

The United States and the “Offsets in Defence Trade” Issue

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Abstract

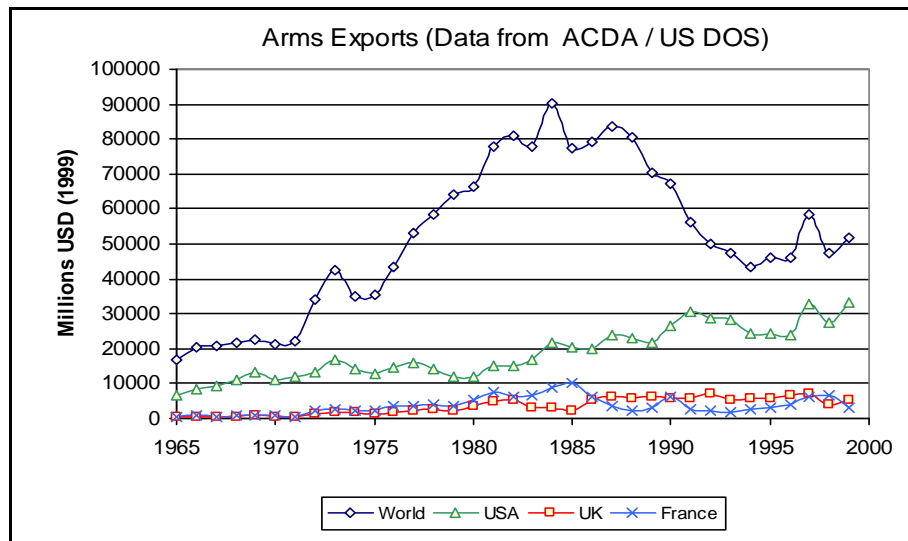
Since the end of the Cold War the United States has emerged as the world's largest and almost unchallenged arms exporter. However, the export success story of US defence firms has also led them to cast as the largest offset obligor. In this paper we analyse how the US public and private actors has reacted to the increasing importance of offsets in international arms trade. We will show that, from the 1970s, two groups of actors has appeared, holding opposite views about what the US reaction on this issue should be. An equilibrium was then established, quickly pushing the US administration to adopt a rather neutral attitude exemplified in what is known as the “Duncan Memorandum” of 1978. In spite of the important evolutions that had occurred later, the spirit of the “Duncan Memorandum” still constitutes the heart of the US government official attitude towards offsets in defence trade. However, the JSF program, with its specific work sharing process, may be considered as indirect and innovative US reaction to the offset issue.

Keywords: Offsets, Defence Trade, United States, Public Policy.

1. Introduction

The important decline in defence spending following the end of the Cold War resulted in reduced levels of international arms trade. However, the US defence industry experienced a genuine export success story during this same period. Between 1984 and 1994 world arms exports shrunk from more than 90 billion¹ of dollars to only 44 billion. In 1999 the level of world arms trade was still representing only 57 per cent of its level of 1984. Simultaneously, US defence companies succeeded in maintaining an overall increasing trend in their exports. In 1999 US arms exports totalled 33 billion of dollars comparing with only 22 billion in 1984. The US share of world arms exports more than doubled between 1984 and 1999, increasing from 24 to 64 per cent.

Figure 1. Arms Exports



Source : ACDA/USDOS

US defence firms also became more dependent on foreign markets: according to SIPRI Lockheed Martin's share of exports in total arms sales raised from 8 to 24 per cent between 1989-1991 and 1996-1998. For Boeing it increased from 16 to 25 per cent and for Raytheon from 8 to 11 per cent. Situation was almost the same in Western Europe: facing defence spending adjustment European firms also tried to compensate by increasing exports. Comparatively to their US counterparts, they were less successful in augmenting their market share but the importance of exports in their activity was also rising.

¹ In constant 1999 US dollars, data from World Military Expenditures and Arms Trade (WMEAT) reports published by the US Arms Control and Disarmament and Agency (ACDA) and later by the US Department of State. Last data available is for 1999, because no new report has been released since 2002.

Thus, the level of competition in the international defence equipment market noticeably increased since the end of the Cold War, giving buyers negotiating power they didn't enjoyed before. But instead of using it to exert pressure on armaments' prices, importing countries resorted to increasingly demanding offset policies.

Offsets represent provisions to an import agreement, between an exporting foreign company and an importing public entity, that oblige the exporter to undertake activities in order to satisfy a second objective of the importing entity, distinct from the acquisition of the goods and/or services that form the core transaction. They were already present in the 1970's but until the end of the Cold War they became omnipresent. Almost every arms importing country today has, whether by practice or law, offset requirements attached to its import agreements.

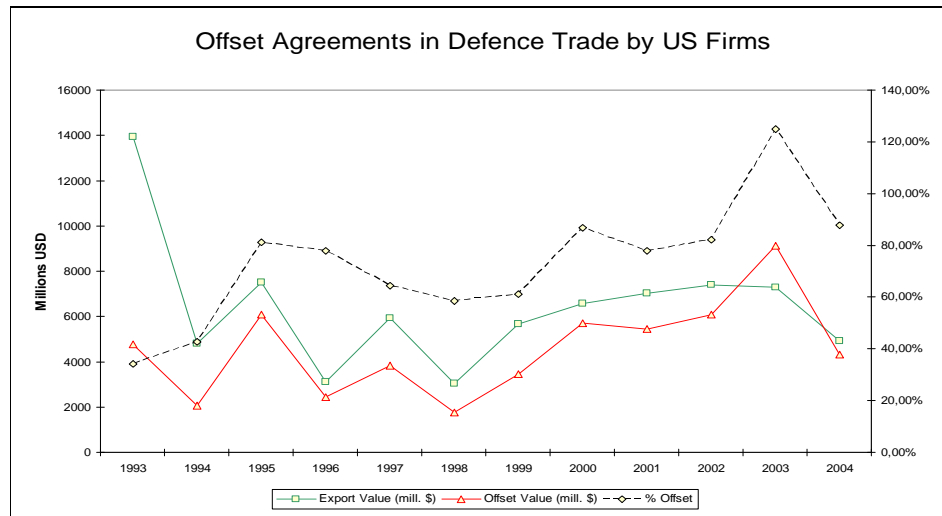
Facing the combination of reduced defence spending and continuous rise of armaments' unit production costs, an increasing number of small and medium countries found they were unable to maintain an independent defence industry (Struys [2004]). The only way their industries can be perpetuated is through access to large world's prime contractors supply chain and offsets appeared as a fundamental tool to obtain it.

The export success of US defence producers also led them to cast as the largest offset obligor. Data provided by the United States Department of Commerce's (US DOC) annual report on "Offsets in Defence Trade"¹ can illustrate this trend. Graph 2 shows the evolution, between 1993 and 2004, of offset agreements entered into by U.S. defence contractors. We can see that both the value of offset agreements and the offset percentage² have been increasing since 1993. Between 1993 and 2004 offset agreements totalled 55 billion dollars. The last report published states that "the weighted world trend in offset percentages rose from 49.3 percent to 99.5 percent" if expressed by a moving three year weighted average. Over the period European countries were the most demanding with an offset percentage increasing from 87.1 percent (1993-1995) to 128.5 percent (2002-2004). However, in the Rest of the World offset percentages demonstrated a highest rate of growth over the same period: from an initial value of 27.6 percent they reached 77.9 percent.

¹ United States Department of Commerce, "Offsets in Defence Trade", various editions (last 2005).

² The Offset percentage is the ratio of the value of offset agreements on the value of the related exports. It is the most adequate measure of the level of offset requirements, offsets agreements value being very sensitive to year by year changes in the value of related exports sales.

Figure 2. Offset Agreements in Defence Trade by US Firms



Source: US DOC

As the export share of US defence companies' business was increasing and simultaneously offset requirements were becoming more demanding, the "offsets in defence trade" issue gained in importance. However the US Government Policy towards offsets has remained surprisingly stable since the end of the 1970's. It is essentially based on the "Duncan Memorandum of 1978" that first introduced the neutral stand of the US Government that is still in force today. It is therefore important to investigate the positions of the US private parties concerned with offsets in order to provide a consistent analysis of the determinants of the related US Government policy.

The purpose of this paper is not to provide a complete description of all measures related to the US Government policy towards offsets and its evolution: such a survey can be found in Milligan [2003]. We will instead focus on the analysis of private parties' positions in relation with the offset issue before describing the main aspects of the resulting public government policy. Taking into account the influence of private sector's positions in the defence offset issue will be our main contribution comparatively to previous studies on the US policy towards offsets by Udis & Maskus [1996] and Milligan [2003].

Section 2 (3) analyses the contrasting positions held by two groups of private parties affected by offsets: the large exporting prime contractors on one side (section 2.1-3.1) and representatives of labour, small and medium subcontractors and firms unrelated to the defence and aerospace sectors on the other side. Then, section 3 (4) will highlight the main characteristics of the resulting US Government policy towards offsets. Finally, section 4(5) will account for recent developments and shed some light on future prospects.

2. Private Sector's Positions towards Defence Offsets

The increasing role of offsets in international defence trade induces contrasting reactions from the actors involved. Two positions have emerged in the US context, the first opposed to any attempt to limit industry's ability to provide offsets, the second advocating even unilateral action to limit their effects or simply eliminate them.

2.1. Prime Contractors: Offsets as a fact of life

Large US defence and aeronautics prime contractors exhibit a long-lasting suspicion of any US government's potential action that could reduce their liberty in operating offsets linked to export sales. In the highly competitive defence equipment market of the post Cold War era, offsets are among the most powerful tools to winning export contracts. Some rare cases have even been reported where, in the process of evaluation of competing bids, importing governments attach more importance to the quality of the offset propositions than to the technical characteristics of the defence equipment they are buying.

Therefore, from the prime contractor's point of view, any inability to satisfy importer's demands will more than probably result in surrendering export contracts to competition. As summarised by Joel Johnson from the International Aerospace Industry Association during congressional hearings held in 1999, "*... offsets are an issue that is controversial, but one with which we in industry must cope if we are to continue making the foreign sales that are critical to maintaining our defence industrial base and the jobs of the workers that constitute that base... The US government should not take unilateral measures through statute or regulation to control offsets which would simply cause business to go to foreign competitors (except for current technology transfer restrictions related to security)*"¹.

This argument is reinforced by the export success of the US defence and aeronautics sectors are exhibiting. While the US economy as a whole displays huge trade deficits, these two sectors count among those that present a genuine trade surplus. And offsets are sometimes supposed to have a considerable influence over this success: "*US has the world's largest economy, it can be argued that offsets provide a form of marketing advantage to US firms. That is, the US can absorb offset requirements, including some purchases from the*

¹ Testimony of Joel Johnson (International Aerospace Industries Association), U.S. House of Representatives [1999], Committee on Government Reform, Subcommittee on Criminal Justice, Drug Policy, and Human Resources, "Offsets Related to Military Sales", June 29, 1999.

customer country, with little or no impact on our overall economy, more readily than our competitors. This marketing tool is particularly important to the US defence industry given the lack of official US export finance for defence products and technology transfer controls that often preclude our competing with our best technology. “¹

Studies on the impacts of defence offsets on the US defence preparedness and industrial base undertaken by US Office of Management of Budget and by the US DOC also provide support for such a position. Not a single report has been able to establish the presence of a net negative effect of offsets on the US defence industry. Quite the reverse, conclusions steadily support that the jobs lost in result of offsets are more than compensated by the jobs created or maintained by the export sales they made possible. As reported by the National Defence Industrial Association (NDIA), “It is worth noting that the Department of Commerce has determined that U.S. defence exports with offset agreements have resulted in U.S. job creation at a net of over 28,000 workyears annually since 1993”².

Despite the fact that report’s conclusions are generally favourable to the prime contractor’s point of view, some have expressed concerns regarding their publication. According to them the publication of aggregated data on offset agreements and transactions induce two important types of risks. First, there is the possibility of an exaggeration of “the problem”, especially by people who are not familiar with the offset question. Second, giving publicity to present and past offset agreements may result in increasingly demanding importer’s offset policies in the future.

Finally, a last argument may be provided in explaining prime contractor’s position on offsets. We already mentioned that offsets may be considered as a “necessary evil” that is crucial in winning export contracts. But evidence exists, suggesting that offsets per se may in some cases provide direct benefits to the exporting firms. Neuman [1985] reports that Rockwell International trying to satisfy countertrade obligations discovered a new supplier for forgings permitting to realize savings of 40 percent. Redlich & Miscavage [1996] provide another instance: « Members of the client company recognised that by acting as a catalyst to bring representatives from numerous parts of the corporation to Israel, the need to develop offsets opened up opportunities that otherwise would have gone unnoticed, or still worse, gone to the competition. Of the 100 potential projects, over 30 were rated as top priority initiatives. Several were signed and executed towards the end of 1993, prior to any selection of the plane or the engine, due to their enormous relevancy and contribution to the needs of the company. »³

Indirect evidence can also be gathered in the survey by Martin & Hartley [1995a] on the experience of British exporting firms with offset requirement by importing

¹ Ibid.

² NDIA [2004], “Background Paper on Offsets”, p. 1.

³ Redlich and Miscavage [1996], “The Business of Offset: A Practitioner’s Perspective. Case Study: Israel”, in Martin Stephen (ed.) [1996], “The Economics of Offsets”, p.404.

governments¹: “In six of the 11 offset sales the respondents said that the offset obligation had led to the discovery of new, lower cost, sources of supply and in all six cases the intention was to continue to do business with new source once the offset obligation had been fulfilled.”² It can be argued that changing suppliers of complex components induce high search and switching costs that may act as barriers to entry and trade. Therefore, if the expected gains are limited in comparison to search and switching costs relations with incumbent suppliers are continued even if potential more efficient suppliers exist (Ianakiev [2005]). Offsets are then used by importing governments to induce this search and switching activity. Offsets not only provide higher incentives to operate such activities, but also give the possibility for search and switching costs to be subsidized by the importer. Costs of offsets are almost always integrated in the price of the equipment sold in the core transaction and are therefore supported by the importer³. For US exporters, the recovery of offset costs is even possible inside the Foreign Military Sales at the condition that these costs are funded by foreign government cash or repayable Foreign Military Financing funds⁴.

In short, US defence and aerospace prime contractors are relatively favourable to multilateral negotiations with foreign governments but strongly oppose unilateral government’s initiatives that could undermine their use of offset as a competitive tool for winning export contracts. The sole exception admitted concerning cases when only US companies are competing for an export contract.

In general, the position of prime contractors is reinforced by the findings of the studies on the impacts of offsets, but they are rather cautious in what concerns the data publication. Of course, they are also favourable to the possibility to recover offset costs in the FMS system.

2.2.Labour Unions and Small Suppliers and Subcontractors: Offsets are stilling our jobs

Offsets point out to an extraordinary asymmetry between the exporting prime contractor’s and some of their suppliers. While the former form an essential party in export contract negotiations with foreign governments, the latter, and especially small and medium sized, are mostly absent. As a consequence, they are not able to directly defend their interests during offset agreements’ negotiations. The same reasoning applies also to labour organisations and to firms unrelated to defence or aerospace that are hurt by what is known as “indirect non-defence offsets”. It is not surprising to see that the main concerns about offsets are raised by these same

¹ The survey concerns exclusively the British defence firms’ experience, but there is no reason to reject, in principle, that the results can transpose to the US case.

² Martin and Hartley [1995a], "Defence Equipment, Exports and Offsets: The UK Experience." *Defence Analysis*, 11:1, p 29.

³ Evidence can be found in Martin and Hartley [1995a]. This is also a fact that is openly admitted by defence industry’s offset representatives.

⁴ Detailed discussion can be found in Milligan [2003].

parties. They form the principal group asking for government intervention in the offset issue and their action has been frequently echoed by different members of the United States Congress¹.

The difference in conceptions between the prime contractors and the labour organisations can be exemplified by the following declaration by Thea Lee from AFL-CIO: *“Industry clearly believes that offsets are not a major problem. It is not surprising that the issue is perceived differently by industry and workers. It is an issue of inconvenience to industry. It is a problem of much greater significance to workers. Industry can move production to gain market access and still earn profit; workers are left out”*².

The important reduction in employment in the sectors concerned, especially in aerospace, represents naturally a huge issue for labour organisations. According to Stanley Sorscher’s (Society of Professional Engineering Employees in Aerospace) statement during congressional hearings held in 2004, total US aerospace employment fell by 50 percent between 1990 and 2004. In what concerns R&D scientists and engineers there is an 83 percent reduction when comparing to levels of 1990³. Of course, a large part of this employment reduction is the result of industry consolidation. But for labour and supplier associations, offsets also bear an important responsibility in explaining the loss of jobs. Therefore, from their point of view *“ ... the United States can no longer be complacent with leaving offset policy in the hands of private parties. The conclusion of some people that offsets are at best, a way for the U.S. to enter foreign markets and at worst a “necessary evil” must be rejected once and for all. While much more must be learned about the precise impact that offsets and all of their variations have on the U.S. work force, what we do know is that labelling offsets as “an inconvenience” or a “necessary evil” is an unacceptable response to the U.S. aerospace workers, their families and the communities that have made this industry so successful.*”⁴

Some indirect evidence for the importance of the asymmetry between parties involved in offset negotiation and fulfilment and those that are absent can be found in the US DOC study on the effects of offsets on the US subcontractor base⁵. Results show that subcontractors involved in fulfilling offset obligations had an average gain in employment of 20 percent between 1998 and 2002, while

¹ Another group can also be mentioned : defenders of strict arms control as the Federation of American Scientists are also opposed to offsets (Udis and Maskus [1996]). However their influence seems to be limited and the FAS internet site’s “Offsets Monitoring Page” is apparently not updated.

² In Wessner (ed.) [1999], “Trends and Challenges in Aerospace Offsets”. Washington: National Academy Press, p. 77.

³ Testimony of Stanley Sorscher (Society of Professional Engineering Employees in Aerospace), U.S. House of Representatives [2004], Committee on Armed Services, “Department of Defence Trade Offsets”, July 8, 2004.

⁴ Testimony of Owen Herrnstadt (International Association of Machinists and Aerospace Workers), US House of Representatives [1999], op. cit.

⁵ US DOC [2004], “Offsets in Defence Trade and the US Subcontractor Base”, August 2004.

subcontractors that were not involved had a 2.5 percent drop (and a 10.9 percent drop for the subcategory with negative view on offsets). However, the same report states that 51 percent of responding subcontractors had positive experiences with offsets comparing with 36 percent with negative experiences. Another interesting conclusion is that employment, for both prime contractors and subcontractors, significantly increased between 1998 and 2002. Such conclusions substantially weaken the positions of parties advocating a direct intervention of the US Government aimed at reducing or eliminating offsets. Their arguments are however frequently echoed by members of the US Congress, but with a rather limited effect on legislations that are effectively adopted.

Less regularly, companies unrelated to defence and aerospace are harmed by offsets and enter the debate. The most famous example is the complaint by the Wisconsin-based Beloit Corporation concerning Northrop's support to the Finnish company Valmet in a competition for the supply of paper-making machines to the International Paper Company. Northrop offered an incentive payment to favour the Finnish offer in order to satisfy offset obligations contracted during the sale of F-18 to Finland. Finally, Beloit was able to win the contract by substantially lowering its bid. This case eventually called the attention of senator Feingold who sponsored, in 1994, one of the little offset-restricting legislations that were successfully adopted. Further discussion on the "Feingold Amendment" will be provided in section 3.

To summarise, labour associations, small and medium sized suppliers' representatives and some indirectly hurt companies, form the core of the group of private agents asking for the US Government to directly interfere and regulate offsets. Of course, they are favourable to multilateral negotiations, but also strongly advocate unilateral action. Unlike prime contractors they are eager for more data to be collected and published. Finally their views are frequently conveyed by some members of the Congress.

In the following section we will show how these private parties positions were transposed in the US Government's posture towards offsets in defence trade.

3. The US Government policy toward offsets

It is possible to distinguish three main questions concerning the US Government response to the offset issue: the question of the direct involvement of the government in offset transactions, the one concerning the data gathering and publications and finally the question of multilateral negotiations versus unilateral action.

3.1. Direct involvement in offset agreements

The first modern offset agreement¹ involving the US government was entered into in 1973 (Milligan [2003]). Australia purchased three frigates from the US and an offset agreement aiming at an offset objective of 25 percent on best effort basis was concluded. Obligations has to be met by private contractors, but, in case of failure, the US DOD has to provide opportunity for Australian companies to bid for US Government purchases on a strictly competitive basis (Milligan [2003]).

In July 1975 another offset agreement was signed, which was to produce much more important consequences. In this agreement, related to the Swiss purchase of F-5 combat aircrafts, the DOD acted “as guarantor for the offset commitments entered into by the major US prime contractors”². As Northrop and General Electric were unable to comply on time, DOD was constrained to intervene by directly purchasing, or promoting the purchase, of Swiss products (Udis and Maskus [1996]).

Finally, a third large contract was signed with a buyer’s cartel formed by the governments of Belgium, Denmark, Netherlands and Norway. In 1975 they purchased 348 F-16 combat aircrafts and were granted participation in their production for a value of 40 percent of the purchase. They also obtained a 10 percent participation in the production of the US F-16 order and 15 percent for third countries’ orders (Struys [1996]).

This early experience with offsets promptly induced a change of the DOD policy. Dissatisfaction with the outcome of the Swiss offset transaction finally led, on the fourth of May 1978, to the establishment of a formal statement on the DOD policy towards offsets known as the “Duncan Memorandum”³. From that moment on the DOD, and more generally the US Government, refused any involvement in offset agreements. The responsibility for concluding offset agreements and satisfying the resulting obligations was entirely devolved to the exporting companies. From 1978 to present days US Government conscientiously respected the rule established by the “Duncan Memorandum”. Only one exception was made in 1984 when DOD took part in an offset agreement with Netherlands related to the sale of Patriot Missiles, but it was motivated by national security concerns (Milligan [2003]).

If we consider the private parties positions described in section 2, the “Duncan Memorandum” appears as a clever positioning by the US Government in relation with the emerging offset issue. In what is frequently regarded as a “hands off

¹ From a US point of view the origin of offsets is to be found in the coproduction agreements of the post World War II period. Their objective was to help European allies in rebuilding consistent defence production capacities. However, these arrangements were quite different from the current offsets that really emerged in the 1970’s. More detailed discussion can be found in Milligan [2003].

² Udis and Maskus [1996], “US Offset Policy”, in Martin Stephen (ed.) [1996], op. cit., p.359.

³ The memorandum was signed by Deputy Secretary of Defence Charles Duncan.

policy”, almost entire freedom was granted to exporters to enter into offset agreements. Potential support to offsets transaction from the DOD or other agencies was no more available, but defence prime contractors’ ability to compete for export contracts remained intact.

The Memorandum presents a second advantage of the higher importance. It protects the US Government from being criticised because of participating in offset agreements. It is unquestionably more comfortable to face labour and supplier associations’ criticism against offsets from such a neutral position: not doing enough to protect US jobs is not such a crime if compared to being directly involved in their transfer abroad.

The “Duncan Memorandum” established a surprisingly stable institutional compromise. Its spirit still forms the heart of the US official attitude towards offsets and has survived to numerous attempts by the Congress aiming to inflect policy towards a less neutral stand. In 1990 the White House, prompted by the Congress, issued “The US Government Policy on Offsets in Military Exports”. The statement was a response to President’s obligation to establish a comprehensive policy on the subject resulting from the National Defence Authorization Act of 1989 passed by the Congress several months ago. The policy statement (Box 1) is essentially a restatement of the “Duncan Memorandum” reasserting the neutral attitude of the administration towards offsets. Immediate disapproval arose from some members of the Congress arguing that a policy of non-involvement in offsets was actually a “non-policy”¹. As multiple examples quoted in section 2 attest, this same criticism, under various forms, is still present today. The President’s statement was later embedded into law with the Defence Production Act Amendments of 1992. Despite criticism and attempts from members of Congress to pass “less neutral” legislations, the “Duncan Memorandum” - based US Government Policy is still in force and has sustained only minor modifications.

¹ Senator Dixon’s reactions reported by Milligan [2003], “The Determinants of United States Government Policy and Practice Towards Offsets in International Trade”, Thesis – Naval Postgraduate School, Monterey, California, p.65,

Box 1: 1990 Presidential Policy on Offsets¹

The policy was announced by the President in April 1990, in a statement issued by the White House Press Secretary. Congress incorporated this policy statement into law with the Defence Production Act Amendments of 1992 (Pub. L. 102-558, Title I, Part C, § 123, 106 Stat. 4198) as follows:

(a) In General. Recognizing that certain offsets for military exports are economically inefficient and market distorting, and mindful of the need to minimize the adverse effects of offsets in military exports while ensuring that the ability of United States firms to compete for military export sales is not undermined, it is the policy of the Congress that--

(1) No agency of the United States Government shall encourage, enter directly into, or commit United States firms to any offset arrangement in connection with the sale of defence goods or services to foreign governments;

(2) United States Government funds shall not be used to finance offsets in security assistance transactions, except in accordance with policies and procedures that were in existence on March 1, 1992;

(3) nothing in this section shall prevent agencies of the United States Government from fulfilling obligations incurred through international agreements entered into before March 1, 1992; and

(4) the decision whether to engage in offsets, and the responsibility for negotiating and implementing offset arrangements, reside with the companies involved.

(b) Presidential Approval of Exceptions. It is the policy of the Congress that the President may approve an exception to the policy stated in subsection (a) after receiving the recommendation of the National Security Council.

(c) Consultation. It is the policy of the Congress that the President shall designate the Secretary of Defence to lead, in coordination with the Secretary of State, an interagency team to consult with foreign nations on limiting the adverse effects of offsets in defense procurement. The President shall transmit an annual report on the results of these consultations to the Congress as part of the report required under section 309(a) of the DPA.

3.2.Data collection and publication

A field where anti-offset parties were relatively more successful concerns the collection of data on defence offsets and its subsequent compilation and publication. In 1984 the US Congress enacted amendments to the Defence Production Act (DPA) of 1950 requiring, under section 309, the President to submit an annual report on the impact of offsets on defence preparedness,

¹ United States Department of Commerce [2005], "Offsets in Defence Trade", p. 26.

industrial competitiveness, employment, and trade of the United States. The President delegated responsibility for preparing the reports to the US Office of Management and Budget (OMB), which produced six reports between 1985 and 1990. The report series was discontinued from 1990 because of the Expiration of the DPA. In 1992 the latter was amended and responsibility for providing the reports on offsets was shifted to the US Department of Commerce (DOC)¹. Congressional dissatisfaction with the conclusions contained in the OMB reports motivated this modification (Udis and Maskus [1996]). For instance the fifth report submitted by the OMB stated that *“The effects of offsets on total US employment are minor. That is to say, military sales abroad with contractually required offsets are likely to increase domestic employment by somewhat more ... than would comparable sales without offsets ... largely because offsets are substitute for (but are less labour intensive than) the imports that would replace them to finance the foreign sales...”*²

The reports produced under section 309 of the DPA are based on data mandatory reported by exporting firms entering into offset agreements exceeding a defined value. During the 1992 reshape of the DPA this reporting threshold was lowered from 50 to 5 million of dollars. DOC was able to submit its first report in 1996. Since then it has produced ten reports. Unlike the OMB, DOC has never advanced that export with offsets may be more beneficial to the US economy than equivalent exports without offsets. However the even nature of their conclusions has remained very close to those contained in the reports issued in the late 1980's. As mentioned before, on a steady basis the DOC is ascertaining that net impact of offset transactions to the US defence industrial base remains positive because jobs losses resulting from offsets are more than compensated by jobs maintained or created by the exports made possible by offsets.

Dissatisfaction about the data and studies available on offsets in defence trade is omnipresent each time the issue is raised. Parties advocating the establishment of limitations on offset activities by US firms are obviously frustrated by the conclusions contained in the OMB and DOC reports. Calls for data were so frequent during the Hearings held in July 2004 by the Committee on Armed Services of the US House of Representatives that they prompted the following reply by Representative Jim Marshall: *“All three of you repeatedly called for data. Data calls, and in my experience, that just assures further delay. It is, in my opinion, a recipe for disaster. And if I am right, then you can call for as much data as you wish, and you will never understand the full problem. There will always be a call for more data and for more information before making decisions.”*³

One specific issue retained attention: the lack of data and specific studies investigating the impacts of offsets on subcontractors, which are the party the

¹ The preparation of the reports on offsets in defence trade is under the responsibility of the Bureau of Industry and Security.

² Quoted by Udis and Maskus [1996], op. cit., p. 365.

³ U.S. House of Representatives [2004], op. cit.

most exposed to the potential negative effects of offsets. Eventually, democrat Senator Christopher Dodd managed to introduce an amendment to the Department of Defense Production Act Reauthorisation of 2003 requiring the DOC to produce a report reviewing the impact of defence offsets on at least the first three levels of the US subcontractor base. The report was issued in August 2004 and once again conclusions did not provided strong arguments to supporters of government limitation of offset transactions (discussed in section 2).

Finally, the important controversy that arose in relation to the Presidential Commission on defence offsets must be considered. The Commission was established in 2000 in response to obligations introduced by the Defence Offsets Disclosure Act adopted the previous year. The Commission comprised five members from the executive branch, three from industry, two from academia and one from labour. An interim report was made public in January 2001 but the final one was never issued. As the Clinton administration was replaced by the Bush administration during 2001, the Commission was actually dismantled. The five members representing the executive branch during the Clinton administration resigned and were never replaced. Thus, the President's obligation to provide a report on the desirability and feasibility of a multilateral treaty on offsets was never enacted. This report was owed within the 90 days following the publication of the Commission's final report that eventually never occurred.

Box 2: Selected Findings of the Presidential Commission on Defence Offsets¹

- Offsets have a direct effect on U.S. jobs by facilitating exports, but they also supplant a significant amount of work and jobs that would go to U.S. firms if export sales occurred without offsets.
- In some cases, offsets hurt the U.S. defence supplier base by transferring work to foreign firms, but the erosion has yet to show up in overall trade statistics.
- At the same time, defence export sales may be important to the economic viability of aerospace firms and may provide an incentive for their development of new defence products and technologies.
- In a number of cases, U.S. technology transfers improved foreign firms' competitiveness but rarely resulted in technology transfer back to the United States.
- Technology transferred to foreign firms through offsets does not appear to pose a special security risk above and beyond that posed by other technology transfers by U.S. firms.
- However, recent examples show that U.S. export control processes are not flawless in preventing the transfer of sensitive technology abroad and that offsets could exacerbate any leakages.

¹ GAO [2003], "Report and Recommendations of the Defence Offsets Commission Still Pending", p.4.

In May 2003 the US General Accounting Office (GAO) reported to Congress that the report and recommendations of the Defence Offsets Commission are “*still pending*”¹ In 2004 the issue was raised during the hearings held by the Committee on Armed Services of the US House of Representatives. A few months later the Bush administration was once again harshly criticised, by Senator Dodd, for the decision to discontinue the Commission’s work². Nevertheless, no progress has been noticed since then and the Commission remains inactive.

3.3. Multilateral negotiations versus unilateral action

The necessity to conduct multilateral negotiations is amongst the few offset-related issues on which a large consensus exists. Various legislations since the 1980’s have prompted the President to enter into negotiations with foreign governments in order to limit offsets or their effects³. An interagency team led by the DOD was established by the Defence Production Act Amendments of 1992 in order to consult with foreign nations on limiting the adverse effects of offsets. After exhibiting no activity at least since 2001 the team was suddenly revived in 2004 following the adoption of the Defence Production Act Reauthorization for 2003 and the bitter critics Senator Dodd addressed to the administration during the preceding discussions. According to the last report on defence offsets released by the DOD, consultations took place in November 2005 with representatives from the governments of France, Germany, Italy and the United Kingdom. However, no details have yet been made public. A second round of consultations is scheduled with representatives of seven other countries.

Despite the large domestic support to multilateral negotiations, the chances for success appear extremely limited. A resolute opposition can be expected from European governments and industry because of the link they establish between offsets and access to the US defence equipment market. From the European standpoint offsets are essentially a reaction to the lack of access to the US market resulting from various “Buy American” formal or informal policies. A report released by the DOD in April 2006 shows that during fiscal year 2005 less than one percent of overall DOD contracts were awarded to foreign suppliers (US DOD [2006]).

What’s more, some of the incriminated protectionist measures also produce effects similar to those of offset policies, a fact that is admitted even by US industry associations: “*While there are no U.S. government laws or regulations mandating offsets when the Department of Defense (DOD) acquires foreign military equipment, there is a de facto U.S. government “offset policy.”*”

¹ Ibid.

² Dodd [2003], Letter of Senator Dodd to Secretary of Commerce Donald L. Evans, August 8, 2003.

³ Such measures are present in the National Defence Authorization Act for 1989 and for 1990-1991, in the Defence Production Act Amendments of 1992, in the Defence Offsets Disclosure Act of 1999 etc...

Moreover, that de facto policy has been in place for over 20 years.”¹ On the European side, industry’s position can be summarised by the following statement: “Unless the issues of imbalance of defence trade or a lack of reciprocal access to the (US) market are resolved, European nations should not abolish offsets requirements, as a sole way to balance trade and assure access to technology. The USA does not impose formal offset requirements but uses tools such as local content requirements and creation of local second sources to exactly the same effect as direct offset.”² Despite recent support by the DOD to grant some market access to suppliers from allied countries, as exemplified by the award of the Presidential Helicopter contract to Augusta-Westland, deep changes in US defence procurement practice are not expected. Therefore, European countries will probably be reticent to curbing their offset requirements. And even if a formal agreement is reached its enforcement will be extremely difficult as demonstrated by flourishing offsets in civil aviation despite prohibition by WTO’s Agreements on Government Procurement and Trade in Civil Aircraft.

As multilateral negotiations on offsets has never brought a positive result³ some parties turned their attention towards potential unilateral actions. According to Milligan [2003] propositions to enact a legal prohibition of offsets were already in discussion in 1988. However, any radical proposition has been, until now, stopped by vigorous opposition from the large Prime Contractors frequently backed up by the DOD or the entire administration.

As far as the executive branch is concerned only one direct intervention aiming to limit offsets can be mentioned. In 1989 two US companies (General Dynamics and McDonnell-Douglas) were competing for a combat aircraft procurement contract by the Republic of Korea. Initially Korean authorities were requiring a 30 per cent offset agreement. When they raised their demands to a 60 per cent level the DOD reacted by prompting the US companies to oppose offset demands in excess of the 30 per cent level (Udis & Maskus [1996]). Such an intervention was made possible only because of the lack of non-US competition over the contract. Koreans officially accepted the 30 per cent limit but were able to actually extract a much higher value (Udis & Maskus [1996]).

Members of the Congress were much more active in proposing legislations to limit offsets. However, only a few of these proposals were eventually enacted into law and their scope was rather limited. The most famous example is the Feingold Amendment to the State Department Authorisation Act of 1994. Direct result form de Beloit-Valmet-Northrop case discussed in section 2 the Feingold Amendment “*prohibits U.S. contractors from making incentive payments to a U.S. company or individual to induce or persuade them to buy goods or services*

¹ NDIA [2004], “Background Paper on Offsets”, p. 2.

² European Defence Industries Group (EDIG) [2001], “EDIG Policy Paper on Offsets”, 2001.

³ The only case when an agreement appeared possible was during the negotiations on the NATO Code of Conduct that took place in the early 1990’s. However the entire Code of Conduct project failed and no agreement was enacted.

from a foreign country that has an offset agreement with the contractor “¹. Penalties up to 500 000 dollars or five times the value of the incentive payment can be applied in case of violation. However the lack of precision in the formulation of the amendment has prevented its practical enforcement. This problem was already reported by the GAO in a report addressed to Senator Feingold in 1997². For some specialists’ the lack of precision appeared strong enough to raise doubts about the ability of the amendment to even prevent the case that led to its creation³.

Other legislation that is worth mentioning includes the National Defense Authorisation Act of 1989 directing the president to enter into negotiations with foreign governments in order to limit the adverse effect of offsets. It served as a justification to the above mentioned DOD intervention during the Korean purchase of combat aircraft in 1989. Otherwise, its application was more than limited.

Surprisingly, and despite chronic failures of congressional attempts to curb offsets, an important onslaught on the “neutral” US Government policy took place in 2003 and 2004, led by Senator Christopher Dodd and Congressman Duncan Hunter.

4. Recent Developments and Future prospects: Head-on Attack or Indirect Strategy.

4.1. Recent Congressional attempts to put an end to the “neutral” US policy on offsets

In 2003 Senator Dodd successfully introduced an amendment to the Department of Defence Appropriations Act of 2004, requiring the Secretary of Defence to review offset agreements and their effects on specific subsectors of the US industrial base. The Secretary has to produce a report including also recommendations to the President regarding “*the use or administration of contractual arrangements and memoranda of understanding ... that the Secretary considers an appropriate response*”. The required report was produced by DOD in February 2005⁴. It basically stated that according to law, DOD is not participating in offset agreements and is not empowered to ask details of such contracts from private companies. For analysis of the effects of offsets on the industrial base DOD directed to the DOC reports.

¹ US GAO [1997], “Military Offsets. Regulations Needed to Implement Prohibition on Incentive Payments”, August 1997, p.2.

² Ibid.

³ CTO, “The Feingold Amendment – Enforcing Ethics or Restricting Offsets?”, CTO, Vol. XXI, N°11, p. 3.

⁴ US DOD [2005], “Report on Contractual Offset Arrangements, Memoranda of Understanding, and Procurement Waivers”, February 2005.

A second intervention by senator Dodd occurred during discussions surrounding the reauthorisation of the Defence Production Act of 2003. In August 2003 he addressed a letter to Commerce Secretary Evans that pointed to the “troubling conclusions” and the “seriously out of date data” contained in the DOC reports on defence offsets¹. Carrying on the fight, Senator Dodd, succeeded in introducing an amendment to the Act, requiring the DOC to produce the report on the effect of offsets on the subcontractor base (discussed in sections 2.2 and 3.2).

However, Senator Dodd’s initial intentions were to take advantage of the Defence Production Act Reauthorisation in order to enact much stronger offset-limiting measures. With a bill introduced in October 2003, he was proposing to establish an interagency team, led by the Secretary of Commerce², in charge of negotiating with foreign governments “*the elimination of offset arrangements, industrial participation, or similar arrangements in defence procurement*”. If cases were established by this team, where foreign governments were requiring offset agreement with offset percentage superior to 100 per cent, they had to be referred to the United States Trade Representative (USTR). In accordance to section 304 of the Trade Act of 1974, the USTR was then supposed to take the appropriate actions given the presence of arrangements considered as “*an act, policy, or practice by the foreign country that is unjustifiable and burdens or restricts United States commerce*”.

However, in the final Defence Production Act Reauthorisation of 2003, enacted in December 2003, only a much softened modifications requirements were present restating that an interagency team is to be designated that should “*consult with foreign nations on limiting the adverse effects of offsets in defence trade ...*”

In 2004 another attempt to curb offsets by passing legislative measures was made. This time the first move was made by the House of Representatives. The first version of the National Defence Authorisation Act for Fiscal Year 2005 sponsored by Congressman Duncan Hunter, Chairman of the Committee on Armed Service, included a section 811 prohibiting the DOD from procuring defence articles or services from, or permitting subcontracts with, foreign suppliers unless the countries in which they are located agrees “*to apply offsets agreements to the procurement of defence articles and defence services from the United States firms in the same manner and to the same degree as such agreements are applied by the Department of Defence to the procurement of defence articles and defence services from that country*”. Under section 811, exceptions were allowed only if justified on national security grounds and 30 days after the publication of a notification in the Federal Register.

¹ Dodd [2003], op. cit.

² The already existing interagency team was placed under the leadership of the Secretary of Defence. The change of leadership proposed is not insignificant: it is the result of the defiance towards the desire of the DOD to take strong actions aimed at limiting offsets. DOD was the initiator of the “neutral policy” towards offsets and has always been supportive to the defence prime contractor’s position.

When the bill came to the Senate, Senator Dodd joined in by proposing an amendment requiring the Secretary of Defence to impose offsets on foreign suppliers or subcontractors originating from countries imposing offsets in excess of 100 per cent to US exporters. Offsets could also be applied to suppliers from countries imposing offsets to US suppliers under contracts exceeding 5 million of dollar.

House section 811 and Senator Dodd's amendment caused quite an uproar¹. During May and June, Acting Under Secretary Mike Wynne sent letters to members of the Congress expressing DOD's strong opposition to the section 811 of the House Bill. He emphasised that this measure will apply to almost any US defence procurement from foreign suppliers and may question US armed forces access to some best value state of art products. Concerns were expressed in relation to possible resulting failures in cooperative projects like the JSF and reduced export opportunities for US defence companies.

NDIA was also very active in fighting anti-offset measures. Letters were sent to members of the Congress and a specific page on the association's web site was dedicated to the issue. Finally, following continuous pressures from industry and administration, the anti-offset provisions of the bill were dropped or markedly softened. Only remained a requirement to the Secretary of Defence to "*develop a comprehensive defence acquisition trade policy that provides the necessary guidance and incentives for the elimination of any adverse effects of offset agreements in defence trade*". The neutral policy towards offsets, originating from the "Duncan Memorandum" of 1978, has once again resisted an audacious assault. As stated before, this policy results from a specific configuration of private actors' positions regarding offsets. The resulting US Government's Stand is therefore characterised by a high degree of stability. Changes are not to be expected unless a major disruption occurs in the positions held by private actors and head-up attacks against the official US Government policy will probably still be successfully repealed in the foreseeable future. However an indirect response to the issues related to defence trade offsets can be found in the emergence of new types of international cooperation projects like the JSF program.

4.2.The JSF: an indirect strategy against offsets?

The JSF program was officially launched in 1995 following the merger of two previous programs (JAST and ASTOVL/CALF). Its purpose is to develop a new generation of combat aircraft for the joint needs of the US Air Force, The US Navy and the US Marine Corps. Teams led by Lockheed Martin and Boeing were selected for the Concept Demonstration Phase (CDP). In 2001 the team comprised of Lockheed Martin, Northrop Grumman and BAE was selected and the System Development and Demonstration (SDD) phase was launched.

¹ The bill also contained export control provisions which was also strongly opposed by industry and DOD.

One of the fields where the program is innovative concerns its international cooperation aspects. The JSF introduces an original model in this respect. Unlike other cooperative projects the JSF is characterised by clear US leadership, strict US control on technology transfer and a “best value” approach to contracts’ awarding. The latter implies that there is no link between the financial contributions of participating nations and the work share their industry will obtain. Contracts for different systems and sub-systems are competed by the prime contractor, with suppliers from participating nations being offered the opportunity to bid.

This type of industrial organisation is clearly distinct from the traditional approach of “juste retour”¹ typical especially in traditional European cooperation projects. It is also “a very radical departure from the offset paradigm”² by the early stages financial implication of partner nations. Normally no offsets should be available to countries that choose to buy the aircraft later without participating in the program. In theory such an organisation will avoid costs increases resulting from duplications or from the necessity to provide work to comparatively inefficient suppliers. In the same time access will be granted to foreign suppliers to the extent that they are more competitive.

However, the reality is sometimes rather different than the theory. Dissatisfaction was quickly expressed by partner countries in relation with the insufficient number of contracts obtained by their industries. Complaints expressed by representatives of Italy, Denmark and Norway concerned, among others, the fact that members of the winning team leaded by Lockheed Martin were awarded contracts without real competition, the preference given by US subcontractors to their national partners, the lack of systematic information diffusion concerning existing opportunities and the release problems related to sensible technologies (Masson [2004]). The frustration of some partner countries’ industry representatives was large enough for them to declare that “*The ‘best value’ concept is good in theory, but has failed miserably in implementation.*”³ It is worth noting that one the major reasons for non-US companies not being able to obtain more JSF contracts is to be found in the rigidity of the US defence technology transfer controls. Foreign suppliers frequently found themselves unable to compete for contracts because of the impossibility to obtain the necessary authorisations on time.

As result from the partner’s discontent, and facing threats of withdrawal from the program, several changes in the organisation of the JSF program were made.

¹ “Juste retour” implies the respect of proportionality between participating nations’ financial contributions and the work share awarded to their national industry.

² Testimony of Suzanne Patrick (Deputy Under Secretary of Defence – Industrial Policy), US House of Representatives, Committee on Government Reform, Subcommittee on National Security, Emerging Threats, and International Relations, “Joint Strike Fighter (JSF) International Industrial Participation”, July 21, 2003.

³ Tom Gerhardsen, President of Kongsberg Defence and Aerospace, quoted by DOD [2003], “International Industrial Participation: a Study of Country Approaches and Financial Impacts on Foreign Suppliers”, June 2003, p. 58.

Agencies responsible for export-licensing process dedicated specific staff to the JSF licensing process and a Global Project Authorisation was approved by the Congress in 2002. These measures aimed at facilitating the procedures related to the transfer of low technology and nonsensitive items (GAO [2006]). The prime contractor was also directed to establish an international industrial plan to anticipate time frames concerning licensing decisions.

Concerning the industrial participation another modification occurred: the “Best Value” approach was replaced by a “Strategic Best Value” one. The latter consisted in awarding some contracts without competition to targeted partner countries’ companies. This is a significant departure from the initial framework because it re-establishes to some extent a link between financial contribution and work share. Therefore these effects of foreign government’s pressures on the prime contractor, who bears the main responsibility in organising the subcontract competition process, has led some observers to recognise important similarities with the characteristics of the offset issue: *“Much as it has in its offset policy, the U.S. Government is taking a hands-off approach to industrial participation in the JSF program, preferring to let the prime contractor negotiate not just with potential supplier companies but with their home country governments. Those governments are also potential customers for the JSF. And their approach to participation in the program mirrors their approach to offsets. That is, countries have high expectations of getting contracts and know-how through development and production of the aircraft in exchange for their monetary contributions to the program”*¹.

Currently the debate surrounding the JSF program is regaining intensity. A new memorandum of understanding (MoU) organising the production, sustainment and follow-on-development (PSFD) phase is to be concluded by the end of 2006. Partner countries will then commit to future purchases. And while Lockheed Martin representatives are reasserting their commitment to “best value criteria” and “no offsets”², the European partners intend “to focus new MoU on European ‘footprint’”³. While admitting that they don’t expect they can “convert the US program to become offset-based”⁴, some partner’s governments are still threatening to withdraw and turn to non-US options if positive steps are not made towards an enhanced involvement of their industry.

Until now, the JSF program’s indirect strategy to limiting offsets appears to be the most appropriate option available to the US Government. However, it is too early to presume that it will eventually succeed in curbing offsets.

¹ Testimony of Katherine Schinasi (US GAO), U.S. House of Representatives [2004], op. cit.

² “Pressures builds on JSF partner countries”, Jane’s International Defence Review, Vol. 39, April 2006, p. 5

³ “JSF partners to focus new MoU on European” footprint”, Jane’s Defence Weekly, Vol. 43, issue 9, 1 March 2006, p.4.

⁴ Norway’s State Secretary for Defence Barth Eide quoted in “Norway steps up pressure for JSF industrial share”, Jane’s Defence Weekly, Vol. 43, issue 9, 1 March 2006, p.4.

Discussions and conflicts surrounding both the JSF program and US Government Policy on offsets are pointing to a more general issue. This issue concerns the international division of labour in the defence industry sector. The increasing trend in defence equipment's unit production costs and the budget restrictions on military expenditures represent a huge danger for the survival of the defence industry in small and medium sized countries and a threat to their strategic independence. Simultaneously policy-related and natural barriers to trade are perpetuating established patterns of trade and are frequently preventing the spontaneous establishment of international industrial relations between these industries and the large world prime contractors. As this is the only way for survival, small and medium countries' governments will maintain the pressure they are exercising when casting as importers. Offsets will therefore remain a major factor in international defence trade until a more acceptable solution is found to the issues related to the defence industry's international division of labour.

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