

A CRITICAL EXAMINATION OF OFFSETS IN
INTERNATIONAL DEFENSE PROCUREMENTS:
POLICY OPTIONS FOR THE UNITED STATES

Mark J. Nackman

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I. INTRODUCTION

When most Americans think of the U.S. defense industrial base, their minds immediately generate a list of the major prime defense contractors like Lockheed Martin, Northrop Grumman, Boeing, General Dynamics, and

Mark J. Nackman (mark.nackman@gd-ais.com) is assistant general counsel at General Dynamics Advanced Information Systems, having recently held the position of vice president, associate general counsel with Alliant Techsystem’s ATK Missile Products Group. This Article was submitted in partial satisfaction of the requirements for the degree of Master of Laws in Government Procurement Law at The George Washington University Law School. The author especially thanks his wife Evelyn for her unwavering support and Professor Christopher R. Yukins for his insight and guidance. The views expressed in this Article are those of the author and do not reflect the position of General Dynamics, Alliant Techsystems, or The George Washington University. This Article was selected as the Division II second-place winner of the American Bar Association Section of Public Contract Law 2010 Writing Competition.

Raytheon. While the large prime contractors undoubtedly add value to U.S. defense procurements, the real muscle required to successfully execute major defense programs exists at the subcontractor levels.¹ In fact, many of the trade secrets that go into making essential components of major defense programs come from third- and fourth-tier subcontractors.² Thus, subcontractors comprise the real core of the U.S. defense industrial base when total employees, combined gross revenues, and combined portfolios of intellectual property are considered.³

Increasingly for many specialized components, there are only one or two subcontractor-suppliers in the entire U.S. defense industrial base.⁴ Many of those suppliers are very small companies; in 2005 the U.S. Department of Defense (DoD) stated that thirty-four to forty-five percent of the contractors supplying “critical, innovative technologies” required for twenty-first century wars had fewer than 100 employees.⁵ This vital segment of the U.S. defense industrial base can be weakened when large prime U.S. defense contractors agree to offsets⁶ and other types of countertrade as part of large defense procurements with foreign countries.⁷

When this portion of the U.S. defense industrial base is eroded, the risk of reliance on foreign suppliers for key subsystems and components in major defense programs rises. Such foreign reliance could ultimately lead to the denial of critical technologies and components necessary for major defense programs. Therefore, as the strength of the domestic supply chain is compromised, so is U.S. national security.⁸

1. See, e.g., U.S. DEP’T OF DEF. 2010 QUADRENNIAL DEF. REV. REP. 82 (2010) [hereinafter QDR], available at http://www.defense.gov/qdr/images/QDR_as_of_12Feb10_1000.pdf.

2. *Id.*

3. See *id.* at 81–83.

4. See, e.g., William R. Hawkins, *The Need for Socioeconomic Guidance in Defense Procurements*, PROCUREMENT LAW, Summer 2005, at 8.

5. Michael W. Murphy, *To Defeat Today’s Threats, the Pentagon Needs Innovative “Mid-Tier” Contractors*, NAT’L DEF., June 2010, at 16–17 (citing OFFICE OF THE DEPUTY UNDER SEC’Y OF DEF. (INDUS. POLICY), U.S. DEP’T OF DEF., DEFENSE INDUSTRIAL BASE CAPABILITIES STUDY: PROTECTION 30 (2005), available at <http://www.dtic.mil/cgi-bin/GetTRDoc?Location=U2&doc=GetTRDoc.pdf&AD=ADA431913>).

6. “Offsets” are goods or services provided by a supplier to a purchasing country in consideration for the purchase of the article by the foreign country. They are provided in addition to the article at the center of the transaction. See *infra* notes 15.

7. Not surprisingly, though, the U.S. Department of Commerce (“Commerce”) reports that several U.S. prime contractors have indicated that international defense sales with offset requirements help support the U.S. industrial base. BUREAU OF INDUS. & SEC., U.S. DEP’T OF COMMERCE, 14 OFFSETS IN DEF. TRADE i (2009) [hereinafter OFFSETS 2009], available at http://www.bis.doc.gov/news/2010/14th_offset_defense_trade_report.pdf. There are no comments from subcontractors included in the report. See *id.*

8. See, e.g., QDR, *supra* note 1, at 81–83. This is not a new revelation to the DoD. In fact, during World War II it was a key element of the Allied strategy to disrupt Nazi Germany’s military industrial complex. E.g., Hawkins, *supra* note 4, at 8. During World War II, the superior Allied defense industrial base was able to out-produce the Axis powers in every category of military equipment, save submarines. See, e.g., JOHN MORTON BLUM, *V WAS FOR VICTORY: POLITICS AND AMERICAN CULTURE DURING WORLD WAR II*, at 122 (Harcourt Brace Jovanovich 1st ed. 1976).

Finally, other forces also negatively impact the U.S. defense industrial base in the international market. Significant export control restrictions⁹ already limit defense contractor participation in the international market.¹⁰ Thus, offset requirements whittle away at the international sales that export controls regulations do not otherwise prevent.

A. *A Typical International Defense Procurement*

When most foreign countries make large defense procurements, there are several dynamics likely to be at work. First, the procuring nation typically lacks the domestic capability to produce the necessary defense articles, hence the need to acquire from a nondomestic seller.¹¹ Second, the seller is most likely a U.S. defense contractor.¹² Third, that U.S. defense contractor is likely required to provide extra incentives as part of being allowed to consummate the sale in the first place.¹³ Those “extras” are known in the international

These principles remain an essential element of contemporary U.S. national security planning. See QDR, *supra* note 1, at 82; PRESIDENT OF THE UNITED STATES, 2006 NAT'L SECURITY STRATEGY OF THE U.S. 25 (2006). In fact, the United States aspires to “maintain at least a one-generation lead over potential adversaries” in “critical technologies and components.” U.S. DEP'T OF DEF., 2005 ANN. INDUS. CAPABILITIES REP. TO CONGRESS 3–4 (2005) [hereinafter DoD CAPABILITIES REPORT], available at http://www.acq.osd.mil/ip/docs/annual_ind_cap_rpt_to_congress-2005.pdf. Furthermore, 10 U.S.C. § 2501 (2006), entitled “National security objectives concerning national technology and industrial base,” states:

It is the policy of Congress that the national technology and industrial base be capable of . . . (1) Supplying and equipping the force structure of the armed forces . . . (2) Sustaining production, maintenance, repair, and logistics for military operations . . . (3) Maintaining advanced research and development activities . . . (4) Reconstituting within a reasonable period the capability to develop and produce supplies and equipment . . . [and] (5) Providing for the development, manufacture, and supply of items and technologies critical to the production and sustainment of advanced military weapon systems . . .

9. Defense items, including those on the U.S. Munitions List or those for other military use, are regulated under the export control regime set forth in the International Traffic in Arms Regulation (ITAR), 22 C.F.R. § 120.2 (2010), as established by the Arms Export Control Act, 22 U.S.C. § 2778 (2006), and administered by the U.S. Department of State. Commercial items that have potential “dual use” as defense items are regulated under the Export Administration Regulation (EAR), 15 C.F.R. §§ 730.1–730.3 (2010), as administered by Commerce. However, the EAR was originally created pursuant to the now-expired Export Administration Act of 1979. 50 U.S.C. app. §§ 2401–2420 (2006). The EAR was subsequently extended by Executive Order No. 13222, 66 Fed. Reg. 44,025 (Aug. 17, 2001), pursuant to the authority granted to the president under the International Emergency Economic Powers Act (IEEPA), 50 U.S.C. § 1702 (2006).

10. See, e.g., DEF. SCI. BD., TASK FORCE ON DEF. INDUS. STRUCTURE FOR TRANSFORMATION, U.S. DEP'T OF DEF., CREATING AN EFFECTIVE NATIONAL SECURITY INDUSTRIAL BASE FOR THE 21ST CENTURY: AN ACTION PLAN TO ADDRESS THE COMING CRISIS 30 (2008), available at <http://www.acq.osd.mil/dsb/reports/ADA485198.pdf>.

11. DAVID HELD ET AL., GLOBAL TRANSFORMATIONS 117 (1999).

12. In 2007, forty-four U.S. companies accounted for \$212.4 billion of the overall \$346.9 billion in international arms sales, which equals 61.2% of all international arms sales. The next closest were thirty-two companies in Western Europe accounting for \$107.6 billion. Sam Perlo-Freeman et al., *The SIPRI Top 100 Arms Producing Companies, 2007*, in 2009 STOCKHOLM INT'L PEACE RES. INST. Y.B. 288–92, available at <http://www.sipri.org/yearbook/2009/06/06A>.

13. See, e.g., Murat Sumer & Jason Chuah, *Emerging Legal Challenges for Countertrade Techniques in International Trade*, INT'L TRADE L. & REG. 111, 111, 121 (2007).

procurement community as countertrade¹⁴ or, more specifically, offsets.¹⁵ Foreign countries typically perceive multiple benefits from requiring offsets, not the least of which is economic.¹⁶

B. *The U.S. National Security Imperative*

Along those same lines, the United States recently undertook two efforts concerned with U.S. exports. First, the Obama administration established a National Export Initiative.¹⁷ One of its goals is to double U.S. exports over the next five years to support two million U.S. jobs.¹⁸ A key challenge for the newly formed Export Promotion Cabinet¹⁹ (“Cabinet”) will be to figure out how to deal effectively with the issue of defense countertrade. Though some critics question whether defense offsets are a matter of commerce or

14. The United Nations Commission on International Trade Law (UNCITRAL) defines countertrade as “those transactions in which one party supplies goods, services, technology or other economic value to the second party, and, in return, the first party purchases from the second party an agreed amount of goods, services, technology or other economic value.” UNCITRAL, *LEGAL GUIDE ON INTERNATIONAL COUNTERTRADE TRANSACTIONS* 5 (1993) [hereinafter *UNCITRAL GUIDE*], available at <http://www.uncitral.org/pdf/english/texts/sales/countertrade/countertrade-e.pdf>.

15. The UNCITRAL Guide defines offsets as “normally involv[ing] the supply of goods of high value or . . . technology and know-how, promotion of investments and facilitating access to a particular market.” *Id.* at 9. This is not to be confused with the other meanings of “offset” in government procurement law, such as in the Federal Acquisition Regulation (FAR) context, where the term refers to a contractor’s theory for reducing the U.S. Government’s claim during price negotiations arising from submission of defective cost or pricing data. See FAR 15.407-1(b). Nor should it be confused with the use of “offset” in reference to the process of reducing payments to a contractor by the amount that contractor is otherwise indebted to the payor, more properly known as “setoff.” See JOHN CIBINIC JR. ET AL., *ADMINISTRATION OF GOVERNMENT CONTRACTS* 750–52 (4th ed. 2006).

16. Whether defense offsets even result in any lasting economic benefit is highly debatable. Multiple experts have concluded that they are in fact more expensive than procurements without offsets, do not create sustainable employment, and do not result in substantive general economic development for the procuring nation. See, e.g., BEN MAGAHY ET AL., *TRANSPARENCY INT’L-UK, DEFENCE OFFSETS: ADDRESSING THE RISKS OF CORRUPTION & RAISING TRANSPARENCY* 23 (Julia Muravska & Anne-Christine Wegener eds., 2010), available at <http://www.transparency.org.uk/publications/108-defence-offsets-addressing-the-risks-of-corruption-a-raising-transparency>; Keith Hartley, *Offsets and the Joint Strike Fighter in the UK and Netherlands*, in *ARMS TRADE AND ECONOMIC DEVELOPMENT: THEORY, POLICY AND CASES IN ARMS TRADE OFFSETS* 125 (Jurgen Brauer & Paul Dunne eds., 2004) [hereinafter *ARMS TRADE AND ECONOMIC DEVELOPMENT*].

17. State of the Union Address, 2010 DAILY COMP. PRES. DOC. 201000055, at 5 (Jan. 27, 2010), available at <http://www.gpo.gov/fdsys/pkg/DCPD-201000055/pdf/DCPD-201000055.pdf>.

18. *Id.*

19. See Exec. Order No. 13534, 75 Fed. Reg. 12,433, 12,434 (Mar. 16, 2010). Members of the Export Promotion Cabinet include the secretaries for (a) State, (b) Treasury, (c) Agriculture, (d) Commerce, and (e) Labor; (f) the director of the Office of Management and Budget; (g) the U.S. Trade Representative; (h) the assistant to the president for economic policy; (i) the National Security Advisor; (j) the chair of the Council of Economic Advisers; (k) the president of the Export-Import Bank of the United States; (l) the administrator of the Small Business Administration; (m) the president of the Overseas Private Investment Corporation; (n) the director of the U.S. Trade and Development Agency; and (o) the heads of other executive branch departments, agencies, and offices as the president may, from time to time, designate. *Id.*

defense,²⁰ they are squarely a matter of defense and national security. It is imperative, therefore, that the Cabinet develop a position on countertrade that is focused, first and foremost, on national security.

Second, the Obama administration recently established an Export Control Reform Initiative (“Initiative”).²¹ The goal of this Initiative is to “to build high walls around a smaller yard” by focusing enforcement on the U.S. defense industrial base’s “crown jewels.”²² The Initiative also will seek to consolidate export control authority in an effort to improve efficiency.²³ With these two efforts underway, in order to maintain a congruent, strategic U.S. trade policy, it is logical to consider defense trade offsets.

This Article examines the threats that defense offsets pose to U.S. national security and economic interests and recommends appropriate options to begin addressing these threats. This is not an article espousing the use of isolationist or protectionist policies. Rather, this Article suggests how the United States can avoid falling prey to other countries’ attempts to utilize such policies against the United States. This Article engages in a critical examination of the practice of offsets in the international defense trade. Parts II and III examine the legal framework for this controversial practice, given the World Trade Organization’s (WTO) Agreement on Government Procurement (“GPA”). Part IV focuses on the negative impacts of defense trade offsets and efforts being made by the United States to address it. Part V identifies what more can be done by the United States to achieve multiple policy objectives, including the protection of its defense industrial base.

II. DEFINING OFFSETS

Defense countertrade is a label for a variety of industrial compensation arrangements utilized by some governments as a requirement for foreign defense firms in large procurements.²⁴ They function as a condition of the sale of defense articles to the purchasing foreign government, whereby that foreign government or its economy recoups some portion of the acquisition’s value.²⁵ Offsets are measured in monetary terms, while other forms of countertrade involve bartering, required domestic coproduction, subcontracting, or other systems not involving the direct exchange of money.²⁶

20. See Sumer & Chuah, *supra* note 13, at 111, 121.

21. See Press Release, Office of the Press Sec’y, Fact Sheet on the President’s Export Control Reform Initiative (Apr. 20, 2010), available at <http://www.whitehouse.gov/the-press-office/fact-sheet-presidents-export-control-reform-initiative>.

22. *Id.*

23. *Id.*

24. OFFSETS 2009, *supra* note 7, at i.

25. *Id.*

26. *Id.*; see generally ARMS TRADE AND ECONOMIC DEVELOPMENT, *supra* note 16.

There is no international standard for how offsets work.²⁷ However, more than 130 countries engage in the practice in one form or another.²⁸ The labels vary from country to country, but the concept is generally universal.²⁹ Even the new European Defense Procurement Directive³⁰ left the option open for member European nations to require offsets and countertrade in defense procurements, if those procurements “are so sensitive that even the new rules cannot satisfy their security needs.”³¹

27. See, e.g., UNCITRAL GUIDE, *supra* note 14, at 9.

28. See Sumer & Chuah, *supra* note 13, at 111, 121. Ironically, when considering the contemporary negative impacts of offsets on U.S. national security interests, they appear to have roots in the 1950s Cold War era, when they became common in defense procurements between the United States and other NATO member countries. *Id.* at 120; see also MAGAHY ET AL., *supra* note 16, at 8.

29. For example, in Colombia, the practice is referred to as “Industrial and Social Cooperation Agreements.” NAT’L COUNCIL FOR ECON. & SOC. POLICY, PUB. NO. 3522, GENERAL GUIDELINES FOR IMPLEMENTING INDUSTRIAL AND SOCIAL COOPERATION AGREEMENTS—Offsets—RELATING TO ACQUISITION IN THE FIELD OF DEFENSE IN COLOMBIA (2008) (Republic of Colombia), available at <http://www.dnp.gov.co/PortalWeb/Portals/0/archivos/documentos/Subdireccion/Conpes/3522.pdf>. The Czech Republic shortens the label to “Industrial Cooperation Programs.” MINISTRY OF INDUS. & TRADE, PROVISION No. 3/2005, DIRECTIVE FOR THE IMPLEMENTATION OF INDUSTRIAL COOPERATION PROGRAMMES (2005) (Czech Republic), available at <http://www.mpo.cz/dokument14416.html>. In India, they are simply referred to as “offsets.” MINISTRY OF DEF., DEFENCE PROCUREMENT PROCEDURE 2008 (2008) (Gov’t of India), available at <http://mod.nic.in/dpm/welcome.html>; see generally Sandeep Verma, *Offset Contracts Under Defense Procurement Regulations in India: Evolution, Challenges, and Prospects*, 7 J. CONT. MGMT. 17 (2009). Turkey refers to their program as “Defence Procurement Transaction Offsets.” MINISTRY OF DEF., DIRECTIVE ON OFFSET IMPLEMENTATIONS IN DEFENCE PROCUREMENT TRANSACTIONS (2003) (Republic of Turkey), available at <http://www.ssm.gov.tr>. In South Korea, offsets are officially known as “The Korean Defense Offset Program.” E.g., DEF. ACQUISITION PROGRAM ADMIN., http://www.d2b.go.kr/English/jsp/int/HI_HP_D_E_int_Main.jsp?md=152&cf=HI_HP_D_E_int_05_02_08 (last visited Oct. 22, 2010). The United Arab Emirates (UAE) recently announced a broadening of their existing offset program, which is run by the UAE Offset Program Bureau. See OFFSET PROGRAM BUREAU, <http://www.offset.ae/en/faq/index.aspx?mnu=faq> (last visited Oct. 22, 2010). Kuwait runs their offset program through a state-owned company called the National Offset Company. See NAT’L OFFSET Co., <http://www.kuwaitnoc.com> (last visited Oct. 22, 2010).

30. Directive 2009/81, of the European Parliament and of the Council of 13 July 2009 on the Coordination of Procedures for the Award of Certain Works Contracts, Supply Contracts, and Service Contracts by Contracting Authorities or Entities in the Fields of Defence and Security, and Amending Directives 2004/17/EC and 2004/18/EC, 2009 O.J. (L 216) 76.

31. Press Release, European Commission, New Directive on Defence and Security Procurement Enters into Force (Aug. 25, 2009); see also Christopher R. Yukins, *Feature Comment—The European Defense Procurement Directive: An American Perspective*, 51 GOV’T CONTRACTOR ¶ 383, Nov. 4, 2009, at 3, 5 [hereinafter *Feature Comment*]. As some commentators have noted, the new EU Defense Procurement Directive fails to directly address offsets. See, e.g., Marc Gabriel & Katharina Weiner, *The European Defence Procurement Directive: Toward Liberalization and Harmonization of the European Defense Market*, PROCUREMENT LAW., Winter 2010, at 1, 26. However, these commentators suggest, “It is arguable that under the directive offsets are no longer permissible, because in the case of a direct offset, at least the contractor is obligated to subcontract a certain share of the contract to local or domestic companies. This ‘domestic preference’ conflicts with Article 51 of the directive, which provides for the award of subcontracts in a transparent and nondiscriminatory way.” *Id.* However, in light of the Code of Conduct on Offsets by the European Defence Agency, it would appear the Europeans intend for offsets to be dealt with through nonbinding guidance as opposed to binding primary law. See *id.* (citing EUROPEAN DEF. AGENCY, CODE OF CONDUCT ON OFFSETS (2008), available at <http://www.eda.europa.eu/WebUtils/downloadfile.aspx?fileid=460>).

The Bureau of Industry and Security (“BIS”) at the U.S. Department of Commerce provides an annual report to the U.S. Congress that includes an exhaustive glossary of offset approaches and schemes.³² Wherever the practice and whatever the label, the U.S. Government officially considers it “economically inefficient and trade distorting” but permits U.S. companies to engage in the practice of offsets when selling to foreign countries.³³ To those countries engaging in the practice, it can be positively described as an economic policy, a national security policy, or even a private/public partnership program.³⁴ Countertrade also can be a useful technique as a hedge against fluctuations in currency value by reducing or even eliminating all cash-related terms in the transaction.³⁵

Critical labels of those same programs might be protectionism, domestic preference, and the price of admission because the seller has no other option but to agree in order to sell products in that country.³⁶ Countertrade also can be utilized as a means to skirt antidumping laws because valuation becomes much more difficult when the transaction is no longer strictly based on currency.³⁷ In countries where the line between government and corporate entities is difficult to distinguish and state-owned businesses are involved, or where third-party commercial entities are utilized to satisfy offset requirements, an ostensible defense trade offset can quickly develop into a Foreign Corrupt Practices Act (FCPA) violation³⁸ or even an antitrust compliance problem.³⁹ Offsets also present other serious corruption risks.⁴⁰ But to defense

32. Some of the examples that the Bureau of Industry and Security (“BIS”) lists are Co-production, Credit Assistance, Direct Offsets, Indirect Offsets, Licensed Production, Multipliers, Overseas Investment, Subcontracts, Technology Transfer, and Training. OFFSETS 2009, *supra* note 7, Annex E.

33. *Id.* at i.

34. *See, e.g.*, Sumer & Chuah, *supra* note 13, at 121.

35. *See id.* at 111.

36. *See, e.g.*, CHARLES W. KEGLEY JR., *WORLD POLITICS: TREND AND TRANSFORMATION* 336 (11th ed. 2008).

37. *See, e.g.*, Sumer & Chuah, *supra* note 13, at 113 n.30.

38. The U.S. Foreign Corrupt Practices Act (FCPA) makes it unlawful for certain classes of persons and entities to make payments to foreign government officials to assist in obtaining or retaining business. 15 U.S.C. § 78dd(a)(1)(B) (2006). As an example of how offsets can raise FCPA concerns, especially when third parties are utilized to satisfy offset requirements, see U.S. DEP’T OF JUSTICE, *FOREIGN CORRUPT PRACTICES ACT REVIEW OPINION PROCEDURE RELEASE 95-02* (1995), *available at* <http://www.justice.gov/criminal/fraud/fcpa/opinion/1995/9502.pdf>.

39. Conditioning the sale of a product based on the purchase of another can constitute an illegal tying arrangement under U.S. antitrust laws. *See N. Pac. Ry. Co. v. United States*, 356 U.S. 1, 5–6 (1958).

40. *See, e.g.*, MAGAHY ET AL., *supra* note 16, at 2 (“[I]n many countries, there is almost no due diligence on potential improper beneficiaries from the offsets, no monitoring of performance on offset contracts, no audits of what was delivered compared to the pledges, and no publication of offset results, benefits or performance at all. This makes offsets an ideal playground for corruption. . . . There are three main categories of corruption risk from offsets: 1. Improperly influencing the need for a particular defence acquisition in the first place[.] 2. Influencing the competitive decision for the main contract in non-transparent ways[.] 3. Allowing favours to be repaid to corrupt government officials via the offset contracts[.]”).

companies looking to do business in foreign countries that require offsets, it can be positively described as a potential marketing tool or proposal factor.⁴¹ Harsher labels would include bribe and extortion.⁴²

In a purely academic context, an offset is “[a] deduction; a counterclaim; a contrary claim or demand by which a given claim may be lessened or canceled; a claim that serves to counterbalance or to compensate for another claim.”⁴³ In practice, the concept is often much more complicated. One useful distinction, as Figure 1 demonstrates, is to group offsets into direct and indirect, depending on whether the requirements tie directly to the article being traded, or simply represent a counterbalancing value.⁴⁴

The goal of an offset system is to counterbalance the loss of domestic and economic activity, or domestic capability, by ensuring some form of return investment or preservation of domestic capability in exchange for the privilege to be a defense contractor in the applicable country.⁴⁵ The practice is typically limited to defense contracts because of the WTO’s GPA.⁴⁶

III. GENERAL PROHIBITION OF OFFSETS IN THE GPA

The WTO defines offsets as “measures used to improve local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements, countertrade, or similar requirements. . . .”⁴⁷ Offsets are specifically prohibited under article XVI of the GPA.⁴⁸ Thus, it is well established that the international community universally recognizes that offsets are an undesirable practice and has even gone

41. See STEPHEN MARTIN, *THE ECONOMICS OF OFFSETS: DEFENCE PROCUREMENT & COUNTERTRADE* 384 (1996) (claiming that “offsets can be used as a unique business tool to . . . serve the contractor’s interests”).

42. See, e.g., KEGLEY, *supra* note 36, at 336–37.

43. BLACK’S LAW DICTIONARY 1085 (6th ed. 1990).

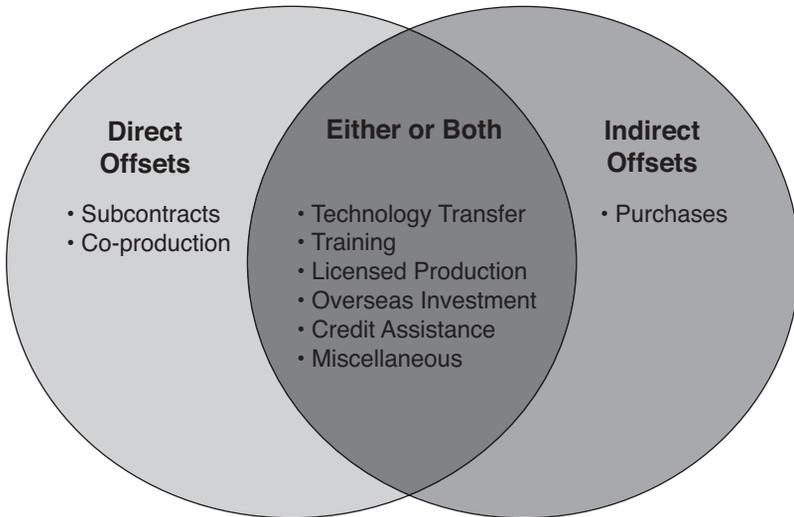
44. OFFSETS 2009, *supra* note 7, at 11. Although trade distorting, indirect offsets involving nondefense products do not represent as significant a threat to the U.S. defense industrial base as direct offsets involving actual major defense program components and subcomponents. This is because most of the international offsets have nothing to do with the defense program being sold, or even any defense product. As examples of how far afield indirect offsets can get from defense trade, consider Thomson-CSF’s garment manufacturing, Giat Industries’ air conditioning, and Boeing’s (formerly McDonnell-Douglas Helicopter Company’s) oil-spill cleanup and photocopyer-recycling businesses in the United Arab Emirates. See, e.g., U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-96-65, *MILITARY EXPORTS: OFFSET DEMANDS CONTINUE TO GROW* 10 (1996). This does raise an interesting question of whether the indirect offset should also be required to qualify under the national security exemption so as to avoid violating the GPA’s general prohibition against the practice. See *infra* notes 49, 52.

45. The Agreement on Government Procurement (GPA), art. XVI(1) n.7, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 4(b) 1994 [hereinafter Agreement on Government Procurement], available at http://www.wto.org/english/docs_e/legal_e/gpr-94_02_e.htm.

46. See generally *id.* art. XVI(1).

47. See *id.* art. XVI(1) n.7.

48. *Id.*

Figure 1: Classification of Offset Transaction Categories

Source: BIS Offset Database.

so far as to ban the practice in the context of almost all international procurement.⁴⁹

The GPA, however, makes two important exceptions to this general prohibition. First, at the time of accession to the GPA, it is possible for a country, particularly a “developing nation,” to negotiate conditions for the continued use of offsets for a temporary period.⁵⁰ Second, and perhaps more significantly, the GPA contains the critical carve-out for “national security or . . . national defence purposes.”⁵¹ Thus, the GPA, including its offset prohibition, does not apply to the international defense trade. This Article focuses on the second exception to the otherwise prohibited practice of offsets.⁵²

49. See, e.g., Jean Heilman Grier, *Recent Developments in International Trade Agreements Covering Government Procurement*, 35 PUB. CONT. L.J. 385, 388 (2006). Furthermore, the European Commission officially considers offsets to “distort the functioning of European defence markets.” See Gabriel & Weiner, *supra* note 31, at 1, 26 (citing *EU Commission Communication Concerning a Strategy for a Stronger and More Competitive European Defence Industry*, at 5–7, COM (2007) 764 final (Dec. 5, 2007)).

50. Agreement on Government Procurement, *supra* note 45, art. XVI(2).

51. *Id.* art. XXIII(1).

52. Beyond this exception, it is important to remember that most of the world’s countries are not parties to the GPA. *Parties to the Agreement*, WTO, http://www.wto.org/english/tratop_e/gproc_e/memobs_e.htm (last visited Nov. 11, 2010).

IV. PRACTICE OF DEFENSE OFFSET AGREEMENTS

There are many reasons why countries require offsets in major defense procurements. Some want to reduce the impact on their economy of losing major defense programs to foreign contractors; others are looking to preserve or improve domestic employment. Still others might want access to defense technology know-how. Finally, some countries could be looking to build their own domestic defense industrial base capability.⁵³ Of course, depending on the specific offset requirement, or combination of countertrade techniques employed, countries could be motivated by all of these as well as other reasons not listed here.⁵⁴ The end result is that there is little incentive for foreign purchasers not to require offsets when they are not prohibited from doing so under the GPA.⁵⁵

The international practice of requiring offsets in major defense procurements has driven many large defense contractors to establish international subsidiaries, capable of satisfying significant offset requirements such as in-country production and sourcing.⁵⁶ There also would appear to be a significant marketing advantage generated by local subsidiaries when knowledge of language, culture, and consumer preferences is considered.⁵⁷ Of course, this use of international subsidiaries still has the effect of diffusing the U.S. defense industrial base by splitting overall capabilities between domestic and foreign subsidiaries of even the largest U.S. prime defense contractors.⁵⁸

A. *Negative Impacts of Offsets*

This Article is primarily concerned with two categories of negative impacts from offsets: first, the impact that offsets have on the calculation of trade balances and foreign aid; second, the impact of offsets on the defense industrial base. In the case of trade balances and foreign aid, it is a matter of distortion. However, with the defense industrial base, it is a matter of erosion.

1. Distorted Trade Balances and Untracked Foreign Aid

One problematic side effect of offsets and other countertrade is that most systems meant to keep track of international trade fail to account for them.⁵⁹ Offsets distort real trade balance, making trade surpluses seem much larger in many cases.⁶⁰ As one detractor noted, “[T]hey mask the economic impact of direct procurements, and dilute transparency, especially when one considers

53. See MARTIN, *supra* note 41 at 40.

54. See *id.*

55. For more information on the economic analysis of offset policies, see generally MARTIN, *supra* note 41, at 15–48; ARMS TRADE AND ECONOMIC DEVELOPMENT, *supra* note 16, at 54–65.

56. See, e.g., Susan R. Sandler, *Cross-Border Competition in the European Union: Public Procurement and the European Defence Equipment Market*, 7 WASH. U. GLOB. STUD. L. REV. 373, 402 (2008).

57. *Id.*

58. See *id.*

59. See *id.* at 401.

60. *Id.*

that the value of an offset can be equal to or greater than one hundred percent of a contract's order value. This creates a certain level of market distortion, or the appearance thereof."⁶¹

While the United States does prohibit the direct use of nonrepayable Foreign Military Financing ("FMF")⁶² funds to pay for offset costs,⁶³ that is only a very narrow segment of the overall international trade involving U.S. defense contractors.⁶⁴ Thus, when foreign aid levels are tabulated, some countries are doing far better than "the numbers" show because of their offset and countertrade activities. This is not necessarily a reason to discontinue offsets, but it does demonstrate a need to keep better track and consider the broader implications of the practice.

2. Erosion of the Defense Industrial Base

The U.S. defense industrial base is by no means a self-sufficient entity for the provision of all U.S. defense needs.⁶⁵ Indeed, there are scores of non-U.S. subcontractors on just about every major U.S. defense program, not to mention those programs where the prime contractor is not a U.S. company. In today's global economy, it would be incredibly difficult to develop and produce a 100% U.S. content major weapon system.⁶⁶ As Figure 2 depicts, total domestic content becomes more and more difficult to obtain the further down the supply chain one looks.⁶⁷

One of the most serious negative effects of offsets in a national security context occurs when established U.S. defense systems that are already in pro-

61. *Id.* (citing *EU Commission Green Paper on Defence Procurement*, at 5, COM (2004) 608 final (Sept. 23, 2004)).

62. See *Foreign Military Financing* ["FMF"] Program, DEF. SEC. COOPERATION AGENCY [DSCA], http://www.dsca.mil/home/foreign_military_financing%20_program.htm (last visited Oct. 22, 2010). According to the website, "Congress appropriates FMF funds in the International Affairs Budget, the Department of State allocates the funds for eligible friends and allies; and the Department of Defense executes the program. FMF helps countries meet their legitimate defense needs, promotes U.S. national security interests by strengthening coalitions with friends and allies, cements cooperative bilateral military relationships, and enhances interoperability with U.S. forces." *Id.*

63. See DFARS 225.7303-2(a)(3); DEF. SEC. COOPERATION AGENCY, U.S. DEP'T OF DEF., GUIDELINES FOR FOREIGN MILITARY FINANCING OF DIRECT COMMERCIAL CONTRACTS 7 (2001), available at http://www.dsca.mil/DSCA_memoranda/fmf_dcc_2001/2001_guidelines.pdf; SEYFARTH SHAW LLP, THE GOVERNMENT CONTRACT COMPLIANCE HANDBOOK § 20:18 (4th ed. 2006).

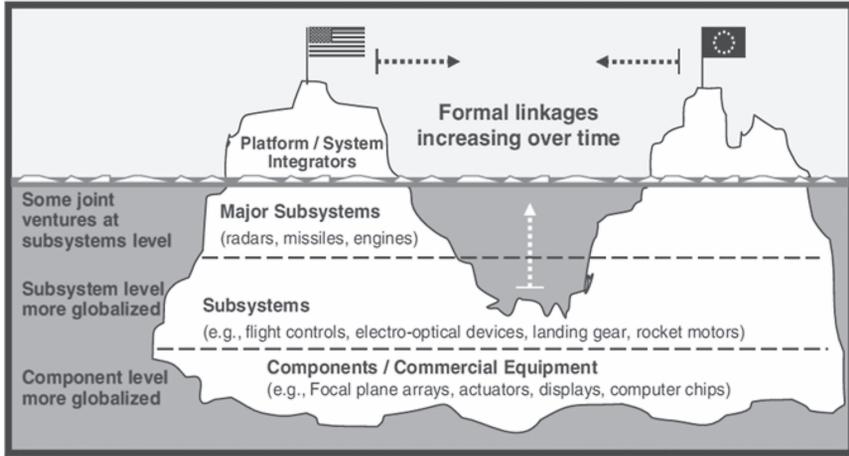
64. For example, the costs of performing offsets associated with foreign military sales ("FMS") contracts can be recovered under a letter of offer and acceptance ("LOA") paid for entirely by purchaser cash or repayable FMF credits. DFARS 225.7303-2(a)(3).

65. See, e.g., EDWARD MONTGOMERY GRAHAM & PAUL R. KRUGMAN, FOREIGN DIRECT INVESTMENT IN THE UNITED STATES 118 (3d ed. 1995).

66. See *id.*

67. *Feature Comment*, *supra* note 31, at 3-4 (citing 1 JEFFREY P. BIALOS ET AL., FORTRESSES AND ICEBERGS: THE EVOLUTION OF THE TRANSATLANTIC DEFENSE MARKET AND THE IMPLICATIONS FOR U.S. NATIONAL SECURITY POLICY 7 (Ctr. for Transatlantic Relations 2009), available at http://csis.org/files/attachments/091030_fortresses_icebergs.pdf).

Figure 2: The Transatlantic Defense Industry



Source: U.S. Department of Defense, Office of Deputy Under Secretary of Defense for Industrial Policy.

duction and fielded by the U.S. military are subsequently sold internationally with direct offset requirements.⁶⁸ This is because such a practice results in the displacement of U.S. subcontractors by foreign sources on programs where those U.S. subcontractors provided the original content.⁶⁹ They also may result in the disclosure of sensitive technical data and intellectual property to foreign sources.⁷⁰ These foreign sources can then become competitors of the U.S. subcontractors, or, worse, potentially provide their newfound technologies to entities hostile to the United States.⁷¹ This could ultimately result in a weaker and less capable U.S. defense industrial base,⁷² moving the United States further away from the goal of maintaining “at least a one-generation lead over potential adversaries.”⁷³

As a result, direct offsets may reduce U.S. industrial base capability⁷⁴ and frustrate national security objectives. The large prime defense contractors

68. See OFFSETS 2009, *supra* note 7, at 14.

69. *Id.*

70. See *id.*

71. See *id.*; U.S. GEN. ACCOUNTING OFFICE, GAO-01-278T, DEFENSE TRADE: OBSERVATIONS ON ISSUES CONCERNING OFFSETS 2 (2000), available at <http://www.gao.gov/new.items/d01278t.pdf> [hereinafter ISSUES CONCERNING OFFSETS].

72. See OFFSETS 2009, *supra* note 7, at 14.

73. See DoD CAPABILITIES REPORT, *supra* note 8, at 3–4.

74. BUREAU OF INDUS. & SEC., U.S. DEP’T OF COMMERCE, 11 OFFSETS IN DEF. TRADE app. H, at vi–vii (2007) [hereinafter OFFSETS 2007], available at http://www.bis.doc.gov/defenseindustrialbaseprograms/osies/offsets/final_offsets_eleven_report.pdf.

might say they do not mind the practice and they consider it a useful marketing tool.⁷⁵ However, the U.S. domestic subcontractors suffer, particularly those utilized in U.S. versions of defense systems but subsequently replaced with offset-satisfying subcontractors for export versions of the system.⁷⁶ Because of their size, resources, and direct privity of contract with the U.S. Government, the large prime defense contractors tend to be better at communicating and more effective at lobbying than their subcontractors, especially those further down into the third and fourth tier of the supply chain. Thus, the U.S. Government is left with the impression that industry does not consider the practice of offsets a problem, especially when subjects like export controls are being debated instead.⁷⁷

The data to support this can be found in the BIS reports to the U.S. Congress.⁷⁸ As the report explains, the total value of all reported U.S. offset transactions in aerospace-related defense exports from 2005 to 2008 was \$4,246,918,125.⁷⁹ Using the BIS report's own formula,⁸⁰ this is the equivalent of 22,838⁸¹ U.S. jobs. In other words, despite how the report presents the information, defense trade offsets cost the United States over 22,800 jobs from 2005 to 2008.⁸² The report obscures this fact with the assumption that none of the international sales with offsets would have even been possible but for the offsets, and that there is still a net jobs benefit when one considers the net value of those sales with the offset requirements subtracted out. This manipulation of statistics loses track of the fundamental question of whether those sales would still be possible without the offsets and more importantly how defense trade policy might be adjusted to reduce the gap between gross and net international sales.

One also should consider the types of professionals it takes to develop and produce a major defense program. They consist of scientists, engineers, the various support functions (including contracts managers and attorneys), skilled technicians, and assembly workers, many of whom possess specialized skills in the most fundamental yet critical defense industrial techniques, such as the "lay up" of carbon fiber, writing of computer code, or smelting of titanium alloys.⁸³ The loss of these 22,838 jobs cannot be overlooked if the Obama administration's goal is to support two million U.S. jobs through

75. See *id.* app. H, at vii–viii.

76. See, e.g., OFFSETS 2009, *supra* note 7, at 14.

77. *Id.*; but see OFFSETS 2007, *supra* note 74, app. H, at vi–vii.

78. See, e.g., OFFSETS 2009, *supra* note 7; OFFSETS 2007, *supra* note 74.

79. OFFSETS 2009, *supra* note 7, at 19.

80. See *id.* at 20–21.

81. $4,246,918,125 \div 185,957 = 22,838.172$ full-time equivalents. See *id.*

82. See *id.*

83. Cf. OFFSETS 2009, *supra* note 7, at 21 (implicating the specialization required for professionals involved in the production of large-scale government defense systems by listing the following examples of such systems: "Aircraft manufacturing" and "Aircraft engine and engine parts manufacturing").

increased exports.⁸⁴ To that end, it seems that increasing the efficiency and economic benefit of current exports might be a good starting point.

B. Ongoing U.S. Initiatives Addressing Defense Trade Offsets

While the official U.S. Government stance on defense trade offsets is one of opposition,⁸⁵ the best way to describe its approach to addressing the problematic practice is that the Government is “studying it.”⁸⁶ Numerous Government Accountability Office (GAO) [formerly General Accounting Office] reports,⁸⁷ a National Commission on the Use of Offsets in Defense Trade, as well as Presidential Council on the Use of Offsets in Commercial Trade,⁸⁸ and fourteen annual BIS reports to the U.S. Congress⁸⁹ represent the bulk of recent U.S. government activity in the area of defense trade offsets.

However, defense trade offsets are treated in a somewhat extraordinary fashion, in that they do not fall under the exclusive jurisdiction of the U.S. Trade Representative as one might expect.⁹⁰ Rather, the U.S. secre-

84. State of the Union Address, *supra* note 17, at 5.

85. OFFSETS 2009, *supra* note 7, at i.

86. The Feingold Amendment, passed in 1994, prohibits U.S. defense contractors from making “incentive payments” to U.S. persons for the purpose of causing such persons to then purchase foreign-made goods in satisfying, in whole or in part, the defense contractor’s offset obligations. 22 U.S.C. § 2779a (2006). While this was certainly a significant legislative act aimed at defense trade offsets, it did not place a substantive ban on the larger practice; instead, it merely prohibited a single, then-popular technique for dealing with offset obligations. *See id.* However, there do not appear to be any publicly recorded prosecutions for violation of the Feingold Amendment.

87. *See, e.g.*, U.S. GEN. ACCOUNTING OFFICE, GAO-03-649, DEFENSE TRADE: REPORT AND RECOMMENDATIONS OF THE DEFENSE OFFSETS COMMISSION STILL PENDING (2003), available at <http://www.fas.org/asmp/resources/govern/gao-03-649.pdf> [hereinafter REPORT AND RECOMMENDATIONS]; ISSUES CONCERNING OFFSETS, *supra* note 71; U.S. GEN. ACCOUNTING OFFICE, GAO/NSIAD-96-65, MILITARY EXPORTS: OFFSET DEMANDS CONTINUE TO GROW (1996), available at <http://www.gao.gov/archive/1996/ns96065.pdf>.

88. In 2000, President Clinton established the National Commission on the Use of Offsets in Defense Trade (“Commission”). Exec. Order No. 13,177, 65 Fed. Reg. 76,558, 76,558 (Dec. 4, 2000). This was done to comply with the congressional directive in section 1247 of the Defense Offsets Disclosure Act of 1999. Pub. L. No. 106-113, § 1247, 113 Stat. 1501, 1501A–502 (codified as amended at 22 U.S.C. §§ 2776, 2779a (2006)). The Commission was established to study defense offset impacts and recommend measures to Congress aimed at reducing the negative impacts thereof. *See* Alan W.H. Gourley et al., *International Procurement*, 35 INT’L LAW. 395, 398 (2001). In particular, the Commission was charged with analyzing (1) the collateral impacts on U.S. industries, (2) U.S. national security and industrial base impacts, and (3) competition impacts on the U.S. defense industry in international trade. *Id.* According to GAO, “[t]o address the use of offsets in commercial trade, the President established the Presidential Council on the Use of Offsets in Commercial Trade. Membership of the Council was identical to the Commission.” REPORT AND RECOMMENDATIONS, *supra* note 87, at 2 n.3.

89. The Defense Production Act Amendments of 1992, Pub. L. No. 102-558, § 123(c), 106 Stat. 4198, 4206–07 (codified as amended at 50 U.S.C. § 2099 note (2006)), established the requirement for Commerce to track and collect information regarding offset agreements in excess of \$5 million. Reporting of Offsets Agreements in Sales of Weapon Systems or Defense-Related Items to Foreign Countries or Foreign Firms, 15 C.F.R. § 701.1 (2010). These reports are gathered by BIS, which in turn generates an annual report to Congress pursuant to section 309 of the Defense Production Act of 1950, Pub. L. No. 81-774, 64 Stat. 798 (codified as amended in 50 U.S.C. app. §§ 2061–2171 (2006)). *See* 15 C.F.R. § 701.1.

90. *See* OFFSETS 2009, *supra* note 7, annex F, at 2.

taries of Commerce, Defense, Labor, and State, as well as the U.S. Trade Representative, comprise an Interagency Working Group chartered “to consult with foreign nations on limiting the adverse effects of offsets in defense procurement.”⁹¹ However the “future activities” planned by the working group are neither well defined nor extensive, as they consist of only two paragraphs in the Interagency Working Group’s eight-page annual report.⁹²

V. POLICY OPTIONS TO ADDRESS CURRENT INCONSISTENT U.S. TREATMENT

Several options exist for the U.S. Government in this area. However, before any substantive policy shifts can be implemented, two basic steps must be taken. First, the U.S. Government needs to collect complete and accurate real-time data on offset obligations U.S. defense contractors are incurring.⁹³ Second, the U.S. Government must back away from current policies that reduce transparency and mislead the public regarding offset agreements.⁹⁴ Once these first two steps have been accomplished, additional substantive policy options can be considered.

A. *Require Real-Time Reporting for All U.S. Contractor Defense Countertrade Arrangements*

Defense trade offsets end up acting as a privately funded form of foreign economic and military aid.⁹⁵ Because the U.S. Government collects data after the fact, and even then only for offset requirements in excess of certain thresholds,⁹⁶ the value of the offsets and other countertrade provided to those foreign countries receiving them is not captured or reflected in U.S. foreign aid reports,⁹⁷ let alone incorporated into the advance planning of any future foreign economic or military aid. This means that some countries are undoubtedly receiving far more in total support than the U.S. Government knows or intends.⁹⁸

91. Defense Production Act Amendments of 1992, Pub. L. No. 102-558, § 123(c), 106 Stat. 4198, 4206–07 (codified as amended at 50 U.S.C. § 2099 (2006)); OFFSETS 2009, *supra* note 7, annex F, at 2.

92. See OFFSETS 2009, *supra* note 7, annex F, at 7–8.

93. See, e.g., MARTIN, *supra* note 41, at 61.

94. See *id.*

95. See, e.g., OFFSETS 2007, *supra* note 74, at 3–9.

96. See 15 C.F.R. § 701 (2010); see generally BUREAU OF INDUS. & SEC., U.S. DEP’T OF COMMERCE, GUIDANCE FOR COMPLYING WITH THE BUREAU OF INDUSTRY AND SECURITY’S PROCEDURES FOR REPORTING ON OFFSETS AGREEMENTS ASSOCIATED WITH THE SALES OF WEAPON SYSTEMS OR DEFENSE-RELATED ITEMS TO FOREIGN COUNTRIES OR FOREIGN FIRMS (2010), available at <http://www.bis.doc.gov/offsetguidance.htm>.

97. See, e.g., U.S. CENSUS BUREAU, THE 2010 STATISTICAL ABSTRACT sec. 28, tbl.1263 (2010), available at <http://www.census.gov/compendia/statab/2010edition.html> (Table 1263 lists “U.S. Foreign Economic and Military Aid by Major Recipient Country: 2000 to 2007”).

98. See ISSUES CONCERNING OFFSETS, *supra* note 71, at 3–5.

It would be useful as a matter of efficient diplomacy and security for the U.S. Senate's Foreign Relations Committee, the U.S. House of Representatives' Foreign Affairs Committee, and various Executive Branch agencies such as the State Department, Department of Defense, and U.S. Agency for International Development to have access to real-time offset and other countertrade data.⁹⁹ This could be accomplished through a federal database system with a requirement to enter offset agreement information in advance of final agreement signature. This information could then also be used to adjust planned foreign economic or security aid prior to the U.S. Government finalizing such commitments.

Requiring real-time reporting of all defense trade offsets and other countertrade arrangements and then annually publishing the results is also consistent with the recent recommendations of Transparency International, which recommended that governments should publish all offset obligations of their defense contractors on an annual basis as a means to improve "transparency, accountability and integrity."¹⁰⁰ This is juxtaposed to the U.S. system that currently requires certain categories of offset information, when reported to the U.S. Government, to even be treated as classified information.¹⁰¹

B. Reverse the "No Known Offsets" Policy

When the Defense Security Cooperation Agency (DCSA) publishes a news release regarding a particular new foreign military sale ("FMS"), there are several boilerplate sentences that will appear in the press release. One conspicuous sentence relevant here is: "There are no known offset agreements proposed in connection with this potential sale."¹⁰²

This language seems to imply that U.S. Government, as the broker for the FMS case, has special insight into the transaction and is almost certifying that there are, in fact, no offsets.¹⁰³ Nothing could be further from the truth. The real U.S. government policy, as stated in the template language of the standard DCSA FMS letter of offer and acceptance ("LOA"), is that the DoD is not a party to, nor assumes any obligations for, offset agreements, and if the purchasing country wants visibility into offset costs being rolled back into

99. See *id.*

100. MAGAHY ET AL., *supra* note 16, at 42.

101. See DEF. SEC. COOPERATION AGENCY, U.S. DEP'T OF DEF., SECURITY ASSISTANCE MANAGEMENT MANUAL 245 (2010) [hereinafter SAMM] (citing Arms Export Control Act of 1976, 22 U.S.C. § 2776 (2006), and Export Administration Act of 1979, 50 U.S.C. app. § 2411(c) (2006)), available at <http://www.dcsa.mil/samm/Chapter%2005%20-%20FMS%20Case%20Development.pdf> (specifically, find at C5.6.5.5 in the SAMM).

102. See, e.g., News Release, Def. Sec. Cooperation Agency, U.S. Dep't of Def., India—M777 155mm Light-Weight Towed Howitzers No. 09-79 (Jan. 26, 2010), available at http://www.dcsa.mil/PressReleases/36-b/2010/India_09-79.pdf.

103. See Defense Production Act Amendments of 1992, Pub. L. No. 102-558, § 123(c), 106 Stat. 4198, 4206-07 (codified as amended at 50 U.S.C. § 2099 (2006)) (whereby the U.S. Government purportedly prohibits any agency of the U.S. Government from encouraging or committing U.S. firms to any offset arrangement in connection with the sale of defense articles or services to foreign governments).

their purchase price, they need to talk directly with the contractor.¹⁰⁴ Indeed, U.S. Government personnel are prohibited from discussing the “nature or details of an offset agreement” with a purchasing country.¹⁰⁵

The resulting practice is that offset discussions take place directly between the purchasing country and the contractor, outside of U.S. Government earshot, despite the technical absence of privity of contract. Further, the contractor does not disclose the offsets to the U.S. Government, but factors the cost of offset performance into the proposal price, and the U.S. Government supposedly remains blissfully ignorant of the fact of their existence. Yet it is no secret which countries have offset requirements, as the offsets are ultimately later disclosed to the U.S. Government as part of an annual reporting requirement to BIS,¹⁰⁶ shortly after the DCSA news release is published.¹⁰⁷ Thus, DoD turns a blind eye to defense trade offsets in FMS, and in so doing implicitly endorses the practice, despite the official U.S. government position against offsets.¹⁰⁸

The statement “there are no known offset agreements proposed in connection with this potential sale” should only appear in press releases for transactions where the DCSA has received certification from the contractor that there are none.¹⁰⁹ Instead of presenting a false impression that an offset transaction is not taking place, DCSA should become actively involved in offset arrangements that arise in the context of FMS transactions.¹¹⁰ Before any substantive policy shifts can take place, transparency needs to replace the status quo.¹¹¹ If nothing else, this will enable a more informed public discussion of the issue. The cost of this policy change would be negligible and should result in more transparent proposal pricing for foreign partners as well.

C. Substantive Follow-on Policy Options

Following the initial steps outlined above, the U.S. Government needs to increase pressure to eliminate defense trade offsets, especially those that

104. SAMM, *supra* note 101, at 145–48; *see also* FAR 225.7306 (stating, “[t]he decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, resides with the companies involved”).

105. *See, e.g.*, ANTHONY J. PERILIO, FOREIGN MILITARY SALES HANDBOOK 2009–2010 § 5:28 (2009).

106. *See* 15 C.F.R. § 701.4 (2010).

107. Note that DCSA seems not to be in the practice of retracting news releases in an effort to rectify them with data subsequently collected by BIS.

108. In the case of other-than-full-and-open-competition FMS procurements, the contractor is required to provide estimated offset costs that have been included in the FMS pricing to the implementing agency or military department. SAMM, *supra* note 101, at 260 (specifically at C6.3.9); *see also* PERILIO, *supra* note 105, § 5:27.

109. Such a certification would also be a new requirement, which could be accomplished with a Defense Federal Acquisition Regulation Supplement (DFARS) amendment.

110. Alternatively, the military department or implementing agency executing the FMS case should become involved in FMS case offset agreements.

111. This approach also would be consistent with the recommendations made by Transparency International in its recent report on offsets. *See* MAGAHY ET AL., *supra* note 16, at 42.

involve direct offsets where U.S. suppliers are replaced with foreign ones. This work could probably be accomplished through the Interagency Working Group.¹¹² The United States clearly cannot simply prohibit U.S. companies from participation in offsets through regulation, as that would prove crippling in the international defense trade market; rather, a global prohibition is needed.

Second, in the FMS context, an expansion of regulatory prohibition beyond the qualified foreign military financing ban is worth considering. It is inconsistent with the intent behind existing U.S. defense industrial base policies to allow U.S. prime defense contractors to replace domestic subcontractors on major defense programs that originated as U.S. defense programs, paid for through the U.S. defense budget, where those domestic subcontractors are being replaced with foreign ones only to satisfy offset requirements in follow-on, highly profitable, international sales.¹¹³ At a time when the United States is looking to overhaul its Cold War relic export controls regime, while concurrently creating jobs through exports, it would make sense to simultaneously reexamine its Cold War era offset policy.¹¹⁴

A deceptively appealing option might be to reverse course and begin requiring offsets in U.S. defense procurements from foreign contractors, with the goal of using the practice as a stick to drive the WTO to eliminate the offset prohibition loophole altogether. However, when one considers the predominately Western European nationalities of the largest non-U.S. defense contractors,¹¹⁵ it is clear they are not the developing nations described in the “typical international defense procurement” above.¹¹⁶ Thus, a U.S. shift to requiring offsets would harm our closest defense partners in the transatlantic defense industry, incentivizing them to move toward more protectionist measures at a time when they are beginning to move away from them. Finally, such a policy shift would have little or no effect on the developing nations that require offsets of U.S. defense contractors as almost none of them provide defense products or services to the United States.¹¹⁷

Finally, the U.S. Government, through the U.S. Trade Representative or the entire Interagency Working Group, could push to standardize the defense

112. The Interagency Working Group was initially comprised of the U.S. secretaries of Defense and State, but has expanded to other secretaries as well. See Defense Production Act Amendments of 1992, Pub. L. No. 102-558, § 123(c), 106 Stat. 4198, 4206-07 (codified as amended at 50 U.S.C. § 2099 (2006)).

113. A reasonable compromise might be to allow foreign subcontractors and their work content to be replaced with other foreign vendors to provide the U.S. prime defense contractor some maneuvering room for direct offsets, but require U.S. defense contractors to “lock in” the U.S. suppliers and their work share.

114. See, e.g., Roxana Tiron, *New Agency Will House Export Rules*, THE HILL (June 30, 2010), <http://thehill.com/business-a-lobbying/106597-new-agency-will-house-export-rules>; Sumer & Chuah, *supra* note 13, at 121.

115. See generally Perlo-Freeman et al., *supra* note 12.

116. See *supra* Part I.A.

117. See *id.*

trade offset practice by pushing for additions to the GPA. Such standardization would at least make the practice predictable and regulated at the WTO level, with the ultimate goal of eradicating the practice entirely.

VI. CONCLUSION

Defense trade offsets represent a U.S. national security concern that threatens the nation's defense industrial base, especially when major domestic prime defense contractors replace domestic subcontractors with foreign ones on heritage U.S. major defense programs for the international market. Although somewhat difficult to define, the real first steps in formulating an adequate U.S. policy are to (1) accurately measure all defense trade offsets that U.S. defense contractors enter into and (2) reverse existing policies that hinder transparency and create a false impression of an absence of offset arrangements in FMS transactions. Only from there can the U.S. Government consider more substantive policy actions.

