefits that firms provide to foreign governments as inducements or conditions for the purchase of military goods and services. They include, for example, coproduction arrangements and subcontracting, technology transfers, in-country procurements, marketing and financial assistance, and joint ventures. Views on the effects of offsets are divided between those who believe they are an unavoidable part of doing business overseas and those who believe they negatively affect the U.S. industrial base.

In 1984 and again in 1999, the Congress placed data collection and reporting requirements on the administration in an attempt to obtain information as a basis for an analysis of the impact of offsets on the U.S. industrial base. On June 29, 1999, you chaired a hearing to discuss concerns raised by opponents of offsets and explore both sides of the issue.¹ As a result of that hearing, you asked us to review the administration's data collection and policy coordination efforts concerning offsets. Accordingly, you asked us to determine (1) the number of federal agencies collecting data on offsets and the type of data they collect and (2) the extent of coordination among federal agencies for data collection and policymaking related to offsets.

RESULTS IN BRIEF

Three federal agencies are required by law to report to the Congress on defense offsets, although other agencies may collect related data. The Department of

¹ "Defense Offsets: Are They Taking Away Our Jobs?" Hearing before the Subcommittee on Criminal Justice, Drug Policy, and Human Resources of the Committee on Government Reform, House of Representatives, June 29, 1999.

Commerce, the primary agency collecting data on offsets, is required by the Defense Production Act of 1950 to submit an annual report to the Congress on offsets. The Department of Defense is required by the Arms Export Control Act to report offset information to the Congress as part of the information it reports on Foreign Military Sales of defense items to foreign governments. Similarly, the Department of State is required by that Act to report on offset information related to commercial sales of defense items. The Department of Defense also maintains databases that collect data related but not specific to offsets. For example, Defense's Office of Foreign Contracting maintains a record of the extent of foreign participation in defense contracts.

Coordination of data collection on offsets is limited. This lack of coordination, however, may not be significant because the agencies charged with collecting offsets data collect different data covering different time periods or about different offset situations. For example, Commerce collects data on offset activity whereas Defense and State collect information on prospective offsets based on proposed sales. Commerce does, however, coordinate its congressional report with a variety of other agencies. Further, Department of Defense agencies have coordinated on policy changes affecting offsets such as the recent clarification on cost recovery for costs incurred to implement offset agreements. Additional coordination may occur once the National Commission on the Use of Offsets, established by the Defense Offsets Disclosure Act of 1999, begins its work.

BACKGROUND

The rising cost of defense equipment, limited defense budgets, concerns about employment levels, and the importance of industrial competitiveness in a global economy have led governments to leverage their imports of major weapon systems so as to yield benefits for their domestic economies. Offsets are one way to achieve these benefits. Such programs are often an essential part of weapons procurement and allow the purchasing government to build public support for large expenditures of public funds.

Foreign governments can obtain military equipment through the foreign military sales program operated by the Department of Defense (DOD) or directly from defense contractors through commercial sales. These transactions are often accompanied by offset agreements between U.S. defense contractors and purchasing governments. Companies may undertake a broad array of activities such as co-production and subcontracting, technology transfers, in-country procurements, marketing and financial assistance and joint ventures to satisfy offset requirements. Offset agreements may specify a level of offset required and the types of activities that are eligible for offset credit. An offset may relate to the defense item being sold (direct offset) or to some other defense item or even non-defense goods or services (indirect offset). Using offsets, foreign governments can reduce the financial impact of procuring U.S. defense products, obtain technology and manufacturing knowledge, support domestic employment, and create or expand their own defense and commercial industries.

The value of an offset obligation can exceed 100 percent of the value of the export contract. However, countries can grant offset credit that is greater than the dollar

value of the activity to encourage companies to undertake highly desirable offset activities. For example, a country may grant offset credit for advanced technology or training activities based on what the country would have paid to procure or develop the training or technology. Countries may also offer large multipliers to encourage desired activities.²

AGENCIES COLLECTING DATA ON OFFSETS

Three federal agencies collect data specifically on defense offsets to support reports to the Congress that are required by law. These are the Department of Commerce, the Department of Defense, and the Department of State. Other agencies may collect data related to offsets but the purpose and use of the data is generally not related to offsets.

The Department of Commerce has the primary data collection role. The Defense Production Act of 1950,³ requires the Department of Commerce to report annually to the Congress on the impact of offsets on the U.S. defense preparedness, industrial competitiveness, employment, and trade. The regulations⁴ implementing the law require companies to annually report such information as the names of the country purchasing the defense item or service for which the offset is required, the credit value of the offset, the actual dollar value of the offset, and a description of the type of offset. Specifically, Commerce requires companies to report (1) offset agreements entered into during the previous year that are valued at more than \$5 million and are associated with sales of defense articles or services and (2) completed offset transactions being used to meet existing offset commitments that have a credit value of at least \$250,000. A complete list of the information Commerce collects is included in enclosure I.

The Departments of Defense and State report offset information to the Congress pertaining to individual sales of defense items. The Arms Export Control Act⁵ requires the President to notify the Congress of any agreements to sell defense articles or services over a certain amount. The President delegated this reporting function to the Secretary of Defense for foreign military sales agreements and to the Secretary of State for commercial sales of defense items that require an export license.

Prior to November 29, 1999, the law required that the congressional notification contain only a statement of whether or not an offset agreement was associated with the sale, if that fact was known. The Defense Offsets Disclosure Act of 1999⁶ amended the Arms Export Control Act to require a description of the offset agreement. The Defense Security Cooperation Agency, which is responsible for preparing notification packages for the Secretary of Defense, has not provided guidance on what specific information industry is to report. The State Department is

² A multiplier is used to increase the value of an offset project when determining offset credit. For example, if a company helped facilitate a \$10,000 export of a product with particular importance, the country could offer a multiplier of 5, thereby increasing the amount of offset credit to \$50,000.

³ 50 USC app. §2099, as amended.

⁴ 15 CFR Part 701.

⁵ 22 USC 2776, as amended.

⁶ 22 USC 2776 (b)(1) and (c)(1) as amended by section 1245 in appendix G of P.L. 106-113.

drafting guidance that it plans to issue late in 2000 to respond to the increased reporting requirement.

In addition to the information needed to comply with requirements of the Arms Export Control Act, the Department of Defense collects data potentially related to offsets. Through its Office of Foreign Contracting, the Department collects information from U.S. contractors on the extent of foreign participation in its contracts.⁷ The information is collected to assess matters related to defense trade balances and domestic industrial base capabilities. Prior to 1995, companies were required to state whether the subcontract would apply toward fulfillment of an offset agreement and to what program or offset agreement it was related. DOD officials told us that the requirement for this information was discontinued because many companies did not correctly report the information and it generally was not used in DOD's analyses. The information the Office of Foreign Contracting collects is included in enclosure II.

FEDERAL AGENCY COORDINATION EFFORTS RELATED TO OFFSETS

Federal agencies generally have not coordinated defense offset data collection efforts. This lack of coordination, however, may not be significant because the data being collected by each of the reporting agencies differs or the required reporting time period differs. However, agencies have coordinated on reporting and some policy issues. Coordination has included (1) Commerce's annual report to the Congress on offsets and (2) policy changes incorporated into the Defense Federal Acquisition Regulation Supplement concerning cost recovery for implementing offsets.

As stated above, Commerce collects specific information on transactions that have taken place in relation to a specific effort. For example, companies report to Commerce the name of the entity fulfilling the offset transaction and the dollar value of the offset both with and without any multipliers. State and Defense, on the other hand, have historically reported the existence of a proposed offset connected to the sale of a defense item or service but not the specific transaction undertaken to fulfill the offset requirement. Further, the time periods covered by the reporting differ. Commerce data covers the prior year, whereas State and Defense report prospective offsets without a specific time frame. For example, companies were required to report offsets activities that occurred during calendar year 1998 to Commerce by June 15, 1999, for inclusion in its annual report.

The Department of Commerce is required by section 309 of the Defense Production Act to coordinate its report with other federal agencies, namely the Secretaries of State, Defense, and Treasury, and the United States Trade Representative. In practice, the report is also coordinated through the Office of Management and Budget with the Department of Labor and with several other agencies. Commerce Department officials told us that most agencies perform only a cursory review of the report and provide limited comments. However, some agencies, particularly the Department of Defense, perform a detailed review.

⁷ We reported on problems with this database in Defense Trade: Weaknesses Exist in DOD Foreign Subcontract Data, (GAO/NSIAD-99-8, Nov. 13, 1998).

Recent clarifications to the Defense Federal Acquisition Regulation Supplement (DFARS) also involved coordination among the relevant defense agencies. Section 225.7303 of the DFARS permits U.S. companies to recover all costs associated with implementing offset agreements. However, U.S. companies and the individual military services have interpreted the new section in various ways. These differing interpretations have resulted in confusion over what costs could be charged and how they should be charged. In September 1999, the language in the DFARS was revised to provide clarification that a U.S. defense contractor may recover all costs incurred for implementing offset agreements with a foreign government. This revision was coordinated among various defense agencies and military services.

Federal agencies also have the opportunity to coordinate on policies pertaining to offsets through the Interagency Offset Steering Committee chaired by the Department of Defense. In 1992, Public Law 102-558 directed the Secretary of Defense to lead an interagency team to consult with foreign nations on limiting the adverse effects of offsets. As of September 1, 2000, the interagency committee has met with representatives of the governments of Canada, France, Great Britain, and the Netherlands. They also have sent letters to other nations with which the U.S. government has memoranda of understanding requesting meetings to discuss offsets. The committee recently has also begun to consult with industry.

The Defense Offsets Disclosure Act of 1999 established a National Commission on the Use of Offsets in Defense Trade. The law directs the President to appoint commission members by the end of March 2000 to study the effects of offsets and report back to the Congress one year later. The Commission is to be comprised of members from government as well as industry and academia, and the Office of Management and Budget is to chair the commission. As of September 22, 2000, the commission has not met. However, potential members have been identified subject to congressional approval. This body, once it is established, may provide an impetus to greater coordination of U. S. government data collection and policy efforts concerning offsets.

AGENCY COMMENTS

We requested comments on a draft of this letter from the Departments of Commerce, Defense, and State. The Department of Defense provided technical comments, which were incorporated as appropriate. The Departments of Commerce and State did not provide comments.

SCOPE AND METHODOLOGY

To identify which federal agencies collect data on offsets, we reviewed legislation pertaining to offsets to identify those agencies that have a legislative requirement to collect offset related data. In addition, we contacted various agencies to determine whether they were involved in collecting information on offsets. We also interviewed officials at defense contractors that have offset obligations to determine what kind of data on offsets they are required to submit to federal agencies, as well as to identify the data collecting agencies.

To determine the extent of coordination among federal agencies, we reviewed legislation to determine what coordination is required, interviewed officials at the relevant agencies, and reviewed data on coordination efforts provided by those agencies.

We conducted our work from February through September 2000 in accordance with generally accepted government auditing standards.

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We are sending copies of this letter to the Honorable Norman Y. Mineta, Secretary of Commerce; the Honorable William S. Cohen, Secretary of Defense; the Honorable Madeleine K. Albright, Secretary of State; and the Honorable Jacob J. Lew, Director, Office of Management and Budget. We will also make copies available to others upon request.

Please contact me on (202) 512-4841 if you or your staff have any questions concerning this letter. Major contributors to this letter were Thomas J. Denomme, Paula J. Haurilesko, Lauri A. Kay, and Richard Burrell.

Sincerely yours,

A handwritten signature in cursive script, appearing to read "Katherine V. Schinasi", is written over a vertical line.

Katherine V. Schinasi
Director
Acquisition and Sourcing Management

Information Pertaining to Offsets that Industry
Reports to the Commerce Department

For offset transactions completed during the previous year:

- Name of country or entity purchasing the weapon system, defense item or service subject to offset requirement
- Name or description of weapon system, defense item or service subject to offset requirement
- Name of entity fulfilling the offset transaction
- Name of entity receiving benefits from the offset transaction
- Dollar value of offset credit claimed by entity fulfilling the offset transaction, including any intangible factors or multipliers
- Actual dollar value of offset transaction without any intangible factors or multipliers
- Description of the type of offset (e.g., co-production, technology transfer, subcontract activity, etc.)
- Broad classification of the industry in which the offset transaction was fulfilled (e.g., aerospace, electronics, chemicals, etc.)
- Direct or indirect offset
- Name of country in which the offset was fulfilled.

For offset agreements entered into during the previous year:

- Name of country or entity purchasing the weapon system, defense item or service subject to offset requirement
- Name or description of weapon system, defense item or service subject to offset requirement
- Names and titles of the signatories to the offset agreement
- Approximate value of the export sale subject to offset requirement
- Total value of offset agreement
- Term of offset agreement (in months)
- Description of performance measures (e.g., “best efforts,” liquidated damages)

Information Collected by the Defense
Department's Office of Foreign Contracting

- Prime contract number
- Program identification
- Name and division of prime contractor
- Address of prime contractor
- Name of subcontractor or foreign division of prime contractor
- Address of subcontractor or foreign division of prime contractor
- Value of effort performed outside the United States
- Country of origin of actual producer or service provider
- Description of supplies or services obtained outside the United States
- Name of company submitting report

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