

Offsets in Defense Trade 1996

EXECUTIVE SUMMARY

The costs and benefits of offsets in defense trade have been long debated within the U.S. Government. At issue is the adverse impact that offsets may have on the U.S. employment, industrial, and technology base versus the benefits of increased export levels in a competitive buyers-market business climate, the creation of export-related jobs, and additional sales of U.S. spares and services over the life time of the exported hardware.

Because of the superiority of U.S. technology and weapon systems, U.S. defense companies usually have an advantage over foreign companies in terms of the types of direct and indirect offsets they can provide. However, this superiority presents a double-edged sword. As the world's preeminent supplier of weapons (over 45 percent market share) and high-cost/high-technology hardware, U.S. corporations are also highly vulnerable to offset demands. Their traditional consent to such impositions is a sign of competitive pressures.

The Administration, based on previous studies as well as the current study, continues to be concerned that defense offset practices may be detrimental to the nation's defense industrial base, particularly to small- and medium-sized defense subcontractors. Defense offsets may create or enhance foreign competitors, exacerbate already excessive defense production capacity, displace U.S. firms, and reduce U.S. employment. In fact, the great majority of offset demands are from economies with major commercial competitors of U.S. firms, including Canada, Japan, and most Western European nations. Further, the use of offsets in defense trade has expanded in recent years to additional countries. Moreover, with the apparent increase in the use of indirect offsets, more industries, many not related to defense, may be affected.

In the post-Cold War environment, defense offsets are being used primarily as a tool to achieve economic policy goals. Developed countries with established defense industries are using offsets to channel work or technology to their domestic defense or aerospace companies. Countries with newly industrialized economies are utilizing both military and commercial related offsets that involve the transfer of technology and know-how. The developing countries with less industrialized economies generally pursue indirect offsets to help create profitable commercial businesses and build their infrastructure. All Organization for Economic Cooperation and Development (OECD) countries engage in military offsets. Many emerging markets have offset programs linked to government procurement which either affect designated sectors (e.g., Brazil, South Korea, and Taiwan) or are triggered by the size of the procurement (e.g., Indonesia and the United Arab Emirates).

Findings

Based on BXA 1993-1994 data collection, the following findings are apparent:

1. The average level of offsets in defense trade required by most countries appears to be about the same between the 1980-1987 OMB data and the 1993-1994 BXA data. The average for all countries represented in the OMB data was about 57.2 percent. The average for the BXA data was 54.8 percent (excluding two unusually large sales). The BXA data indicates that several countries (Taiwan, Malaysia, Kuwait, and UAE) have developed new offset policies and now require offsets as a condition of sales contracts.

According to BXA and original OMB data as well as the recently released General Accounting Office report (AMilitary Exports: Offset Demands Continue to Grow@), the level of offsets countries apply tend to increase with time and experience.

2. Indirect defense offsets relative to direct defense offsets are substantially higher than they were in the 1980s. This is based on a comparison of OMB=s new agreements data for 1980-1987, which reported indirect at about 53 percent (excluding unknown), and BXA=s transactions data which indicates indirect are about 67 percent (excluding unknown). The fact that worldwide defense exports are down may underlie the shift toward indirect, and may further reduce demands for direct offsets in the future. About three-fourths of the offsets were comprised of purchases, subcontracting activity, and technology transfer, all of which provide support for local business. It was also noted that the Pacific Rim countries were highly focused in indirect aerospace offsets.

3. With the rise of indirect defense offsets, a broader band of industries is now affected by offsets. Based on OMB billings data (Table 4), over 68 percent of offsets were aerospace related (SIC 372 & 376) compared to just over 45 percent (within SIC 37) for the BXA data. There also appears to be a noticeable increase in non-manufacturing offsets, which were negligible for the OMB data, but are nearly 14 percent in the BXA data.

4. European new offset agreements and offset transactions with the United States as a partner have declined, tracking the decline in defense trade. This is probably closely related to the collapse of the Soviet Union, lowered defense budgets, the European recession, national budget constraints, and more intra-European offset partnering. However, upcoming European and NATO procurements indicate a significant offset requirement and could reverse this trend.