

DEFENCE OFFSETS

ADDRESSING THE RISKS OF CORRUPTION
& RAISING TRANSPARENCY



Transparency International (TI) is the civil society organisation leading the global fight against corruption. Through more than 90 chapters worldwide and an international secretariat in Berlin, Germany, TI raises awareness of the damaging effects of corruption, and works with partners in government, business and civil society to develop and implement effective measures to tackle it. For more information go to: www.transparency.org

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Publisher: Transparency International-UK

Authors: Ben Magahy, Francisco Vilhena da Cunha and Mark Pyman.

Editing: Julia Muravska and Anne-Christine Wegener.

Design: www.onehemisphere.se

Transparency International-UK

Downstream Building, 1 London Bridge
London SE1 9BG, United Kingdom

Phone: +44 (0)20 7785 6358

defence@transparency.org.uk

www.defenceagainstcorruption.org

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DEFENCE OFFSETS

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FOREWORD

This report addresses one particular area of concern in the defence sector: offsets. Defence offsets are arrangements in which the purchasing government of the importing country obliges the supplying company of the exporting country to reinvest some proportion of the contract in the importing country. Offsets are big business, and yet they are very opaque and receive much less transparency and attention than they should, given their susceptibility to high corruption risk. Many government and defence industry professionals share our view that the integrity around offsets transactions needs to be improved significantly.

This report explores the issue in depth, looking at current industry and government practices, and exploring the nature of the corruption risks associated with offset arrangements. We also look at the economic arguments in favour of and against offsets: it is important for importing governments, in particular, to recognise that the supposed industrial and economic benefits stemming from offsets are far from certain. We make recommendations for governments, for companies and for defence industry associations on ways to raise integrity and transparency of the contracts, and to reduce the corruption risk.

This report is intended, above all, for ministers and officials in the defence and economics ministries of purchasing governments, as well as their advisers. It is strongly in their interest to improve the integrity of offset contracts. Increasing transparency is crucial for economic reasons – offset arrangements carry substantial hidden costs – and because corruption in these deals leads to significant embarrassment and loss of reputation not only for the relevant ministries, but for the country as a whole. It is also due to such significant risks that defence and security companies should make similar efforts in raising transparency and integrity.

I would like to thank Ben Magahy and Francisco Vilhena da Cunha for all the effort they have put in as principal authors. I would also like to thank Anne-Christine Wegener and Julia Muravska of the DAC team for all their editorial and supporting effort. In addition, I would like to thank the many people in the industry and in a wide range of governments who have engaged energetically in the discussion of corruption risks in offsets with us and contributed hugely to our knowledge of the subject. Many of the suggestions have come out of these discussions. However, the responsibility for the report and all the recommendations is ours.

We very much hope that this report will lead to defence institutions incorporating many of these proposals into their national practices and procedures, in collaboration with defence companies, parliaments and civil society.

Mark Pyman

Director, International Defence against Corruption Programme
Transparency International-UK
London, April 2010

Many government and defence industry professionals share our view that the integrity around offsets transactions needs to be raised.

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EXECUTIVE SUMMARY

Defence and security is one of the most corruption-prone sectors, after the construction and the oil and gas sectors. The defence industry and governments are increasingly aware of corruption risks and are beginning to tackle these. However, one area of the arms trade remains disturbingly non-transparent, carrying high corruption risks that are not being adequately addressed: defence offsets.

Defence offsets are arrangements in which the purchasing government of the importing country obliges the supplying company of the exporting country to reinvest some proportion of the contract in the importing country. This can be done through defence-related projects, for example, by sub-contracting, or through a defence-unrelated enterprise such as purchases of goods or services.

Virtually all importing governments require offsets when purchasing defence material. The percentage of the offsets contract in relation to the original defence contract is large, often more than 100% of the value of the defence contract, with EU member states in particular documenting such high-value offsets. During the period 1993-2008, the average value of offset agreements entered by US defence companies—embedded in what is arguably the largest defence industrial base— with 45 different countries amounted to approximately 71%.¹

Defence contracts involve great expenditure, and thus the offset arrangements are similarly large in value. They are also highly susceptible to corruption.

Offsets are under much less scrutiny during their negotiation than the main arms deal. This holds true for both governmental scrutiny and for public awareness of such contracts.

Worse, in 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.

The lack of surveillance of the offsets contracts is amplified by their complexity. Offsets processes involve a range of complicated and detailed contracts and often include investments into a variety of companies and subsidiaries, making monitoring even more difficult.

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

¹ US Department of Commerce (USA) 2009:5

Offsets are claimed to offer economic benefits to countries. However, the current economics literature reveals the weakness and uncertainty of this claim. Arranging offsets adds costs to the value of the defence purchasing contract, and these costs are borne by the importing country and not by the supplier.

Where offsets are to be utilised in defence purchases, the frameworks and monitoring of these deals need to be much better constructed and much more transparent. This is not "mission impossible" – with a will to raise transparency and accountability across the industry and in governments, a suitable set of standard guidelines and requirements can be established and implemented. This is precisely the objective of this paper—to alert importing and exporting governments as well as defence companies to the nature, magnitude and detrimental impact of the corruption risks inherent in defence offsets. The document also provides these actors with a comprehensive and targeted informational platform regarding offsets from which policy may be formulated.

Transparency International calls on governments and the defence industry to work collaboratively to raise integrity and reduce the corruption risks in all offset contracts.

Importing governments requiring offsets should ensure that performance delivery and transparency are the cornerstones of the offsets policy.

DEFENCE OFFSETS

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RECOMMENDATIONS

Importing Governments

Offsets framework

Importing governments requiring offsets should ensure that performance delivery and transparency are the cornerstones of the offsets policy.

National governments should ensure that defence purchases do not deviate from the basis of strategic security requirements on account of the offset arrangements.

Offsets management

Procurement directors should ensure that the offsets team is properly constituted with competent and experienced personnel bound by a robust code of conduct – offsets are a specialist area not suitable for defence ministry officials or military officers without experience in the field.

Procurement officials should be subject to regulations requiring the disclosure of any potential conflicts of interest, particularly in respect of possible beneficiaries from the offset package or contracts.

Governments and procurement agencies need to establish clear responsibility and accountability for oversight and management of offsets programmes. They should ensure that there is an agreed cycle of performance and value-for-money audits.

National governments should require due diligence to be carried out to ensure that no member of the government or official will benefit improperly from any offset contract, and to ensure that all potential conflicts of interest by officials, military officers and Parliamentarians are disclosed

Evaluation, monitoring and transparency of offsets

National governments should require that every offset obligation contract is specific about how offset performance will be monitored. They should be public about their valuation mechanisms, and should establish incentives and penalties for performance.

National governments should commit to publishing the offset obligations and publish annually the achievement of progress against those obligations.

National authorities dealing with defence procurement should actively consider a dual pricing requirement to facilitate an enhanced monitoring process. This involves all bids being submitted with two prices for the defence capability being procured: one with the offsets package and one without, allowing for a real cost-benefit analysis to be made on offsets and increasing visibility over the economics of offsets.

National governments should develop mechanisms to recognise each other's black listing processes, increasing the toll on improper conduct from suppliers.

Supplier Companies and Industry Associations

Private defence companies should take an active approach to minimising corruption risk in offsets arrangements, and explicitly address this risk through internal codes of conduct, compliance standards and business ethics programmes. They should ensure that these are communicated to and implemented among the subcontractors, as well as agreed to by local partners and third parties. They should also ensure that the offset elements of their codes and compliance programmes are appropriately audited and evaluated.

Companies can contribute to the appropriate development of offsets packages by being transparent with government about the costs that different packages will incur, and helping to set realistic expectations regarding the management of offsets arrangements and commitment level needed from governments to increase the likelihood of their success.

Companies should conduct due diligence on offset intermediaries and all third parties who may benefit from association with the offsets package or obligation.

Defence industry associations should take the lead in promoting transparency in offsets contracts. This may be done through developing and publishing guidance on what a high transparency/high integrity offset package should look like; collating experience from within the industry on corruption in offsets contracts, the better to assist and guide companies in the future; and ensuring that offsets corruption risks are thoroughly discussed within the industry.

Exporting Governments

Exporting governments should publish annually all offset obligations into which national defence companies have entered.

National governments should make companies liable for the actions of partners and third parties in offsets agreements, including local companies, agents, representatives, and consultants involved in the process. Exporting governments should also increase enforcement of anti-corruption laws.



DEFENCE OFFSETS

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INTRODUCTION

Building integrity and reducing corruption in defence offsets arrangements

Defence has many characteristics that are unique to this business sector. One of the most sensitive ones in the international setting is the continuing practice and increasing number of defence offsets agreements.

Defence offsets are a counter-trade mechanism agreed between purchasing governments and supplying companies when the former acquire military equipment or related services or works from the latter. They are frequently used as industrial (sometimes even social or economic) policy tools aimed at improving balance-of-payments accounts and compensating the purchaser's economy (and tax payers) for a public investment that will not have an immediate direct impact on the wellbeing of the population.

Offsets consist in packages valued to a percentage of the acquisition contract and may take many forms, for example, agreements for co-production, licensed production, subcontracting, training, technology transfer, or other investments in the purchasing country's economy. Typically, they fall under one of two headings, direct offsets, in which the investment is directly related to the subject of the acquisition, and indirect offsets, which can be defence or civil, and are not related to the subject of the acquisition.

In economics literature, many criticisms exist of defence offsets agreements, alleging inefficiency; high costs, typically borne by the importing country rather than the supplying company; and inappropriate uses of resources resulting generated by offsets agreements.

However, the magnitude of risk of offsets agreements constituting or giving rise to corruption has been virtually unexplored in the literature concerning offsets. This paper takes a first step in filling that gap, and argues that offsets agreements at present encompass corruption risks that need to be tackled through efforts to increase transparency, integrity and accountability. This paper offers an analysis of where the opportunities for malfeasance arise in offsets contracting and puts forward a series of measures targeted at mitigating those risks.

This paper is structured as follows. Section two considers the structure of the international defence sector and how offsets fit into this marketplace. In the third section, the paper reviews the economic criticisms of defence offsets, and complements these with an analysis of further aspects which have not been considered thus far. The fourth section discusses the specific corruption risks related to offsets. Section five considers in detail three case studies based on publicly available sources highlighting corruption risks and their potential impact, as well as a summary of other cases of alleged corruption in offsets agreements. The sixth section discusses practical measures to improve offsets' transparency, integrity, and accountability.

Defence offsets are arrangements between a national government and a foreign military equipment supplier to direct some benefits of the contract back into the purchasing country's economy.

1 BACKGROUND: DEFENCE AND OFFSETS

1.1 DEFENCE MARKETS AND INDUSTRY

Since the end of the Cold War there have been several developments leading to the restructuring of defence industries. One main contributing has been the decline of defence expenditures throughout the 1990s, as the US, European countries, and the successor states of the Soviet Union sought to reap 'peace dividends'². National ownership patterns broke down as defence industries became private companies, precipitating cross-border mergers and take-overs, as the industry concentrated in a small number of very large firms, as well as increased tendering for defence contracts by trans-national consortiums³.

Governments have maintained a high degree of control over the sector through the monopsony power they have wielded as the sole legitimate purchasers of defence equipment⁴. Governments control the demand for defence products and thus influence the size and structure of the industry, its productive efficiency, and the level of exports⁴.

Besides being customers, governments perform other overlapping roles as regulators, owners and sponsors of their defence industries⁵, often undertaking the financial risks of the development of military equipment, underwriting research and development (R&D), sustaining production lines, and in some cases providing capital investment and infrastructure. Individual defence contracts tend to be of large value and span substantial periods of time, often up to 40 years.

Annual global expenditure in defence in recent years has been approximately US\$1.4 trillion, accounting for about 2.5% of global GDP⁶. Following the decline in global defence expenditures in the early 1990s, between 1998 and 2007 global defence spending rose by about 45% in real terms, with an especially marked increase in the period after the September 11 attacks (2001)⁷.

All in all, there are a small number of buyers (national governments) and a small number of large suppliers (defence companies), with relations between purchaser and supplier being close. A dynamic balance exists between governments' monopsony power and the industry's high degree of monopoly power. The latter is under intense pressure from shareholders and exporting governments to win contracts which are relatively scarce but highly lucrative and, therefore, competition between the existing companies is fierce.

The international defence sector continues to be characterised by a small number of large firms.

Defence contracts tend to be of large value and last for long periods of time.

² Dorman et al., 2007

³ Dorman et al., 2007

⁴ Dorman et al., 2007

⁵ Dorman et al., 2007

⁶ SIPRI, 2007

⁷ SIPRI, 2008

Offsets agreements have been a feature of the international defence sector since the end of the Second World War, initially as a means of building defence industrial bases in European countries but soon becoming means of improving balance-of-payments accounts.

1.2 DEFENCE OFFSETS

Offsets can encompass a wide variety of activities, such as co-production, production under license, marketing/exporting assistance, subcontracting, training, technology transfer; financing or foreign investment.

The approaches to offsets vary from country to country, in particular regarding the choice between direct or indirect offsets. The amount (percentage of the total offsets package) of direct offsets that a country can request usually depends on the size and maturity of its defence industry. This is why countries with a developed industrial base and domestic defence industry request higher percentages of direct offsets, while many developing countries tend to have larger proportions of indirect offsets. South Korea, Singapore, and Indonesia, for example, have been reported to employ offsets as a means of accessing technologies for use in their growing civil industries, especially aerospace and electronics,⁸ during the period of these countries' rapid economic development.

Offsets agreements have been a feature of the international defence sector since the end of the Second World War, initially as a means of building defence industrial bases in European countries but soon becoming means of improving balance-of-payments accounts. In some countries they became a general tool of industrial policy, and have become increasingly popular since the 1970s⁹.

The type of offsets demanded has undergone an evolution since the early post-war period¹⁰. Beginning as direct defence offsets in European countries, offsets agreements then grew to include indirect defence offsets designed to improve the defence industrial base without having a direct effect on the main contract. Typically, advanced industrial countries demand both direct and indirect defence offsets.

Over time, there has been an evolution in the types of indirect offsets demanded by countries to include indirect defence-civil offsets, which are offsets from defence contracts directed toward civilian sectors. Examples of countries which have made extensive use of these include Saudi Arabia, Malaysia, Oman, and Kuwait.

The US government is deeply sceptical of offsets, regarding them as 'economically inefficient and trade distorting'¹¹, and thus has no official offsets policy for its own defence purchases. However, US defence procurements do frequently contain 'buy American' clauses, which amount to an unofficial 'compensation' programme by requiring defence platforms to be built substantially in-country¹².

Saudi Arabia's Al-Yamamah contracts¹³ with the UK included offsets to develop in-country a Tate & Lyle sugar processing complex, a Glaxo pharmaceutical plant, and commercial computer training facilities. Malaysia's offsets programmes have seen the development of its higher education sector through investments in universities, while Oman has directed investments towards air traffic control colleges and commercial training, and Kuwait has used offsets to develop small and medium enterprises (SMEs) in the civilian sector.

⁸ Willett and Anthony, 1998

⁹ Ianakiev and Mladenov, 2009: 186

¹⁰ Matthews, 2004

¹¹ US Department of Commerce (USA) 2008:i

¹² Davies, 2009

¹³ Contracts for fighter/attack aircrafts (Tornado), trainer aircrafts (Hawk and PC-9), missiles, munitions and other equipment

These allowed for a further evolution: civil-civil offsets, already outside the scope of this document. Following their experiences with defence-civil offsets, developing countries request them in capital- and technology-intensive industries such as aerospace, power generation, and telecommunications. Kuwait, Indonesia and China constitute some examples.

Kuwait has introduced a policy of requiring 35% counter-trade, principally in offsets investments, for government contracts with foreign companies of value greater than KD 10 million (about US 35 million). Indonesia and China have both developed offsets programmes for civilian aircraft in deals with Airbus and Boeing, which have seen assembly and sub-assembly facilities being developed in-country.

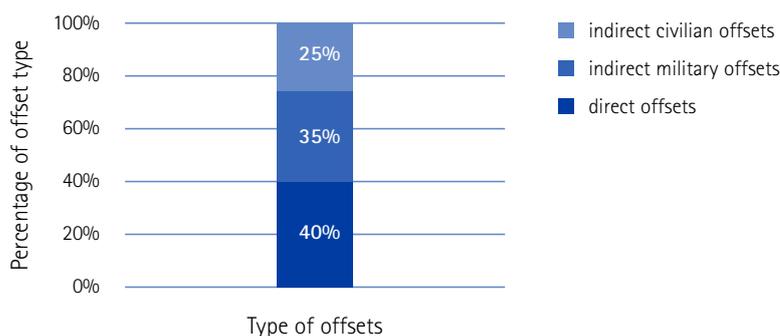
The final stage in the evolution of offsets has seen the development of civil-defence offsets, with contracting in the civilian sector being used to direct investments into the country's defence sector, principally through the development of dual-use technologies. Japan has been the leader in this field, helped by its large conglomerates which have diversified operations across civilian and defence spheres. Singapore has also adopted the same strategy¹⁴.

However, as an important exception to this trend, India requires 30% reinvestment directly into its defence sector when the value of the main contract exceeds US 69.7 million. The analytical opinion is that India's defence policy makers believe offsets can be utilised as instruments to increase domestic production¹⁵.

1.3 SOME FACTS AND FIGURES

The number of countries currently using offsets agreements is believed to be approximately 130¹⁶. Moreover, the value of offset agreements as a percentage of the contract value has been increasing, and in many cases, the value of the offset can exceed 100% of the value of the main contract. In 1999, US offsets to European countries amounted to 100% of the export on average. For non-European nations, it was 64% of the contract value¹⁷.

GRAPH 1: Distribution of offsets in the EU



Data source: EDA 2007: 19-23

¹⁴ Matthews, 2004

¹⁵ ISS, 2010

¹⁶ Maj. Gen. Mrinal Suman, 2005. Bharat Rakshak Online Edition, available at: <http://www.bharat-rakshak.com/SRR/Volume12/mrinal.html>

¹⁷ Department of Commerce (USA) 2003: vi-vii

Despite the growing popularity of offset requirements among importing countries, increasingly ambitious proposals from governments, and attendant progressively onerous conditions on supplying companies, non-completion of offset obligations appears to be widespread.

The European Defence Agency¹⁸ (EDA) estimated that the average offset percentage among European Union (EU) member states over the period 2000–2006 was 135%. The EDA further estimated that in the EU, 40% of offsets were direct, 35% were indirect military, and 25% were indirect civilian. Finally, the report noted that there was a tendency for offsets percentages to increase over time.

In the most recent US Department of Commerce (2009:5) report on defence offsets, it was stated that over 1993–2008, 677 offset agreements with 48 countries were entered into by US companies, totalling US 68.93 billion. This equalled 71% of the US 97.13 billion defence export contracts over the period. During these years, direct offsets accounted for 41% of the actual value of offset transactions, with indirect offsets accounting for 58% (the remainder relates to a small number of reported offset transactions not specified as direct or indirect). Unfortunately, the US data does not distinguish between indirect military and indirect civilian offsets programmes.

The impact of offsets is not known with certainty. While the economic impact of offsets agreements has received some academic interest¹⁹, there has been a general lack of monitoring of offsets on the part of importing governments. Governments of exporting countries will in some cases undertake monitoring of the offsets activities of their firms overseas, with the US being the most relevant example.

Further, despite the growing popularity of offset requirements among importing countries, increasingly ambitious proposals from governments, and attendant progressively onerous conditions on supplying companies, non-completion of offset obligations appears to be widespread. Contractors are liable for damages from non-completion of offsets agreements, but in practice many offsets agreements are renegotiated when they fail to deliver²⁰.

1.4 INTERNATIONAL LEGAL FRAMEWORK FOR OFFSETS

Offsets are prohibited under the World Trade Organisation's (WTO) Agreement on Government Procurement (GPA)²¹ binding nearly 40 countries. The GPA defines offsets as "measures used to encourage local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements, counter-trade or similar requirements."

Nevertheless, some exceptions are considered:

- For developing countries acceding to the GPA, offsets can be negotiated in the qualification phases of tenders as long as they are not considered as award criteria²².
- Procurement processes can be excluded from the scope of the GPA, and thus the prohibition of offsets, if governments find it necessary to protect their national security interests²³. By being excluded from the agreement, these processes can encompass offsets.

¹⁸ EDA 2007:19–23

¹⁹ See the volumes by Martin (1996) and Brauer and Dunne (2004), for example

²⁰ Wayne, L., *New York Times*, 'Foreigners Exact Trade-Offs from US Contractors', 16 February 2003

²¹ *The Agreement on Government Procurement (GPA)* is available at www.wto.org/english/docs_e/legal_e/gpr-94_e.pdf

²² Article XVI: 'Offsets'

²³ Article XXIII: 'Exceptions to the Agreement'

The latter exception is used by most countries party to the Agreement²⁴ to demand offsets in defence procurement.

In the European Union, countries are also bound by the EU treaties, with the directives approved in the EU Parliament and EU Council. General procurement rules prohibit offsets but, due to an Article 296 exception included in the Treaty establishing the European Community²⁵, defence procurement may, in some cases, derogate from such general rules.

Article 296 states that a country "may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material.." This allows states to have military procurement derogating from the general public procurement framework and to consider the use of mechanisms such as offsets, as long as they do not affect competition in civil markets.

The derogation permitted under Article 296 is used extensively by member states as a way to escape the inadequacy of the general procurement framework when applied to the complexity and sensitivity of the defence sector. Further, the WTO exceptions paved the way for diverse defence procurement legal frameworks within Europe, leading to offsets practices with a wide variety of guidelines and little or no oversight from the international community.

Recognising this situation, the European Commission issued an Interpretative Communication in 2006 on the application of this exception clause to defence procurement, aiding countries in the assessment of the suitability of the exception to specific tenders. The Commission has also more recently prepared a new directive²⁶, specific to defence and security related procurement that was adopted by the EU Parliament and EU Council in July 2009, and is pending transposition into national law.

The Article 296 exception remains applicable to procurements that are sensitive from security interests' standpoint, still arguably giving member states plenty of leeway, but the directive does limit its use and provides Community-wide set of standards for defence and security related procurement. However, government to government agreements and industrial participation programs fall outside the directive's scope.

The European Defence Agency developed a non-binding Code of Conduct on Offsets, applicable to tenders that fall under Article 296 derogation.



²⁴ A list of the parties to the GPA is available at www.wto.org/english/tratop_e/gproc_e/memobs_e.htm#parties

²⁵ In the new version of the Treaty on European Union, amended according to the Treaty of Lisbon, it is Article 346

²⁶ Directive 2009/81/EC



Within this scenario, the framework for offsets in the EU depends on the characteristics of the procurements which can be generally divided into three categories:

- **Procurement of military equipment, sensitive equipment for security purposes, and related services and works** The legal framework applicable is the generic public procurement one, defined in Europe by directives 2004/17/EC and 2004/18/EC. In this framework, used for civilian acquisitions, offsets are not considered since they are seen as discriminatory.
- **Procurement of military equipment that does not require special rules to protect essential security interests, or sensitive equipment for security purposes and related services and works** The new procurement directive for defence and security applies. There is no reference to offsets in the text of the directive, the Commission's position being that since offsets are discriminatory by nature the directive cannot rule them. It was understood that the wide variety of forms in which offsets exist in the EU makes it extremely difficult to approach them comprehensively.

The Commission also states that if using offsets, member states must ensure that they are in line with the directive and the rules of the Treaty. This means that offsets should not be part of the award criteria, since these should be linked to the subject-matter of the contract. The Commission also discourages civil offsets, as they could adversely affect competition in other markets.

- **Procurement of military equipment that requires special rules to protect essential security interests** These tenders fall within the exception permitted by Article 296, making it possible for member states to use practices that are not aligned with the internal market policy of the EU. This includes the use of offsets. However, member states must ensure that these do not affect competition in civil markets.

The EDA's code of conduct applies also to this case and requires participant member states to disclose and report a set of general information regarding the procurements and related offset arrangements. It also encourages the use of offsets solely for the development of the EU's collective Defence Technological and Industrial Base.

1.5 OFFSET ACTORS

In order to fully perceive the offsets corruption risks, it is important to understand each actor's "business model" for offsets. The most important actors are:

1. Importing countries that acquire the equipment or service and demand an offset package along with it. Offsets' costs are usually undisclosed and included in the acquisition price. Therefore, importing countries, through their offset authorities, attempt to get the most socioeconomic or technological impact from the offset package. Offsets authorities define the offsets guidelines and framework.
2. Suppliers of the equipment/service, that become offset obligors. Being a company, their goal is to maximise profit, meaning that, if the offset budget is secured from the beginning, their goal will be to ensure the fulfilment of the project, reducing, whenever possible, the implementation costs. They can engage the services of other entities to define, negotiate and deliver the offset programme, notwithstanding that the ultimate responsibility for the program will always be with the obligor.

The third-party entities can be:

- Brokers, usually knowledgeable of the local realities, that can engage with local partners for the projects and even interact with the offset authority;
- Consultants, usually specialists in the local industries that provide technical advice on the way to define and develop the projects;
- Third party offset executors that can be companies or R&D centres engaged in the process by the obligor to provide orders, technology, training, etc. to beneficiaries.

Offset beneficiaries (local companies, R&D centres and, sometimes, the Armed Forces) are the receivers of the offset package and want to ensure their direct benefit from it.

Offsets are usually under-scrutinised in comparison to the major contract; for instance offset programs are not analysed by the court of auditors.

2 OFFSETS AND CORRUPTION

2.1 CORRUPTION IN THE DEFENCE SECTOR

Procurement constitutes an area of particularly high corruption risk in the field of defence. Furthermore, the highly competitive nature of the defence industry, coupled with the complexity and large monetary values of defence contracts, creates risks that bribery may be incorporated into such arrangements and obstructs their scrutiny. Moreover defence acquisitions are often afforded the protection of secrecy for reasons of national security.

For several years, the defence sector has been rated among the most corruption-prone, following such sectors as extraction and construction and public works²⁷. According to a 2006 survey by Control Risks²⁸, roughly one third of international defence companies felt they had lost out on a contract in the preceding year because of perceived corruption by a competitor. The US Department of Commerce Trade Promotion Co-ordinating Committee Report of March 2000²⁹ claimed that the defence sector accounted for 50% of all bribery allegations over 1994-1999 – all the more startling, since defence constitutes a very small proportion of international trade.

2.2 TYPES OF CORRUPTION

Transparency International defines corruption as the abuse of entrusted power for private gain. Bribery constitutes perhaps the most easily recognised form of corruption and typically falls into one of four broad categories:

1. Bribes may be paid for (a) access to a scarce benefit, or (b) avoidance of a cost.
2. 1.Bribes can be paid for receipt of a benefit (or avoidance of a cost) which may not be scarce, but over which state official exercise discretion.
3. Bribes can be paid not for a specific public benefit itself, but for services associated with that benefit, such as speedy service or inside information.
4. Bribes can be paid (a) to prevent others from sharing in a benefit or (b) to impose a cost on another party³⁰.

In addition to bribery, there are forms of undue influence exerted by individuals for their private gain which entail material benefits other than monetary gains. For instance, inflating the price of a contract quoted to a supplier company and using the subsequent funds as a kickback to a political or administrative official, is another well-known form of corruption. There is also a form of political corruption that is particularly insidious in its effects– the utilisation of the proceeds of corruption for political advantage. Even though such arrangements may not benefit individuals in a strictly monetary sense, their position of power is thus perpetuated. For example, the use of the proceeds from corrupt activity to fund election campaigns has been well-documented³¹.

Corruption may entail networks of patronage, meaning the undue award of favours to persons in return for support. Two specific adaptations of the concept of patronage take the form of 'cronyism', which is undue partiality to long-standing friends, and 'nepotism'—that to members of family.

Corruption, by Transparency International's definition, is the abuse of entrusted power for private gain.

²⁷ Transparency International Bribe Payers' Index 2002, available at www.transparency.org/policy_research/surveys_indices/bpi/bpi_2002#sectors

²⁸ Control Risks and Simmons Et Simmons (2006) *International business attitudes to corruption - survey 2006*, available at www.control-risks.com/pdf/corruption_survey_2006_V3.pdf

²⁹ Daley W.M., "The National Export Strategy: Working for America", Trade Promotion Coordinating Committee, Department of Commerce, Seventh Annual Report to the United States Congress: 11, March 2000, available at www.ita.doc.gov/media/nesonline.pdf

³⁰ These categories were developed by Jeremy Pope (2000)

³¹ For a discussion of this phenomenon in the defence sector, see Magahy et al. 2009: 15, 30-31

The abuse of entrusted power need not refer only to political or state-bureaucratic offices, and can also be applied to private entities; private-to-private corruption, which entails private actors making undue payments to one-another for the purpose of acquiring benefits, is also covered under the blanket of 'corruption'. Moreover, corruption entails the theft of state or private resources by those entrusted with them, even where no other party is involved.

This list is not exhaustive, but it is sufficiently wide to cover the main pillars of what constitutes corruption. Offsets potentially serve as vehicles of corruption across the full spectrum outlined above.

In the rest of this section, corruption in offsets is first discussed in broad outline according to why the characteristics of offsets arrangements make them susceptible to corruption. Specific pathways by which offsets can be used as vehicles of corruption are then discussed in the next section, using some examples to highlight the vulnerabilities of offsets, and in the final one some mechanisms that could be employed to improve integrity in the use of offsets.

2.3 CHARACTERISTICS OF DEFENCE OFFSETS WHICH GIVE RISE TO CORRUPTION

- 1. Offsets used as industrial policy** Defence offsets tend to be used as industrial policy tools by governments to influence the country's economic development through targeted interventions. The economic literature on industrial policy, both theoretical and empirical, has been highly critical of such interventions³², and partly from such discussions the rent-seeking literature developed³³, closely bound to the concept of economic inefficiency. The development of companies and industries under governmental support, besides risking unsustainability once that support is withdrawn, can also generate vested interests.

Access to offsets arrangements distributed by officials can become more lucrative than competitive activities, creating an incentive for networks of corruption to proliferate around them. Offsets may become a convenient means for governments to support local suppliers, potentially allowing inefficient suppliers to be propped up in exchange of bribes to officials and political parties. Thus, in the extreme case, the offset might become a vehicle for bribery, not a means of pursuing industrial development.

Defence offsets tend to be used as industrial policy tools by governments to influence the country's economic development through targeted interventions.

³² Lal, 2000; Bhagwati, 2004
³³ Krueger, 1974



2. **Offsets as capital-intensive outlays** As noted earlier, offsets, both direct and indirect, will often be used to facilitate the transfer of capital-intensive industry to the importing country. In fact, technology transfer is often used as a key justification for the use of offsets, in advanced industrial as well as developing countries. This would seem to be a reasonable objective. If countries are seeking to benefit from offsets packages, they must be seeking to do so in sectors in which they otherwise find it difficult to entice private actors to invest. Such sectors are likely to be industrial sectors, which again are likely to be capital-intensive rather than labour-intensive, and characterised by relatively high levels of technology.

Consequently, there are several inherent corruption risks. First, high-technology and capital-intensive industries are themselves prone to corruption, which may take corruption outside the defence ministry and into other areas of the public sector. Economic literature³⁴ suggests that government and administrative officials seeking to benefit from bribery will choose to invest in capital-intensive rather than labour-intensive projects, as there is more potential for illicit gain and less chance of detection. Capital-intensive investments (such as in infrastructure and heavy-industry) tend to be long-lasting, technical, difficult to comprehend in the absence of specialist knowledge, and have a limited number of actors who can be party to them. Thus, there is a heightened scope for corruption within the contracts under defence offsets.

Second, because the projects occur under defence offset processes rather than through regular government procurement procedures, the anti-corruption elements normally found in large-scale public contracting are bypassed and transparency is highly diminished. Moreover, corruption may spill over into civilian sectors along with investments generated by offsets.

Third, as such investments are occurring through the offset package, there is a greatly increased number of agencies involved in the process, including the political actors from the executive and legislature, various procurement officials, the exporting country's government officials, the main supplier company, brokers, consultants, and third party offset executors, as well as potential beneficiary companies. The presence of a myriad of actors makes it more challenging to duly follow negotiations and pinpoint irregularities, which in turn makes opportunism more likely.

3. **Opacity of offsets** Corruption thrives when it is shielded from attention. When processes, decisions, and actions are observable, they are less likely to be hijacked by opportunism and corruption. Offsets, however, are highly opaque instruments, with decisions made away from legitimate scrutiny, contracts awarded on a discretionary basis, and little commitment to management evaluation, audit or completion of offsets contracts. When processes are unobservable and the potential private benefits of corruption are high, malfeasance is likely.

³⁴ Tanzo and Davoodi, 1997

- 4. Potential for distribution of a restricted resource** Procurement officials dealing with offsets typically possess a significant amount of discretionary power in terms of how the offsets package can be divided up and distributed. And, since by international agreement offsets generally cannot be pursued in other sectors, the power to distribute offsets constitutes a limited resource. As a result, officials may use that power to demand illicit enrichment or to repay favours illicitly. Offsets agreements, as opaque, complex contracts dealing with long-term investments, offer particularly attractive opportunities for such malfeasance. To counter it, sound policies are needed to introduce transparency, integrity, and accountability to the offsets process, from the development of the offsets requirement, to the award of contracts, the execution of those contracts, and the management of the investments.

2.4 OFFSETS-RELATED CORRUPTION TYPES

Before examining the pathways for corruption in offsets, it is important to note that such corruption may be classified in two types. In the first case, corruption is restricted to the scope of offsets and entails the party(ies) involved in the definition, negotiation, management and monitoring of offset programs obtaining undue benefits from the offsets themselves. Some examples may be the obligor bribing public officials to release offset credits without real fulfilment; or the obligor buying invoices from local companies (resulting from projects unrelated with offsets and constituting a lack of causality) and passing them off as offsets.

The second type involves the use of offsets to complete a corruption cycle within an acquisition. Offsets are usually under-scrutinised in comparison to the major contract; for instance offset programs are not analysed by the court of auditors, allowing for money to be easily transferred through offsets to corrupt ends. Some examples may be offset projects involving oversized profit margins to the beneficiary, allowing for a part of this margin to be released for undue payments; offset projects favouring companies directly or indirectly related to public officials involved in the acquisition; or offset projects that are fictitious or lacking causality (where the intervention of the obligor was not determinant to the project) that allow for the obligor to use the resources allocated to it to other ends.

One other aspect of offsets deserving mention is denomination of their value not in actual currency but in offset credits. These can refer to the impact of the offsets in the purchasing country or even be unrelated to any type of economic indicator regarding the project. The relation between the actual investment in an offset project and the offsets value associated with it can vary drastically.

Offsets are usually under-scrutinised in comparison to the major contract; for instance offset programs are not analysed by the court of auditors.



2.5 SOME GENERAL PATHWAYS

Within the above general structure, there are many specific opportunities for corruption to permeate into offsets packages. This section describes some of those opportunities in more detail. While non-exhaustive, it highlights some of the more obvious areas where actors can engage in corrupt activities.

There are five main stages in the process of developing offsets programmes:

- **Decision of the government** to have an offsets package as part of a defence procurement contract
- The **tendering process** and submission of bids from companies for a defence contract.
- The **assessment of bids** for a defence contract.
- The **design of the offsets package** between the government and the main supplier company that can be done simultaneously with the tendering process, that includes the identification of potential beneficiaries
- The **award of contracts** under the offsets package

Corruption opportunities exist at each of these stages for a variety of actors. The key vulnerabilities are summarised in the table below, and subsequently discussed in more detail.

TABLE 1: Corruption risks in offsets

<p>Political corruption</p> 	<ul style="list-style-type: none"> ○ Vested political interests seeking to improperly influence the need for an arms purchase, using the attractiveness of an offsets package as an inducement to government ○ Vested political interests seeking to ensure a contract is awarded to a particular supplier on the basis of the offsets package ○ Political officials engaging in theft of funds allocated to the offsets package ○ Political officials accepting payments from companies for award of contract
<p>Bureaucratic corruption</p> 	<ul style="list-style-type: none"> ○ Procurement personnel taking advantage of offsets package as a vehicle for payment of bribes ○ Procurement personnel accepting or soliciting illicit payments during design of the offsets package ○ Procurement personnel accepting or soliciting illicit payments during award of contracts under the offsets package
<p>Private sector corruption</p> 	<ul style="list-style-type: none"> ○ Potential beneficiary companies offering payment or other benefit to main supplier company to gain access to a contract under the offsets package ○ Beneficiary companies and main supplier company colluding for payments to be made by the beneficiary company to a political or procurement official in order to gain undue influence on behalf of the supplier company ○ Agents or other intermediaries acting on behalf of the supplier company paying bribes in efforts to secure undue advantage ○ Offsets brokers using offers of benefits to officials to generate demand for offsets packages in defence contracting

Political corruption – Improperly influencing the need for a particular defence acquisition in the first place Political corruption can result at any stage of the process which grants discretion over the defence procurement to political officials from the executive, legislature, or the ruling party, with corruption activity permeating into the offsets package. Thus, political actors may create the need for the offsets package itself; ensure a contract is awarded to a supplier; or even siphon funds from the offsets package. Offsets may also play a role in international political bargaining, with political officials from the exporting country proposing, on behalf of its companies, an offsets package that will benefit vested political interests in the importing country and thus ensure the award of the main contract to that company. Such practice, of course, entails a breach of public duty and a bribe.

Bureaucratic corruption – Influencing the competitive decision for the main contract in non-transparent ways Like political corruption, bureaucratic corruption may occur at any stage of the offset development where state officials, most likely procurement personnel in the defence ministry, offset authorities or equivalent, have discretion in the procurement process. Procurement personnel, as a key corruption³⁵ vulnerability in the defence establishment, can also act as a vehicle for corruption in the offsets package. For example, a main supplier company may facilitate the bribery of a procurement official through the offsets' projects rather than the main contract, avoiding its requisite scrutiny. A main supplier company might also agree to the offsets package containing investments benefiting the private interests of a procurement officer as a means of gaining undue influence. More obviously, a procurement official could siphon funds from the offsets budget for personal enrichment.

Private sector corruption – Allowing favours to be repaid to corrupt government officials via the offset projects The private sector plays a major role in the supply side of corruption. In nearly all of the mechanisms mentioned above, companies are making benefits available to political or bureaucratic officials, either of their own initiative or because those benefits have been solicited. The implication in many of these mechanisms is that main supplier companies may be using the offsets package as a vehicle to offer benefits in return for undue influence or access to defence contracts. Agents, offsets brokers and intermediaries negotiating offsets packages may also be offering benefits to officials to secure undue advantage for the main supplier company or create a demand for offsets in defence contracting. Further mechanisms of corruption in the private sector may exist in the phenomenon of private-to-private corruption, if beneficiary companies are making payments to the main supplier company in return for access to an offsets contract.

³⁵ For more information see Transparency International UK (2004), 'The Defence Procurement Process and its Vulnerabilities', available at www.defenceagainstcorruption.org/index.php/publications

3 THE ECONOMICS AND POLITICS OF DEFENCE OFFSETS

Economics is the language often used to analyse defence offsets, focusing on the effects of governmental attempts to intervene strategically in the economy. As a whole, the economics profession tends to view such efforts with a high degree of scepticism.

3.1 ECONOMIC ARGUMENTS FOR OFFSETS

The economic critique of defence offsets has been articulated frequently, and the following sub-sections are only a summary of such arguments, based primarily on the work of Davies (2009) and the volumes from Martin (1996) and Brauer and Dunne (2004). Typically, there are six arguments made in favour of offsets arrangements, which are discussed in this section, followed by a critique of their conclusions:

- Offsets are an Industrial policy tool
- Offsets facilitate technology transfer
- Offsets allow for the circumvention of informational barriers
- Offsets create a level playing field
- Offsets allow for job creation
- Offsets are a negotiating tool

Economics is the language often used to analyse defence offsets, focusing on the effects of governmental attempts to intervene strategically in the economy.

Industrial policy

The most basic justification for defence offsets is that they can be used as a tool of industrial policy, with the offsets package being designed so as to direct investments into nascent industries, whether in defence or other sectors. In direct offsets, the package is used to develop and sustain defence capabilities, which can fit into a wider strategic defence policy of the host country. In its extreme form, this argument suggests that defence offsets policy allows the host country eventually to hold a degree of autonomy in the support to and even production of defence equipment through developing a capable domestic defence industry. In practice, however, few countries have the ability or the desire to become self-sufficient in defence production.

For indirect offsets programmes, the packages provide a means for countries to develop foreign investment and expertise into industrial sectors in which they wish to become internationally competitive. When tailored correctly and with incentives correctly aligned, offsets packages allow the country to develop domestic industries in areas in which they previously had little capability, experience or expertise.

Deficiencies of the industrial policy argument arise from both the cost of offsets programmes and efficiency of offsets. There are concerns that the capability developed through offsets is more often than not insufficient for making the industry internationally competitive. Offsets need to be paid for and the cost falls on the buying government, not the supplier company. Investment in the domestic economy through this mechanism comes at high cost and is inefficient; the resources would be better spent through other means³⁶.

Underlying these criticisms are the following considerations. First, there is an opportunity cost in using offsets, and the resources used to facilitate investment through offsets might be better deployed elsewhere. Second, the use of offsets restricts competition and provides disincentives to efficiency on the part of beneficiary companies, which further increases the costs of offsets. Third, companies do not simply accept the offsets requirement; they charge a premium to deliver that offset, but the cost remains hidden. In order to realise the true costs of offsets, Davies suggests that procuring governments demand two quotes from companies bidding for a contract: the price of the contract with an offsets package attached, and the price of the contract without an offsets package³⁷.

Thus a successful offsets policy would need to acknowledge the true cost of offsets, to ensure that all investments are made with a robust knowledge transfer package attached, and be designed with sufficient incentives to ensure the long-term viability and competitiveness of the companies and industries which develop under the package.

Facilitation of technology transfer

Alongside the industrial policy argument, the facilitation of technology transfer is the most powerful in favour of offsets arrangements. Technology and technological know-how are valuable acquisitions for the host country if the offsets package can be established correctly so as to facilitate this.

The criticism of this position lies in the quality of technology transferred. Offsets would likely only be beneficial if they were able to transfer high quality technology into the host country. Companies, however, are generally not willing to give up tacit knowledge in strategic technologies and techniques to other companies, and there is no reason to believe that they would do so under an offsets package. Further, what is marketed as high-level technology may not be of sufficient quality to bestow any advantages. For many countries, there are also likely to be significant barriers to the successful absorption of new technology based on their existing industrial capacities³⁸. In fact, defence industry in India, which has an official defence offset requirement, expressed worries precisely about the country's technology absorption capacity, while the armed forces felt offsets demands could constitute a delay in acquisitions programmes, and bureaucrats are concerned about the increased cost of weapons purchases due to offsets³⁹.

This would suggest that in fact the technology transfer argument is likely to be most important for those developing countries for which the upgrading of the technological base, either in defence or other industrial sectors, would not necessarily require the most advanced technology. In such a scenario, the consideration in the development of the offsets package is to design transfers of technology that allow upgrading of the current stock of technological knowledge and which build the capacity for its absorption, rather than necessarily transferring the most advanced technologies.

³⁷ Davies, 2009

³⁸ Interview with Neil Davies, Chief Economist, (UK) Ministry of Defence, February 2009

³⁹ IISS, 2010, p. 475-476



Circumvention of informational barriers

A further argument is that, owing to the presence of information asymmetries in the defence sector, foreign companies may be unaware of subcontractors in the domestic defence market capable of supplying components to the main company. In requiring local content or assembly, governments can reduce these informational barriers and achieve an efficient outcome by forcing companies to seek out local suppliers.

However, this argument does not hold much credibility. It tends to be in a company's best interests to conduct extensive research in any case, in order to find the most efficient sub-contractors and to prepare a large, long-term bid. If there are advantages enjoyed by in-country companies, the companies' research will direct them to this conclusion and be factored into the decision-making process⁴⁰. Nevertheless, there are various examples of offsets successfully being used to overcome information asymmetries.

Level playing field

The international defence sector is characterised by strong links between governments and their domestic defence companies. These links often translate into implicit and explicit support for domestic companies, up to the point of paying them subsidies. In the defence sector, some importing governments treat offsets as a means of overcoming the perceived disadvantages of exporting governments' subsidies to their defence companies, by requiring those companies to invest in the defence industry of their own country.

Subsidies by exporting governments tend to give their companies short-term competitive advantages rather than long-term market advantages, and the use of offsets by importing governments to overcome these short-term advantages seems disproportionate owing to the high costs of offsets.

Job creation

The argument of job creation should be seen in the context of defence contracts being regarded by importing countries as contracting jobs out to other countries. As a way for governments to compensate for apparently lost employment, they can require the company benefiting under the defence contract to conduct some of the production in-country, or otherwise invest in its economy.

Jobs created in this artificial manner do not represent the opportunity costs of labour. This form of employment draws labour away from other activities which may represent actual comparative advantage. The loss therefore needs to be measured as the difference between what could have been generated from productive activity and what is actually generated from the offset programme.

⁴⁰ Davies, 2009; Interview with Neil Davies, Chief Economist, (UK) Ministry of Defence, February 2009

Negotiating tool

One other argument stated in favour of offsets agreements is that they represent a negotiation tool which allows governments to achieve additional benefits in return for a higher cost, which may represent a more optimal outcome than attempting to achieve a lower price in the context of informational asymmetries⁴¹. The quantification of this argument to make it a testable hypothesis would be very difficult, and at any rate, it should be treated as a post hoc justification of offsets rather than a point made in their favour.

Empirical evidence

To date, most academic work on offsets has tended to focus on case studies rather than cross-sectional studies, which makes generalising about their economic effects difficult. The best volumes on the economic impact of offsets arrangements are those by Martin (1995) and Brauer and Dunne (2004).

Brauer and Dunne (2005) perhaps best sum up the general state of these economic analyses by stating the following general conclusions, many of which come from the twenty cases studied in the 2004 volume they edited:

- First, as a general rule, defence offsets are more expensive than 'off-the-shelf' (that is, as imported) defence purchases.
- Second, they create little in the way of new or sustainable employment.
- Third, they do not appear to make a substantive contribution to general economic development processes in countries.
- Fourth, offsets do not for the most result in significant technology transfers, either to the civilian or the military sectors.

Taylor's (2004) work points to the consideration that efficiency in offsets arrangements hinges on the institutions of the purchasing country. Dunne (2004) suggests that at best, even if offsets arrangements are welfare-enhancing of themselves, they do not overcome the welfare-diminishing effects of defence expenditure. Brauer (2004) adds that while positive economic effects from offsets are not impossible, they are 'theoretically implausible and empirically improbable', highlighting that from the literature on defence offsets, no study had yet concluded an unambiguous economy-wide net benefit from an offsets programme.

To date, most academic work on offsets has tended to focus on case studies rather than cross-sectional studies, which makes generalising about their economic effects difficult.

Governments engaging in offsets policies are essentially paying defence companies to deliver economic development projects.

3.2 THE POLITICAL ECONOMY OF DEFENCE OFFSETS

In light of the paucity of clear economic justification for offsets, the question as to why governments engage in the pursuit of offsets packages in the first place naturally arises.

There is a body of economic arguments, and a much smaller body of evidence, to suggest that offsets are inefficient. Even if the aims of the offsets can be achieved, they are still costly; companies will not pay for offsets programmes, rather they charge a premium for them. This is not to say that offsets cannot produce economic benefits; if they can facilitate the development of nascent industries and technology transfer, then they could conceivably provide a platform for assisting a country's economic growth, even with the attendant costs that have been outlined. Why does this fail to occur then? One reason may be that for a defence company, offsets packages represent significant costs of doing business that are imposed on them by purchasing governments. Governments engaging in offsets policies are essentially paying defence companies to deliver economic development projects.

Companies, however, are not agents of industrial development, and their reputations are based on their performances on the main contract and not on the offsets agreement. Precisely for this reason, companies will give less attention to the offsets agreement; it is not going to affect their business in the medium- or long-term if the offsets requirement falls short of delivering on its promise. As defence companies charge a premium for the offsets package in the first place, they do not bear the costs of its failure. Rather the importing country bears these costs through its inefficient and unproductive investment.

Monitoring of offsets and offsets performance

It may then be asked why the government does not force performance on the offsets agreement. The answer could be any of the following. First, it could simply be that governments have short time-horizons, whereas the failure to realise the benefits of offsets packages will not be realised until well into the future. Governments may also reasonably expect that populations will ultimately not hold them to account for failure to realise an offsets package, which is ostensibly a foreign investment at any rate. Public hostility towards the contractor will not matter because if it delivers on the main contract, the government will see its interests realised and the company's reputation will remain intact. However, it is also important to note that in some cases this may not be true.

Second, governments may be prepared to pay the premium on offsets packages for the reason that the cost is hidden to the public and because the offsets package performs a valuable political function of justifying large outlays on international defence spending to their populations. Few states, with the most notable exception perhaps being the US, can be self-sufficient in defence and therefore require many of their purchases to be made in international markets. Populations often object to transferring large amounts of public money to foreign companies, and offsets can be used to help governments convince their

publics to consent to defence purchases. If this is the case, then the importance of the offsets package is not in its execution but in the ability of a government to announce that there is an offsets package to accompany the defence purchase. Failure to realise the benefits of the offsets package will not matter as much to those who agreed it, because to them the value of the offsets package comes from the role it plays in the bargaining process in the development of the defence purchase.

Thus, neither companies nor governments have a strong incentive to ensure delivery of the offsets programme; indeed, in an extreme situation, they may collude to allow non-performance of the contracts.

The strength of such arguments is greatest in the case of indirect offsets. If the offset involves domestic companies becoming subcontractors to the main supplier company, then the latter has an incentive to manage the programme effectively; if the project goes badly, it will be the supplier company that bears the cost. Thus in section 5, one of the policy implications which is drawn from the analysis is that where offsets are to be utilised they should be constructed so as to give the supplier company a direct incentive in the efficient performance of the offsets package. Such incentives should be possible to construct for both direct and indirect offsets.

Thus, neither companies nor governments have a strong incentive to ensure delivery of the offsets programme.

Empirical evidence

As in the economics literature, the political economy of offsets has generally not been studied extensively. One of the most interesting contributions, however, has come from a study by Taylor (2003), which analyses empirically the reasons for governments pursue offsets arrangements.

Taylor's aim was to consider whether procurement officials made decisions as to the requirement for and form of offsets packages according to economic rationale or political rationale. Using transaction-level data to estimate the models, Taylor formed a cross-section study across a range of countries worldwide. His results suggest that while government procurement officials select offsets according to economic rationale, political economy variables are also very important. Some offsets agreements see economic variables (price, quality, transaction costs, and industrial development policy) dominate political variables (bureaucrat maximisation, national security considerations, interest group theory); however in other circumstances, the attributes of the offsets package may reflect political priorities.

In Taylor's empirical modelling, the results suggested the existence of rent-seeking behaviour in government bureaucracies. Testing the relative importance of political economy variables, the preliminary conclusions suggested some degree of transaction cost economising, but also suggest that political variables (security alliances, bureaucrat maximisation, rent-seeking) exert much influence on policy.

4 CASE STUDIES

While there is a general lack of data concerning transparency and corruption in defence offsets arrangements, some highlights of the perils regarding corruption in offsets are presented in the following three case studies—South Africa, Portugal and Greece—where information is available from public source materials. Further cases where offsets agreements have attracted the attention of investigators and the media are also noted.

Increasing transparency is crucial for economic reasons – offset arrangements carry substantial hidden costs – and because corruption in these deals leads to significant embarrassment and loss of reputation not only for the relevant ministries, but for the country as a whole. It is also due to such significant risks, that defence and security companies should make similar efforts in raising transparency and integrity.

Mark Pyman
Director, International Defence
against Corruption Programme
Transparency International–UK



4.1 SOUTH AFRICA

The South African government approved the Strategic Arms Procurement Package in December 1999 costing R 30 billion (ca. US 4.8 billion in 1999). The programme, involving purchases of high-tech warships, submarines, and aircraft from Germany, Sweden, Italy and the UK, has been the source of much controversy, both over the appropriateness of the package for South Africa, and over allegations of corruption in the numerous contracts contained within⁴².

The allegations implicated several senior figures in the South African government in receiving bribes to fund the ruling ANC's 1999 re-election campaign⁴³ and, according to former ANC MP Andrew Feinstein, possibly to support the R 1.7 billion surplus currently held by the ANC⁴⁴.

The programme's ambitious offsets programme was envisaged to run over a period of eight to fourteen years, and initially estimated to create 65,000 jobs and generate revenue of R 111 billion⁴⁵. Such forecasts may have been faulty—one study by Dunne and Lamb (2004) concluded that the economic benefits of offsets were unclear and there were "considerable doubts about whether South Africa as a whole has or will benefit from the deal". According to the authors, offsets' causality and sustainability remained also to be proven⁴⁶. A further study by Haines (2004) concluded that "employment creation by offset projects is limited, particularly in peripheral regions" and that there was evidence of substantial hidden costs associated with offsets⁴⁷. Moreover, according to a 20 March 2008 edition of South African news publication *Mail & Guardian* as well as Scholars Dunne and Lamb, allegations of corruption accused government and senior defence officials of having conflicts of interest when awarding offsets contracts to companies to which they had direct links^{48, 49} in abuse of the policy of Black Economic Empowerment⁵⁰.

Despite such alleged instances of corruption in the offsets programme, a government investigation team reported that though it found irregularities and improprieties in the conduct of certain government officials, it found no evidence of improper or unlawful conduct by the government as a whole⁵¹. However, this report excluded one from the Attorney

General on the submarines' acquisition. This document flagged unlawful practices during the evaluation phase and over the high score given to the largest of the offset projects, affecting the award of the supply contract. What is more, nine years later that project was still not completed⁵². Finally, allegations of corruption in the offset package and the wider defence deal have been routinely featured in the popular media in South Africa⁵³.

The South African case and its accompanying allegations highlight some of offsets' vulnerabilities:

- Offsets may be used to close procurement related corruption cycles, allowing payments to be made to governmental and military officials, directly or indirectly, for undue influences over the decision process.
- Offset programmes may be used to influence award decisions, even though they can be changed afterwards and the decision most times may not.

⁴² Willett, 2007a

⁴³ *USA Today*, 'South Africa Rejects Zuma Arms Deal Criticism', 6 August 2008, available at: http://www.usatoday.com/news/world/2008-08-06-South-Africa_N.htm; Plaut, M., *BBC World Service*, 'ANC and the Arms Deal', 11 March 2008, available at: <http://news.bbc.co.uk/1/hi/world/africa/7255097.stm>; Andrew Feinstein also addresses it in detail in Feinstein A. (2007). *After the Party*. Johannesburg: Jonathan Ball Publishers: 81-83, 155, 177, 240-244

⁴⁴ *Politics Web*, 'Feinstein calls for new investigation into arms deal', 13 June 2008, available at www.politicsweb.co.za/politicsweb/view/politicsweb/en/page71627?oid=91855&sn=Detail

⁴⁵ Roeber, 2005

⁴⁶ Dunne and Lamb, 2004:292

⁴⁷ Haines, 2004:312

⁴⁸ Dunne and Lamb, 2004

⁴⁹ *Mail & Guardian*, 'Arms probe reopened', 20 March 2008

⁵⁰ Roeber, 2005:10

⁵¹ Le Roux, 2006:222-223

⁵² Power M. and Jocelyn Maker; *The Times*, 'Mbeki took R30m, gave some to Zuma', 3 August 2008

⁵³ See Transparency International's *Defence Anti-Corruption Digests* for archives of media reports on alleged corruption in the South African 1999 defence acquisitions programme, available at www.defenceagainstcorruption.org/index.php/digest/



4.2 PORTUGAL

In 2004, Portugal signed the purchase of two submarines in a deal encompassing a EUR 1.2 billion offsets contract that included direct offsets and projects in the naval, automotive and new technologies industries.

In July 2006 Portuguese authorities started investigations into the deal⁵⁴ after questions arose over payments of EUR 30 million to an intermediary company for brokering the deal and the offsets contract. The investigation was incited by a suspicion that this amount was excessive relative to the role that, in the view of the Public Prosecution Service, the company had played⁵⁵. In 2007 the case was made public by a daily newspaper citing telephone conversations that cast doubts on the legitimacy of payments associated with the submarines' acquisition⁵⁶. The fact that the then Minister of Defence, who also led the ruling CDS party at the time, commissioned the construction and delivery of the submarines also led to speculations regarding his involvement⁵⁷. According to public officials, the ensuing investigation concerns cases of corruption, mismanagement, laundering, mostly associated with the financing of political parties⁵⁸, and offsets as vehicles for undue payments.

The investigation has already targeted several offices of the companies and law firms involved, the Portuguese Offset Commission, the MoD, and the houses of senior staff and other personnel linked to the tender^{59, 60, 61}.

The stage of the investigation initiated in autumn 2009 led Portuguese prosecutors to accuse three German executives and seven Portuguese citizens involved in the case of fraud and forgery of documents related to automotive offset projects included in the submarines package⁶². The prosecution targeted projects worth approximately EUR 86 million, claiming that the obligor and a Portuguese consortium colluded to include projects lacking causality (developed solely by the members of that consortium) in the offset

programme, in exchange for a fee on the credited sales volumes totalling EUR 1 million. The prosecution quoted EUR 34 million in damages to the state from these actions and is requesting from the defendants compensation of the same value.

The allegations made in this case have several implications that reinforce the need for specific actions on offsets as part of an overarching effort to build integrity in defence:

- The prosecution targeted offsets specifically, bringing unprecedented responsibility to those managing them, among suppliers, offsets beneficiaries and offset authorities. As a whole, offsets face a significantly reduced scrutiny from authorities.
- The case demonstrates the multiplying effect of offsets (that can be positive or negative). The demanded EUR 34 million compensation for damages to the state also reflected freeing the obligor from implementing the EUR 86 million offset volume and the projected EUR 1 million gains for the Portuguese consortium (although actual gains were around EUR 100 000).
- The case highlights the inadequacy of the evaluation and audit mechanisms implemented by the authorities evaluating and managing offsets.

⁵⁴ Translation from an article from a Portuguese weekly newspaper, *Sol*, 1 December 2007

⁵⁵ Translation from an article from a Portuguese daily newspaper, *Correio da Manhã*, 20 July 2007, available at: <http://www.aremilitar.net/imprensa/imprensa.aspx?nrnot=339>

⁵⁶ Translation from an article from a Portuguese daily newspaper, *Correio da Manhã*, 20 July 2007

⁵⁷ Graeme, C., *Algarve Resident*, 'Germans Deny Submarines Corruption Claim in Portugal', 8 October 2009, available at: <http://www.algarveresident.com/story.asp?ID=34367>

⁵⁸ Translation from an interview with the Director of DCIAP from a Portuguese radio Station, *TSF*, 1 October 2009

⁵⁹ Translation from an article from a Portuguese daily newspaper, *Correio da Manhã*, 22 July 2008, 8 March 2009 and 12 September 2009

⁶⁰ Translation from an article from a Portuguese weekly newspaper, *Sol*, 24 and 25 July 2007, 29 November 2008

⁶¹ Translation from an article from a Portuguese weekly magazine, *Sábado*, 1 October 2009

⁶² Khalib, A. and Anneli Palment, 'Portugal accuses 10 of fraud in submarine deal', *Associated Press*, 2 October 2009, available at www.reuters.com/article/rbssConstructionAgriculturalMachinery/idUSL257190620091002



4.3 GREECE

From a rather different perspective, the Greek case also provides relevant inputs regarding offsets' risks. In an unprecedented move, the Greek MoD is refusing to extend offsets projects' fulfilment period and has warned obligors that penalties will be applied to all offset contracts that are behind schedule⁶³. Greek authorities are calculating the penalties and cashing in the performance bonds, a decision that may affect more than US 1 billion of offset contracts and has incited several reactions from the obligors.

This position contrasts with a more relaxed approach from the government that has been the standard until now, allowing obligors to extend fulfilment deadlines as long as the contract is in force, even if the extension was not foreseen in the original agreement.

Offsets penalties would go toward the pension funds of the acquiring military branch's officers, most of the acquisitions being by the Air Force. This has sparked criticisms that money is detracted from technological and industrial development to provide for "aging officers" and that this move intends to mitigate the effects of the country's financial crisis. Adding to the tense environment are the lack of response from MoD officials to many obligors' letters requesting extensions, some of them within the contract fulfilment period, and the MoD's refusal to accept credit claims. The consequences are far-reaching, with credit lines for defence procurements being affected and suppliers announcing that they will refrain from participating in future tenders in Greece until the revision of the current offset legislation. The offsets' legal framework in Greece has changed in recent years and the different contracts fall under different regimes, adding increased complexity to an already delicate situation. The Greek case raises issues over the effect of offsets on the whole procurement process and the importance of addressing them properly:

- Offsets can be an important part of the external perception of countries' defence procurement. They contribute to solidify or diminish the confidence of suppliers and the rest of the world in the country's defence institutions and its overall credibility.
- When facing high-risk environments, such as in countries with frequently or arbitrarily changing offset guidelines, suppliers might take additional precautions, for instance including the value of offset penalties in the final acquisition price.
- Obligors and third party offset executors tend to prefer conservative and often uninteresting approaches to offsets in order to reduce liability.

Effective, efficient and transparent offsets require a stable framework, with little or no surprises for everyone involved; clear processes and goals for evaluation, valuation, monitoring and crediting of offsets; and flexible but comprehensive offsets contracts that set clear paths for each situation.

⁶³ Countertrade & Offsets Journal, 'The Greek honey trap', 12 October 2009

The Al Yamamah contract negotiated in 1985 between the UK government on behalf of British Aerospace (later BAE Systems) and Saudi Arabia is the largest export in UK history. It has also attracted much controversy.

4.4 OTHER ALLEGATIONS OF CORRUPTION IN OFFSETS PROGRAMMES

Czech Republic The Czech case of Gripen fighters purchases being investigated for bribery also featured questions raised over the offsets package included as part of the deal. The investigations concerned the structure of the tendering process and payments to senior Czech officials allegedly made in 2001. Competing bidders withdrew complaining that the government had intentionally drawn up a contract that would generate a victory for the Gripen fighters. The offsets deal which accompanied the package was also criticised at the time of purchase as being illusory, with two finance ministers criticizing its execution⁶⁴.

UK and Saudi Arabia The Al Yamamah contract negotiated in 1985 between the UK government on behalf of British Aerospace (later BAE Systems) and Saudi Arabia is the largest export in UK history. It has also attracted much controversy. The contracts contained a well-known offset clause whereby some of the revenues generated by BAE Systems from the contract were reinvested into the UK defence industry; the offset has been reported to have had few discernible benefits. Following the US Department's of Justice concerns, the offsets clause was reported⁶⁵ in 2007 to be part of the investigation.

Israel In September 2005, Defense News reported that as part of a major investigation into allegations of fraudulent payments made overseas, the headquarters of Israel's largest aerospace and defence firm, Israel Aircraft Industries, was raided by police. The investigation was focused on ten years worth of suspected bribery and kickbacks, and centred on the disbursement of both export sales and offsets deals⁶⁶.

Romania In the Romanian purchase of two frigates in 2003, allegations emerged as to the payment of commissions. The crucial part of the investigation focused on irregularities in the contract and lost funds centred on the offsets package. In June 2006, the Bucharest Daily News reported that "the real stake appears to be the implementation of the offset contract"⁶⁷. Under this contract, BAE Systems was to use 80% of the acquisition sum to buy products and services from Romania in a combination of direct and indirect offsets. The offsets have continued to prove controversial, as the Jurnalul National reported in September 2003 that the Romanian Ministry of Defence intended to sue BAE Systems if the company did not fulfil its obligations under the offset agreement. The report also stated that the deal remains under investigation in the UK by the Serious Fraud Office⁶⁸.

Taiwan In an article in Defense News highlighting concerns over defence procurement processes in Taiwan, corruption and payments to officials were highlighted as a major problem with defence deals. Amongst the recommendations for improving processes, there was reported to be broad agreement that tackling corruption would require commissions and offsets to be either tightly controlled or ended altogether⁶⁹.

⁶⁴ *ISN Security Watch*, 'Czech-BAE corruption probe worries Prague', 28 February 2007, available at: <http://www.speroforum.com/site/article.asp?idarticle=8213>

⁶⁵ Fidler, S. and Michael Peel, *Financial Times*, 'Web of payments proves a sticky issue', 02 July 2007, available at: www.ft.com/cms/s/0/442d7b18-27f0-11dc-b0da-000b5df10621.html?nclink_check=1

⁶⁶ *Defense News*, 'Israel Police Raid IAI', 30 September 2005

⁶⁷ *Bucharest Daily News*, 'Former ministers in limbo over frigate deal', June 2006

⁶⁸ *Jurnalul National*, 'Romania Will Sue BAE Systems For Breach of Contract', 03 September 2007

⁶⁹ *Defense News*, 'US Warns Taiwan: Clean Up Defense Procurement', 11 September 2006

5 MEASURES TO INCREASE TRANSPARENCY, ACCOUNTABILITY, AND INTEGRITY

5.1 IMPORTING GOVERNMENTS

Defence and offsets policy

The importing government should make performance delivery and transparency the cornerstones of developing a clean offsets strategy. The overall thrust of the offsets policy needs to be considered by the importing government. One of these considerations should be where the offsets policy fits into other national goals and strategies, if it is primarily part of security and defence policy or whether it forms part of a more general strategy of industrial policy and development.

In any case, offsets policies should not be perceived as goals in themselves and they should be carefully integrated into other national concerns. In doing so, incentives are created for the offsets programmes to be properly managed and evaluated in-country, and determining the nature of individual offsets packages can be fit into a larger offsets policy to the benefit of both public officials and the supplier company.

Transparency should be a foundation of the development of the offsets policy. Traditionally offsets have been opaque instruments, but there is no reason why this should be the case. Countries developing offsets policies should do so with proper legislative input and oversight so that those policies reflect the political priorities of the country. Similarly, civil society and other external organisations should contribute to the development of the overall offsets policy to reinforce the legitimacy of this instrument.

In order to perform these roles effectively, legislatures and civil society in many countries need to raise their awareness of defence issues and develop the confidence to address these in national arenas, a process which ultimately will lead to better defence and security policy, as well as helping to transform offsets into policies capable of delivering benefits.

Yet it is important to acknowledge the real costs of offsets programmes. Benefits to local industry are possible through offsets but as has been emphasised repeatedly they come at a high price. Offsets policies therefore would be best constructed if they reflect long-term goals in industrial and economic development, rather than more short-term objectives such as supporting employment levels or maintaining struggling industries. The latter are unlikely to serve as efficient vehicles of investment, and instead are more likely to fall into the familiar patterns of failure in industrial policy and give rise to the development of corrupt networks. When offsets policies reflect a long-term strategic goal, towards which many stakeholders have contributed, there are stronger incentives to manage those policies effectively so that the long-term benefits can be realised.

Offsets policies should not be perceived as goals in themselves and they should be carefully integrated into other national concerns.



Procurement regulations, processes, and staff

Even a well-developed offsets policy should recognise that defence purchases should be made on the basis of strategic security requirements, and that procurement decisions, either at the planning stage or the evaluation of bids, should not be made because of the structure of the defence offsets package.

As far as is feasible, negotiations over the offsets package should be separate from the selection of the winning bid in defence contracting and offsets should not be considered in the award criteria. If offsets are to be considered as such, a further principle will be the weighting of the criteria in favour of considerations such as the technical requirements of the bid, cost, and quality of the bid, and not unduly towards the offsets package. Such criteria should, in any case, be transparent.

Where defence procurements are allowed to deviate from general public procurement laws, the procedure should be clearly laid down in legislation with means to ensure appropriate oversight and accountability, and having competition and transparency as integral parts of the process. As far as is possible to do so without compromising national security and commercial secrecy, information on procurement process (and not on its contents) should be made available to the general public, including the bidding process, the selection and award process, and the implementation process. Thorough and complete records should be kept of procurement processes, which in turn should be audited periodically.

Procurement should be organised in a central procurement office, with a professional staff holding appointments by merit and subject to rotation to prevent the development of inappropriate relationships with suppliers, as well as to evaluation and review on integrity and ethics. Procurement officials should be subject to regulations requiring the disclosure of any potential conflicts of interest and declarations of wealth.

Effective procurement regulations which safeguard value-for-money and integrous behaviour require professional and ethical procurement staff in defence establishments⁷⁰. This requires the development of ethical programmes for defence ministries formalised into codes of conduct⁷¹, as well as the development of technical procurement regulations. Such codes should aim to prohibit practices such as the receipt or solicitation of bribes, inappropriate receipt of gifts and hospitality, and undisclosed conflicts of interest.

Establishing responsibility and accountability within government for oversight and management of offsets programmes involves the creation of dedicated offsets agencies to manage the programme, staffed by professional persons capable of managing large-scale projects and internal audit offices to review projects periodically. As with any agency dealing with large, complicated, and technical projects, it should also develop effective internal anti-corruption and ethical programmes and controls to ensure its effective operation, having its personnel subject to the same codes of conduct as those of procurement. Such agencies should also be accountable to legislative bodies, and the projects they manage subject to external scrutiny and oversight.

⁷⁰ Schooner, 2009

⁷¹ See Magahy and Pyman 2009 for a detailed discussion of this issue

Government monitoring and evaluation

Offsets, as mentioned before, are valued in terms of credits and not currency. The relation between credits and actual currency, or investment by the supplier (offset obligor), can vary significantly from country to country and even from project to project. This ambiguity also presents a serious opportunity for corruption and, therefore, a significant effort should be made on the part of countries to clearly define their offsets valuation mechanisms.

Procurement officials in defence ministries may construct offsets policies with the potential for substantial benefits, but they have little compulsion to ensure effective execution of offsets contracts. While the main contract will often receive much scrutiny, evaluation, and auditing, offsets policies are unlikely to be subjected to the same.

As with other parties engaged in offsets, importing governments and their agencies tasked with managing offsets programmes need to develop their reporting of offsets programmes and increase the transparency of offsets. This means conducting value-for-money audits and requiring independent evaluations of offsets programmes throughout their life-cycles, and collating data and publishing annual reports on the offsets programmes.

In particular, the monitoring of offset programs is particularly demanding since it requires a correctly defined baseline scenario with a proper set of metrics to evaluate each result. The fact that offsets are sometimes expected to have social, technologic and other tacit outcomes, adds to the complexity of this task.

Creating incentives for companies

Generally, there is little accountability when offsets fail to deliver. Part of dealing with this problem on the company side is to tie the company's direct interests to the satisfactory execution of the offsets contracts.

This may be easier to achieve in the case of direct offsets. If companies are to be supplied by local partners with goods or services which in turn will contribute to the performance on the main contract, then companies have a direct incentive to ensure performance on the offsets package. Companies generally eschew suppliers which have corruption problems, as they are unreliable and they carry the danger of damaging reputation through association. On direct offsets, therefore, incentives may be set up in a relatively straightforward manner to give the main supplier company a direct interest in the efficient performance of the offsets package. Further, if direct offsets help develop capability in the importing country, the main supplier company may gain future benefits from the relationship it developed with the partner during the offsets agreement.

On indirect offsets, however, the incentives cannot be embedded into performance on the main contract in such a manner. Should investment under an indirect offset fail it will likely not affect performance on the main contract. Governments and procurement officials could seek to overcome this incentive problem by linking unsatisfactory performance on the offsets arrangements to the terms of the main contract, always having in mind that the higher the penalties, the higher the increase in price due to offsets will be.

5

MEASURES TO INCREASE TRANSPARENCY, ACCOUNTABILITY, AND INTEGRITY

Stricter enforcement of anti-corruption law, although part of a significantly broader effort, is a key part of developing incentives for countries to act with integrity in offsets arrangements.

Blacklisting would also be an effective tool meaning that companies which fail to deliver under their offsets obligations become ineligible to bid for future contracts during a certain period of time. The effectiveness of this measure would be multiplied if there were some inter-governmental agreement to recognise each others blacklists.

Thus it should be possible to link sanctions for non-performance to the main interests of the company. These sanctions should be credible at the time they are agreed so that companies understand fully the costs of non-performance in offsets agreements. If offsets packages carry such sanctions for non-performance, then the integrity of those packages should be increased for the same reason as in direct offsets: corrupt companies are generally avoided by international companies because they are unreliable and because association with them carries reputational risk. Investments made to companies under indirect offsets in this scenario would therefore need to carry anti-corruption safeguards and monitoring and evaluation procedures to ensure their efficient and integrous management.

Governments in importing countries also have an extreme sanction to impose on companies which allow corruption to occur through offsets agreements, in the form of criminal prosecutions. Alternatively, if they are not capable of prosecuting companies within their own jurisdictions, they can provide prosecutors in the companies' home countries with legal assistance in investigating corrupt activities so that they may be prosecuted in other jurisdictions. Stricter enforcement of anti-corruption law, although part of a significantly broader effort, is a key part of developing incentives for countries to act with integrity in offsets arrangements.

Recommendations

Offsets framework Importing governments requiring offsets should ensure that performance delivery and transparency are the cornerstones of the offsets policy.

National governments should ensure that defence purchases do not derogate from the basis of strategic security requirements, and that procurement decisions, either at the planning stage or the evaluation of bids, are not influenced by offsets.

Offsets management Procurement directors should ensure that the offsets team is properly constituted with competent and experienced personnel bound by a robust code of conduct – offsets are a specialist area not suitable for MOD officials or military officers without experience in the field.

Procurement officials should be subject to regulations requiring the disclosure of any potential conflicts of interest, particularly in respect of possible beneficiaries from the offset package or contracts.

Governments and procurement agencies need to establish clear responsibility and accountability for oversight and management of offsets programmes. They should ensure that there is an agreed cycle of performance and value-for-money audits.

National governments should require due diligence to be carried out to ensure that no member of the government or official will benefit improperly from any offset contract, and to ensure that all potential conflicts of interest by officials, military officers and parliamentarians are disclosed.

Evaluation and monitoring of offsets National governments should require that every offset obligation contract is specific about how performance will be monitored and how/when the results will be made public. National governments should be clear and public about their valuation mechanisms and/or corruption experience, and should establish incentives and penalties for performance.

National governments should commit to publishing the offset obligations and publish annually the achievement of progress against those obligations.

To facilitate an enhanced monitoring progress, national authorities dealing with defence procurement should strongly consider a dual pricing requirement. This means that all bids would be submitted with two prices for the defence capability being procured: one with the offsets package and one without. This would allow for a real cost-benefit analysis to be made on offsets and increase visibility over the economics of offsets that allow for an enhanced monitoring process.

National governments should develop mechanisms to recognise each other's black listing processes, increasing the toll on improper conduct from suppliers.

5.2 SUPPLIER COMPANIES AND INDUSTRY ASSOCIATIONS

Supplier companies should take an active approach to minimising corruption risk in offsets arrangements. They should address this risk explicitly through internal codes of conduct, compliance standards and business ethics programmes. Companies should ensure that these are communicated to and implemented among the subcontractors, as well as committed to by local partners and third parties. They should also ensure that the offset elements of their codes and compliance programmes are appropriately audited and evaluated.

Companies can improve the way offsets packages are developed by being transparent and integrous with importing governments about the costs that different packages will incur. They can also contribute to the appropriate development of offsets by helping governments set realistic expectations regarding the management of offsets arrangements and the requisite governmental commitment level.

Companies should conduct due diligence on offset intermediaries and all third parties who may benefit from association with the offsets package or obligation.

Defence industry associations should take the lead in promoting transparency in offsets contracts. This may be done through developing and publishing guidance on what a high transparency/high integrity offset package should look like; collating experience from within the industry on corruption in offsets contracts, the better to assist and guide companies in the future; and ensuring that offsets corruption risks are thoroughly discussed within the industry.

A crucial means of achieving transparency of costs is to submit two prices for bids: one with the offsets package, and one without.

Policy level: development of offsets packages

As described earlier, offsets packages are believed to be proliferating in quantity, in value, and in sophistication. If offsets packages continue to be uncontrolled and not managed effectively, they will likely lead to deadweight losses through inefficiency and corruption. However, with effective management, underpinned by high standards of transparency, integrity, and accountability, offsets packages may allow countries to reap economic benefits.

However, for such industrial benefits to be realised, expectations for offsets packages must be firmly based in reality. That reality includes recognising that the benefits from offsets programmes are not cheap; offsets policies are expensive, but properly constructed may represent a long-term investment in domestic industry from which benefits may accrue over time.

Informally, some defence companies are acknowledging that offsets packages are becoming more demanding and ambitious, and concentrating increasingly away from direct offsets in favour of indirect offsets^{72,73}. Government officials are said often to treat the development of the offsets package as an exercise in 'economic fantasy'⁷⁴, and efforts need to be undertaken by the company to, within its powers, manage government expectations in the development of offsets packages, based on an assessment of what the government wishes to achieve from the arrangements, and what fulfilling these obligations would entail on the basis of the country's domestic industrial capacity.

Wylong (2009) describes the variables involved in this process as including the scope of the offsets package, the deliverables, the understanding of what the government wants from the package, export control restrictions, and the competitive business environment in the country. Montoya (2009) adds to this an assessment of whether government priorities lie in the development of small and medium sized entities, job creation, technology transfer training and education, export promotion, investment, research and development, business output, any other priority, or some combinations of the above. On such bases, companies can begin to tailor offsets packages which reflect what the importing government wants.

Companies can contribute to the appropriate development of offsets packages by being transparent about the costs which different packages will incur and helping to set realistic expectations as to the management of offsets arrangements and the commitment to the packages that governments should give to increase the likelihood of their success. A crucial means of achieving transparency of costs is to submit two prices for bids: one with the offsets package, and one without⁷⁵.

Companies should clearly state their refusal to enter into offsets arrangements which will be used for illicit enrichment of public officials and make this a condition of the agreement.

72 Wylong, 2009
73 Montoya, 2009
74 Montoya, 2009
75 Davies, 2009

Execution level

Within defence companies, anti-corruption programmes are becoming more advanced. US companies, facing the strict enforcement of the Foreign Corrupt Practices Act (FCPA – see Annex 2 for further discussion) and benefiting for more than two decades from the Defense Industry Initiative on Business Ethics and Conduct⁷⁶ have generally developed leading anti-corruption systems and processes to govern their internal conduct. European companies with US subsidiaries have generally developed adequate programmes to protect their US operations, and in recent years the major European companies have increased their attention to compliance and business ethics.

For US companies, one of the greatest vulnerabilities now faced under the FCPA is from relationships with third party actors, including agents, consultants, sales representatives, and joint venture partners⁷⁷. Liability for companies accrues from either direct authorisation of a third party, a failure to conduct due diligence, or from ignoring indications of misconduct by third parties⁷⁸. It is no stretch of logic to apply the same liability to companies engaging in offsets policies as already exist through joint ventures and third parties. Though there have been few cases where corrupt practices under offsets programmes have led to prosecutions, the liability likely already exists under the FCPA and, with anti-corruption laws tightening across the OECD following the OECD anti-bribery convention, in other jurisdictions.

This paper suggests a series of measures that companies should take to deal with the corruption risk they take on in offsets programmes. The first stage for companies is to ensure that their internal compliance and business ethics programmes are adequate for the purpose of preventing corruption emanating from within their own organisations, and that their programmes explicitly address the issue of offsets.

Second, companies need to conduct due diligence on proposed local partners and third parties when they engage in offsets programmes. Third, companies should extend their own compliance and business ethics programmes to local partners and third parties. Fourth, companies need to act to maintain standards among partners and third parties they engage with through audit and evaluation processes to ensure continued compliance, as well as conduct more extensive evaluations of their offsets programmes in a wider context.

The suggested measures entail substantial expense for the company and from the following paragraphs it becomes clear that large numbers of professionals are required to reduce meaningfully the corruption risk associated with offsets. This should serve as a continual reminder that engaging in offsets packages is an expensive operation which should not be entered into lightly by either the supplier company or the importing government. However, the cost to a company of not including significant safeguards of the kind suggested here can be far higher if violations do occur and are detected.

⁷⁶ See defenseethics.org

⁷⁷ von Hehn, 2008

⁷⁸ von Hehn, 2008

However, while at present some companies would discuss relations with subsidiaries, joint-venture partners, and third parties in their codes of conduct; very few discuss offsets programmes as a corruption risk.

Compliance and business ethics programmes

Before supplier companies can become agents of integrity in offsets processes, they have to be confident that their internal procedures are working in a manner to ensure compliance with relevant laws and are promoting an ethos of integrity in business conduct throughout the organisation.

Most major defence companies have developed substantial compliance and ethics programmes, which are formalised into publicly available and widely distributed codes of conduct. However, while at present some companies would discuss relations with subsidiaries, joint-venture partners, and third parties in their codes of conduct; very few discuss offsets programmes as a corruption risk. Indeed, in the ten largest defence companies worldwide⁷⁹, there were no explicit mentions of offsets in any of their codes of conduct. The closest any company comes to being an exception is BAE Systems plc, which in 2008 agreed to implement in full the recommendations from Lord Woolf's review into ethical practice at the company; the Woolf Committee addressed the risks of offsets and made recommendations as to mitigate the risk in its report⁸⁰. The Woolf Committee's recommended an extensive due diligence procedure for offsets contracts and agents⁸¹.

Companies should therefore expand their compliance and business ethics programmes to deal with the risks arising from offsets programmes, and include in their codes of conduct specific sections on offsets programmes and the corruption risks they entail, setting out guidance as to how to manage these programmes with integrity.

Choosing the right partners and third partners: due diligence procedures Even if the company's employees are acting with integrity in offsets arrangements, the company may still be unwittingly engaging in improper practices and incurring corruption liabilities through the conduct of local partners and third parties. In order to mitigate this corruption risk, companies should conduct due diligence on all local partners and third parties prior to entering any agreements or arrangements under the offsets programme. This should extend to both offsets brokers and agents, and to potential beneficiary companies. Due diligence checks allow the main supplier company to understand the risk they are incurring under the offsets agreements and determine whether or not they wish to proceed on the basis of the evaluation of that risk, and put in place safeguards to counter any such risks they may be incurring⁸².

⁷⁹ The Boeing Company, BAE Systems plc, Lockheed Martin Corporation, Northrop Grumman, General Dynamics, Raytheon Company, EADS NV, L-3 Communications, Finmeccanica, and the Thales Group – from SIPRI 2008

⁸⁰ Woolf Committee 2008:27-28, 47-48

⁸¹ For further information on company compliance and business ethics programmes, see Annex 3

⁸² For further information on conducting due diligence checks, see Annex 4

Rolling out the code

One of the means of mitigating the risk is to integrate all partners and third parties involved in an offsets package into the main supplier company's code of conduct. Such procedures should carry the attendant benefits of raising standards in the purchasing country.

Nevertheless, rolling out a code of conduct within a company requires extensive training procedures for staff, the establishment of lines of accountability, mechanisms for complaint which will in some cases include confidential hotlines, and constant review and rejuvenation of the ethical programme. Writing the programme itself contains challenges relating to ensuring the code of conduct at a minimum complies with the law, accurately reflects the values of the organisation, and making sure it is written clearly and intelligibly so that it can be efficiently disseminated to staff. When a company insists its code be applied to other entities, many of these challenges reoccur: the code of conduct must be rewritten in the local language with the same clarity and intelligence, it must comply with local laws, new training, awareness, and refresher programmes need to be devised in a manner appropriate to local labour laws and practices, and new accountability mechanisms need to be designed to ensure compliance with the code.

The undertaking is not so simple as requiring local partners and third parties sign a contract clause stating they will adhere to the code of conduct and other elements of the ethical programme; for the code to act meaningfully, the main company has to embed it among its partners and third parties, and this requires investment in monetary and human resources.

As part of the contracts agreed between the main supplier company and local partners and third parties, the latter must sign up to the ethics and compliance programme of the former. The main supplier company should also include a contractual clause giving it the right to audit and investigate its partners and third parties, which should be exercised at appropriate intervals so as to allow the company to certify continued compliance. Further, it should maintain the right to terminate the contract in instances of corruption and any violations of applicable laws.

Maintaining standards

The above policies represent the bulk of how companies can act to mitigate the corruption risk in offsets agreements on the ground. In doing so, it is possible that they can act as agents of change and help to raise standards in local companies and industry. For the best-performing local partners in offsets packages, the process of engaging on such programmes may allow them to raise their business standards and practice and become more efficient operators, and even to become preferred suppliers to the main supplier company⁸³.



⁸³ Wylong, 2009 describes this process as having occurred through Lockheed Martin Corporation's offsets programme

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MEASURES TO INCREASE TRANSPARENCY, ACCOUNTABILITY, AND INTEGRITY

Companies should take an active approach to minimising corruption risk in offsets arrangements, explicitly addressing this risk in internal codes of conduct, compliance and business ethics programmes;

As long-term strategy for the supplier companies, there are actions that will both maintain standards in-country and reduce the costs associated with engaging on these procedures in future transactions. Through conducting value-for-money audits on offsets programmes and engaging in evaluation of compliance on the part of local partners and third parties and using the results to maintain records of which companies are reliable and which have engaged in poor performance, the main supplier company will be able to improve its offsets programmes and maintain integrity in them. These processes should be integrated into wider programmes of evaluation of offsets packages to ensure that all parties, importing governments, main supplier companies, and local partners and third parties, engage on offsets packages that are appropriate and beneficial.

Companies must also act to increase confidence in the integrity of their offsets programmes by introducing a far higher degree of transparency in their offsets agreements. This should include producing detailed annual reports on outstanding offsets programmes, including volume, type, and concentration, and reports on the results of value-for-money audits and other evaluations.

Recommendations

Companies should take an active approach to minimising corruption risk in offsets arrangements, explicitly addressing this risk in internal codes of conduct, compliance and business ethics programmes; and ensuring that these are communicated and trained through the subcontractors, agreed by local partners and third parties; and appropriately audited and evaluated.

Companies can contribute to the appropriate development of offsets packages by being transparent with government about the costs that different packages will incur, and helping to set realistic expectations as to the management of offsets arrangements and the commitment needed from governments to increase the likelihood of their success.

Companies need to conduct due diligence on offset intermediaries and all third parties who may benefit from association with the offsets package or obligation.

Defence industry associations should take the lead in promoting transparency in offsets contracts, through developing and publishing guidance on what a high transparency/high integrity offset package should look like; Collating experience from within the industry on experience of corruption in offsets contracts, the better to assist and guide companies in the future; and ensuring that offsets corruption risks are thoroughly discussed within the industry.

5.3 EXPORTING GOVERNMENTS

Tighten legal obligations on companies and enhance enforcement

Companies in advanced industrialised countries are facing increasingly onerous obligations to prevent corruption in their activities outside the country. It is yet unclear the extent to which these obligations make supplier companies liable for corrupt practices under offsets contracts. This paper recommends that governments make national companies liable for the actions of partners and third parties in offsets agreements, including local companies, agents, representatives, and consultants involved in the process, and to increase enforcement of anti-corruption laws. By making the main supplier company liable for corruption, which occurs under offsets agreements, exporting governments give those companies powerful incentives to develop anti-corruption procedures and policies for use in offsets agreements. The effect is to turn international defence companies into enforcers of anti-corruption laws⁸⁴.

Increase transparency of offsets arrangements

At present, very few governments require their companies to disclose information on offsets arrangements. The main exception is the United States, which publishes an annual volume of detailed information and data on defense offsets contracts around the world⁸⁵ in a report to the US Congress. Consequently there is a clear need for countries with major defence exporting industries to detail current offsets programmes entered into by their companies, with reports on the performance of the contracts.

There is also scope for far greater work to be taken by industry organisations such as the Aerospace Industries of America (AIA) or the Aerospace and Defence Industries Association of Europe (ASD) and for intergovernmental organisations such as NATO or the European Defence Agency (EDA) to report on the extent of offsets programmes, including the volume and concentration of offsets arrangements.

There is a clear need for countries with major defence exporting industries to detail current offsets programmes entered into by their companies, with reports on the performance of the contracts.

⁸⁴ See Annex 2 for two examples of legal instruments used by countries as preventive and punitive measures against corruption by their companies operating abroad

⁸⁵ These reports, compiled by the US Department of Commerce, are available at www.bis.doc.gov/defenseindustrialbaseprograms/osies/offsets/default.htm



Export credit guarantees

The tightening of regulations surrounding export credit guarantees and who qualifies for them could also have a significant impact on building integrity among supplier companies engaging in offsets programmes abroad. Tighter anti-corruption regulations, for example requiring companies applying for support to demonstrate strict anti-corruption programmes and their application to partners in offsets packages, could provide a valuable complement to legal obligations facing companies.

Export credit guarantee agencies could also make more and better use of audits. At present, many agencies have the right of audit but do not make extensive use of these powers. Increased use of audit powers could both increase the likelihood of detection of illicit activities and discourage companies from engaging in them in the first place. Improved enforcement on the part of export credit guarantee agencies could thereby have the effect of raising accountability in international transactions, including where defence companies engage in offsets programmes.

Recommendations

Exporting governments should publish annually all offset obligations into which national defence companies have entered.

National governments should make companies liable for the actions of partners and third parties in offsets agreements, including local companies, agents, representatives, and consultants involved in the process, and to increase enforcement of anti-corruption laws.

6 CONCLUSION

Offsets are a peculiar phenomenon. They are an economic and industrial development policy tool limited for the most part to the international defence sector. Despite being roundly criticised on grounds of efficiency by a wide audience, they proliferate in an opaque environment, with little attempt to ascertain their true value and whether they deliver on the ground. They lack accountability and transparency, are heavily technical, and involve vast sums of money, all of which would suggest a high potential for corrupt activities.

For all the criticisms which can be levelled at defence offsets, there is no reason why intrinsically they should be doomed to fail to deliver or to entail grand corruption. To be sure, offsets packages do not seem to be well-constructed on either of these grounds, and their practice needs serious consideration to get the best use out of them. Yet, there does exist a possibility for offsets to produce beneficial outcomes to importing countries if they are correctly constructed and if the true cost of offsets is acknowledged and taken into account.

At the centre of efforts to create well-performing offsets packages should be the principles of integrity, accountability, and transparency. There is a wide array of actions which can be taken by importing governments and their offset authorities, supplier companies and exporting governments, and even offset beneficiaries to increase integrity, accountability, and transparency in offsets arrangements.

Actions are required at processes' and actors' levels. On the former, offset institutional frameworks need to become more robust, effective, efficient and transparent, even without interfering with national priorities or conceptual approaches to offsets. On the latter, public procurement and specifically offset authorities personnel require clear and strong ethical guidance empowering them to deal with the unique challenges of their roles.

This paper suggests a combination of increased enforcement of anti-corruption law (although not specific to offsets), taking advantage of supplier companies to disseminate good practice in anti-corruption and raise standards, as well as a series of measures on the parts of importing governments to improve offsets policies and management and evaluation of offsets packages.

For all the criticisms which can be levelled at defence offsets, there is no reason why intrinsically they should be doomed to fail to deliver or to entail grand corruption.



Following such measures, though difficult and requiring substantial commitment and expense, would allow offsets policies to begin to realise their potential and become vehicles of mutual benefit rather than conduits of inefficiency and corruption.

This is not "mission impossible" – with a will to raise transparency and accountability across the industry and in governments, considering the lead role of importing countries, a suitable set of standard guidelines and requirements can be established and implemented.

As a first step, it would be relatively easy for a group of interested parties – governments together with industry – to set out a template of good integrity practice that governments can follow and require in all their offset arrangements.

The next year will be a particularly adequate period to take such a step, using the momentum that is being created in EU around the transposition of the new directive for defence- and security-related procurement to the national legal frameworks, which will have to happen until 21 August 2011.

Since most countries will have to redefine their defence procurement policy in order to comply with the new directive and in fact restrict the use of Article 296 exception; and it is not probable that offsets will simply come to an end, this poses an excellent opportunity to work jointly with European governments, industry and international bodies to ensure that the new frameworks will effectively promote increased integrity in offsets.

Transparency International calls on governments and the defence industry to work collaboratively to raise integrity and reduce corruption risks in offset contracts.

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ANNEX

ANNEX 1 OFFSETS DATA

TABLE 2: European offsets based on 2000-06 SIPRI and study data (data in million €2007)

	Group 1: Germany, France	Group 2: Italy, Netherlands, Sweden,UK	Group 3: Greece, Spain, Finland, Poland, Portugal	Group 4: all other EDA-24	Sum/Average
A. Defence equipment import contracts per annum (SIPRI data)	297	1,461	2,346	374	4,478
B. Defence equipment import contracts with offset per annum		1,461	2,346	374	4,181
C. Offset percentage: average (pMS range)		122% (100-178*)	145% (81*-230)	124% (72-237)	135%
D. Offset agreements per annum		1,783	3,400	465	5,647
E. Direct offset: share of total (uncertainty range)		35% (27-35)	44% (13-48)	3%	38%
F. Defence indirect offset: share of total (uncertainty range)		55% (44-58)	28% (7-34)	20% (2-21)	36%
G. Civilian non-defence offset: share of total (uncertainty range)		10% (7-29)	28% (28-52)	77% (76-95)	26%

* Particularly uncertain data (based on single observations)

Table reproduced from EDA 2007, Table 3.1, page 21

TABLE 3: Offset Agreements: Europe Compared to the Rest of World 1993–2006

Year	Region	# of Agreements	Export Contracts	Offset Agreements	Percent Offsets	Avg. Duration (months)
1993	Europe	13	\$2,975,011,352	\$2,328,047,085	78.30%	85.2
	Non-Europe	15	\$10,959,987,068	\$2,456,381,450	22.40%	84.3
	World	28	\$13,934,998,420	\$4,784,428,535	34.30%	84.7
1994	Europe	20	\$1,508,233,660	\$764,829,660	50.70%	87.6
	Non-Europe	29	\$3,284,186,291	\$1,283,885,998	39.10%	71.2
	World	49	\$4,792,419,951	\$2,048,715,658	42.70%	77.9
1995	Europe	28	\$5,072,223,272	\$5,227,714,629	103.10%	103.8
	Non-Europe	19	\$2,457,697,200	\$874,868,816	35.60%	77.3
	World	47	\$7,529,920,472	\$6,102,583,445	81.00%	92.6
1996	Europe	36	\$2,001,002,040	\$2,063,592,040	103.10%	104.4
	Non-Europe	17	\$1,118,668,414	\$368,032,595	32.90%	65.9
	World	53	\$3,119,670,454	\$2,431,624,635	77.90%	92.1
1997	Europe	30	\$3,760,090,000	\$3,065,000,000	81.50%	81.3
	Non-Europe	30	\$2,165,379,255	\$760,531,633	35.10%	78.4
	World	60	\$5,925,469,255	\$3,825,531,633	64.60%	79.9
1998	Europe	20	\$1,384,538,811	\$1,183,174,983	85.50%	83.7
	Non-Europe	21	\$1,644,663,336	\$584,971,899	35.60%	83.7
	World	41	\$3,029,202,147	\$1,768,146,882	58.40%	83.7
1999	Europe	22	\$3,453,509,184	\$2,546,662,710	73.70%	72.3
	Non-Europe	23	\$2,203,110,302	\$910,226,500	41.30%	80.5
	World	45	\$5,656,619,486	\$3,456,889,210	61.10%	76.4
2000	Europe	24	\$3,892,796,045	\$4,324,000,090	111.10%	87.9
	Non-Europe	19	\$2,683,417,953	\$1,380,814,850	51.50%	66.4
	World	43	\$6,576,213,998	\$5,704,814,940	86.70%	80.4
2001	Europe	18	\$3,972,372,462	\$3,808,280,100	95.90%	82.7
	Non-Europe	16	\$3,044,924,355	\$1,652,574,355	54.30%	77.3
	World	34	\$7,017,296,817	\$5,460,854,455	77.80%	80.4
2002	Europe	23	\$2,168,281,468	\$2,045,362,683	94.30%	79
	Non-Europe	18	\$5,237,949,615	\$4,049,449,367	77.30%	92.6
	World	41	\$7,406,231,083	\$6,094,812,050	82.30%	85
2003	Europe	17	\$5,322,590,122	\$8,159,639,137	153.30%	73.9
	Non-Europe	15	\$1,970,463,350	\$950,800,350	48.30%	80.7
	World	32	\$7,293,053,472	\$9,110,439,487	124.90%	77.1
2004	Europe	22	\$898,000,000	\$574,250,000	63.90%	61.1
	Non-Europe	18	\$4,029,513,954	\$3,755,441,750	93.20%	73.1
	World	40	\$4,927,513,954	\$4,329,691,750	87.90%	66.5
2005	Europe	13	\$804,842,020	\$673,302,020	83.66%	80.2
	Non-Europe	12	\$1,455,027,544	\$790,827,544	54.35%	79.3
	World	25	\$2,259,869,564	\$1,464,129,564	64.79%	79.8
2006	Europe	27	\$3,198,670,499	\$2,734,670,499	85.49%	80.4
	Non-Europe	17	\$1,633,780,084	\$690,684,025	42.28%	64.8
	World	44	\$4,832,450,583	\$3,425,354,524	70.88%	74.4
Totals	Europe	313	\$40,412,160,935	\$39,498,525,636	97.74%	84.3
	Non-Europe	269	\$43,888,768,721	\$20,509,491,132	46.73%	77.5
	World	582	\$84,300,929,656	\$60,008,016,768	71.18%	81.2

Source: BIS Offsets Database

Table reproduced from US Department of Commerce 2007, Table 4-2, page 4-7

Example 1: US Foreign Corrupt Practices Act and Sentencing Guidelines

Example 1: US Foreign Corrupt Practices Act and Sentencing Guidelines
The USA occupies the leading position in anti-corruption activities in international business transactions. Prior to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, the most important international legal instrument in fighting corruption internationally was the US Foreign Corrupt Practices Act of 1977 (FCPA)⁸⁶. In its current guise, the FCPA may apply to the following:

- any corporation or individual who takes action related to a bribe of a foreign official while in the US
- foreign issuers: companies listed on US stock exchanges or which raise capital in the US are issuers under the FCPA and subject to its terms
- agents of US companies, extending to agents, officers, directors, and employees of any company subject to FCPA jurisdiction
- individuals or corporations voluntarily submitting to US jurisdiction
foreign subsidiaries of issuers: issuers must assure that foreign affiliates they own or control meet the accounting standards of the FCPA
- foreign subsidiaries of US corporations: a foreign subsidiary of a US company may face rules by virtue of its parent company's compliance programme
- US subsidiaries of foreign companies
- foreign agents and representatives, including local agents, consultants, or sales representatives
- joint venture partners: US parties with a majority interest in a foreign joint venture must enforce FCPA accounting standards and control and take responsibility for all actions of the minority partner
- foreign takeover targets: a non-US firm that is the target of an acquisition or merger with a US company may come face to face with FCPA rules through a probing due diligence process⁸⁷

The above summary suggests that for US companies, exposure to corruption through offsets packages potentially imposes criminal liability for corrupt actions related to the activities of local companies which benefit under offsets packages. The strength of the FCPA derives from the stringent book-keeping requirements it imposes on companies as well as from its outlawing of bribery and other corrupt practices involving foreign public officials. These provisions require companies under the jurisdiction of the FCPA to maintain records that accurately reflect their transactions and to devise adequate systems of internal accounting controls.

⁸⁶ 15 U.S.C. §§ 78dd-1, et seq.
⁸⁷ This summary is taken from Moyer, 2008



Further, the US Sentencing Guidelines Manual provides incentives for companies to develop compliance programmes as a means of protecting the company in the event a violation occurs. The Sentencing Guidelines encourage companies to develop compliance and ethics programmes that promote an organisational culture that fosters ethical conduct, establishes standards and procedures to detect criminal acts, is communicated periodically and practically to employees, and is monitored, evaluated, and continually modified and improved. Companies which develop strong programmes in ethical compliance are afforded reductions in penalties imposed when violations of the FCPA do occur within their organisations.

To this end, companies such as Lockheed Martin Corporation require partners in Industrial Cooperation Agreements (the Lockheed Martin Corporation offsets programme) to sign up to their own stringent internal ethical standards⁸⁸. The strict requirements the US places on its companies thereby demonstrate the power which a strong legal base can have not only in criminalising corruption but also in encouraging high ethical standards to effect integrity in international contracting, both in the defence sector and elsewhere.

Example 2: UK draft Bribery Bill provisions⁸⁹

In 2009, the UK Ministry of Justice published its draft Bribery Bill⁹⁰ which was designed to replace the existing legal framework for combating corruption in international business transactions, which had widely become regarded as overly complicated and antiquated⁹¹. Clause 5 of the draft Bill would create an offence of negligently failing to prevent bribery being committed as part of the business of a company.

While falling short of full corporate criminal liability, the new offence would increase the exposure of companies operating overseas to corruption risk, and place a strong incentive on companies to develop stringent anti-corruption programmes similar to those of US companies. A simple reading of the draft Bill suggests that a supplier company engaged in an offset programme would be required to ensure anti-corruption safeguards in the process. On the strongest interpretation, the company would be required to roll out its own systems and controls to any local companies or third parties on the ground with whom it is engaged in the offsets programme. At present, there is no guidance under the Bribery Bill as to what would be sufficient to protect the supplier company from the risk it exposes itself to under an offsets agreement. At present however, good anti-corruption compliance and ethical programmes probably do not go far enough to protect companies from the risk they are exposing themselves to under offsets agreements⁹².

⁸⁸ Wylong, 2009

⁸⁹ The Bribery Bill was enacted in April 2010, becoming the Bribery Act.

⁹⁰ Available at www.justice.gov.uk/publications/draft-bribery-bill.htm

⁹¹ See for example the Law Commission (UK), 2008 and OECD, 2008

⁹² The authors are grateful to Peter Burrell for his contributions to this paper which inspired this section

There are two core purposes of a corporate compliance and business ethics programme. First, they represent a component of good corporate governance, instituting a common standard for employees of an organisation as to what is expected from them and what they may expect from others, and allowing the Board to exercise better authority over the company. Second, compliance and business ethics programmes protect the company in cases of individual violations. At a deeper level, there is a longer-term business strategy attached to a compliance and business ethics programme. Bribery is a short-term strategy to win a contract; the cultivation of long-term advantages for a company derives from integrity, from relationships built on trust and nurtured over many years, and from a sound reputation⁹³.

Compliance and business ethics programmes are developed into codes of conduct which are then disseminated to employees. The purpose of these is to clarify to individuals their ethical and compliance obligations, while contextualising individual decision-making processes so that individuals shape their actions in a manner consistent with the ethos of the company. Such programmes go beyond strict compliance with the letter of the law, asking employees to act according to a set of corporate values and principles which characterise the company and the vision it has of itself in the world.

For companies, the key corruption issues include the following⁹⁴:

- Bribery
- Agents and Intermediaries
- Joint Ventures and Outsourcing
- Financial Recording and Auditing
- Political Contributions
- Charitable Contributions and Sponsorship
- Facilitation Payments
- Gifts, Hospitality, and Expenses

The code of conduct needs to develop regulations and guidance on each of these issues, and establish clear lines of accountability within the organisation with senior officers responsible for enforcing, maintaining, and evaluating the compliance and business ethics programme.

Through the compliance and business ethics programme, employees of the company develop anti-corruption awareness and capacity to engage on the company's behalf with integrity. In implementing a strong programme, the company reduces the risk that employees will engage in malfeasance in the conduct of their business including in offsets arrangements.

⁹³ Reber and Wexton, 2008

⁹⁴ From Webley, 2003, 2008. See these for guidance, and also Transparency International, 2009



Many of the techniques involved in due diligence checks can be based on those currently used for third parties and in mergers and acquisitions processes. A system of due diligence checks should take the form of the following⁹⁵.

The initial stage is preparation on the basis of the country in which the company would be operating. One of the first factors to consider is the level of corruption risk in the country, which can be done on the basis of indices such as Transparency International's Corruption Perceptions Index (CPI)⁹⁶ or the World Bank Institute's Control of Corruption index⁹⁷. The company also needs to determine the relevant legal framework, including applicable local laws and the laws of the company's home country (for example, the FCPA in the US and equivalent laws prohibiting bribery of foreign public officials in other OECD countries). The sector may also be a relevant factor. For direct offsets, where the investment will be made in the defence sector, there should already be a high level of alertness to corruption risk, but for indirect offsets also, especially if investments are to involve major construction programmes, pharmaceuticals, or extractive industries, there will be high potential risk. In addition to the CPI, Transparency International publishes a Bribe Payers Index⁹⁸, which includes perceptions of how prone individual sectors are to corruption in international business transactions. Understanding these factors helps a company prepare its due diligence plan and to target its compliance programmes accordingly.

When it comes to conducting due diligence on potential local partners and third parties, there is an onerous process in which companies must engage to protect themselves from incurring corruption risk. The form of due diligence should include written questions, oral interviews, and reviews of documentation. Targets for interview should include high-level personnel and anyone connected with compliance programmes the potential partner has for dealing with corruption risk in that country. If such compliance programmes exist, the company should seek to discover the role of the Chief Compliance Officer in the potential partner, policies and procedures for mitigating against corruption risk, training procedures, and any whistleblower hotlines. The company should also review the potential partner's contracts with third parties, its files for agent due diligence and third party vetting, and the sanctions that the potential partner imposes for violations of the compliance programme. Due diligence should also consider any historic compliance issues the potential local partner has: this should include when and how often violations have occurred in the past, what the response was, how much cooperation with regulations the potential partner exhibited, and any sanctions still in place on the potential partner. Finally, due diligence should look for evidence of any existing compliance issues not yet detected. Red flags would include suspicious payments, altered electronic data, vendor files, lack of descriptions in company books and accounts, relationships with agents and intermediaries, and ties to the government. In the case of state-owned enterprises or partially state-owned enterprises, the company should take additional measures to ensure that the potential partner is not being used as a vehicle for corruption. The company should test for anomalies in the potential partner's accounts, looking at commissions, consultants, entertainment, travelling, lobbying activities, marketing, and any other suspicious payments⁹⁹.

⁹⁵ The following three paragraphs are based primarily on Rieder, 2008

⁹⁶ Available at www.transparency.org/policy_research/surveys_indices/cpi

⁹⁷ Available at www.worldbank.org/wbi/governance

⁹⁸ Available at www.transparency.org/policy_research/surveys_indices/bpi

⁹⁹ Rieder, 2008

Having conducted these extensive checks on the potential partner, the company has to determine the level of risk associated with going into partnership. If the compliance programme of the potential partner is of a lower standard than that of the main supplier company, then the latter should insist its compliance and business ethics programme be adopted by the former. In some cases, the main supplier company may decide that the risk associated with entering partnership with the local company is too high and seek alternatives. If there are no alternatives available, then the company may have to return to the importing government and renegotiate the offsets package¹⁰⁰.

When third parties are individuals such as agents, the company should conduct vetting processes using companies such as TRACE International, Inc¹⁰¹ to establish the third party's background, any potential conflicts of interest they have such as contacts to the government or ruling party, and any previous engagement of the third party in illicit activities. The company should also maintain a database on the third parties it uses in the country and update this on a regular basis so that it can maintain control over third parties¹⁰².



¹⁰⁰ Rieder, 2008

¹⁰¹ For more information see www.traceinternational.org/

¹⁰² Brabers, 2008

www.defenceagainstcorruption.org

Transparency International-UK
Downstream Building, 1 London Bridge
London SE1 9BG, United Kingdom
Phone: +44 (0)20 7785 6358
defence@transparency.org.uk
www.defenceagainstcorruption.org