

Offsets in Defense Trade 2001

EXECUTIVE SUMMARY

The U.S. Department of Commerce, Bureau of Export Administration (BXA), Office of Strategic Industries & Economic Security is responsible for assessing the impact of offsets in defense trade on the United States under the authority of Section 309 of the Defense Production Act of 1950, as amended. This report covers the six-year period from 1993 through 1998.

In defense trade, offsets are industrial compensation practices required as a condition of purchase in either government-to-government or commercial sales of defense articles and/or defense services as specified in the International Traffic in Arms Regulations. Offset agreements are commercial contracts between a defense firm and a foreign government. Companies fulfill their offset obligations over a period of time specified in the offset agreement through a series of offset transactions. Transactions are the actual compensation towards the outstanding balance of an existing offset agreement.

Over 120 countries currently require offsets of some sort. Recently, a number of countries have implemented new, formal offset policies, including Brazil, the Czech Republic and Poland; other countries have increased already established offset percentage requirements.

New Agreements

In 1998, U.S. prime defense contractors entered into 41 new offset agreements with 17 countries. The total defense sales to be exported were valued at \$3.1 billion, with corresponding offsets equaling \$1.8 billion. Thus, the average offset required was 57.9 percent of the value of the sales item. Europe dominated the total amount of defense purchases and offsets provided by U.S. prime contractors. Offsets to Europe totaled \$1.3 billion in 1998 alone; this was 72.3 percent of all U.S. offsets to the rest of the world. Europe accounted for about one-half of the value of all associated defense sales. In 1998, the average offset percentage in Europe was 81.6 percent, almost 24 percent higher than the global average.

From 1993 to 1998, U.S. prime contractors signed 279 new offset agreements totaling \$21 billion, which corresponded to \$38.5 billion in U.S. defense export sales. These new agreements averaged 54.5 percent of the value of the defense item. Approximately 72 percent of the value of new offset agreements was attributed to European nations; the United Kingdom alone was responsible for 23 percent. Almost one half of all new agreements required 100 percent or more in offsets. For the period, offsets with Europe averaged 85.8 percent of the value of the defense sales, and sales to the region accounted for 46 percent of all reported sales. This average was higher than that for the other regions of the world, with the exception of North, South, and Central America, where offsets averaged 95.1 percent; however, that region made up only 1 percent of reported sales.

Offset Transactions

In 1998, 17 U.S. defense firms reported \$2.28 billion offset transactions. These transactions received offset credits of \$2.6 billion, or 114 percent of their actual value. The top three U.S. defense companies who reported offset activity to BXA accounted for

85.6 percent of the value of all reported transactions. Europe was by far the largest offset recipient region, with more than 80 percent of all offsets followed by Asia with only 9 percent. In 1998, direct offsets totaled \$1.43 billion, 62.6 percent of the value of all offsets; this is a 39 percent increase from 1997. This significant rise is attributed to two large transactions totaling more than \$470 million. This increase in direct offsets interrupted a pattern of a relative decline in direct offsets; because it was attributable to just two transactions, this interruption is not likely to result in a lasting change in the long-term pattern. Indirect offsets constituted the remaining activity in 1998, equaling \$850 million.

For 1993 to 1998, U.S. companies provided \$14.1 billion in offset transactions, receiving \$16.6 billion in offset credits. Three countries alone received \$8.2 billion in offsets, which accounted for 58 percent of the total value of all transactions. More than a thousand foreign companies and government agencies received offsets from U.S. firms, providing an average credit of 118 percent of the actual value of the offset. The credit values for Asia and the Middle East are higher than those provided in Western Europe.

Indirect offsets were still the largest type of offsets, totaling \$7.8 billion or 55 percent of the actual value of all offsets. Meanwhile, direct offsets equaled \$5.8 billion, 41 percent of the total. Purchases, the largest offset category, equaled \$5.1 billion followed by Subcontracts with \$4.1 billion. Technology and Credit transfers worth \$1.6 billion and \$1 billion respectively constituted the majority of the remaining offsets.

Between 1993 and 1998, offset transactions were fulfilled in 47 two-digit Standard Industrial Classification (SIC) industry groups. Transportation equipment was the largest industry group of offset activity, approximately 34 percent of the value of all transactions. This is to be expected as 41 percent of all offsets were directly related to the defense item sold, which are generally aerospace-related and usually categorized in this group. The next largest group was a distant second with only 9 percent of all offsets was Electronic & Other Electric Equipment. Following closely behind this sector was Industrial Machinery & Equipment with 6 percent of the value of all offset transactions.

Offsets in Developed vs. Developing Nations

The use and extent of offsets varies widely between developed and developing countries. For developing countries, indirect offsets were the most commonly provided offset, equaling 63 percent, while direct was 36 percent, and unspecified 1 percent. In contrast, developed nations require more direct offsets, 42 percent, while indirect constituted 54 percent and unspecified 4 percent.

Several countries were studied for their use of offsets, and the differences between developed (Finland and Israel) and developing countries (the Czech Republic and the UAE) were highlighted. The developing countries were examined to show different offset policies and how they are used for development purposes. In particular, research was conducted on the extent to which Finnish companies benefited from the receipt of offsets. A majority of the Finnish offsets studied were purchases that directly increased company net income, thus boosting employment and overall economic performance. Another interesting case is that of Israel, which receives foreign military funding from the United States and then requires offsets of U.S. firms.

Presidential Commission

In July, 1999, Senator Russell Feingold of Wisconsin introduced a bill entitled the Defense Offsets Disclosure Act of 1999, which called for increased monitoring of the impacts of

offsets in international defense trade. This bill was incorporated into an appropriations bill that became law in November 1999 and created the National Commission on the Use of Offsets in Defense Trade. A parallel President's Council on Offsets in Commercial Trade was created by Executive Order. The purpose of the Commission and parallel Council is to study offsets, focusing in particular on their effect on the aerospace industry and its suppliers, as well as other high-technology industries, and to analyze their impact on national security.

The Commission and Council share the same membership, which includes representatives from both the public and private sectors. The group must report to Congress and the President by October 2001 on future U.S. policies regarding military and commercial offsets. The final report is expected to include a strategy for unilateral, bilateral, or multilateral negotiations toward a treaty on offset standards, with a goal of reducing any detrimental effects of offsets on the nation's economy.

Notes

In an attempt to standardize U.S. prime contractor offset data, BXA recently updated its database. Therefore, there may be slight discrepancies between data provided in previous BXA offset reports and this report.

All percentages and numbers are stated in terms of the actual dollar value of the offset rather than by the number of transactions. This provides a clearer representation of the state of offset activities and trends. One reason for this change is that prime contractors are allowed to group similar transactions for the same year, thus rendering the "number of transactions" completed inaccurate. All averages, unless otherwise noted, are weighted. Both of these changes provide a more accurate description of the data. Offset agreements and transactions with small monetary value are not given equal significance compared to more noteworthy offset activity. In addition, all offset data are from BXA's offset database.