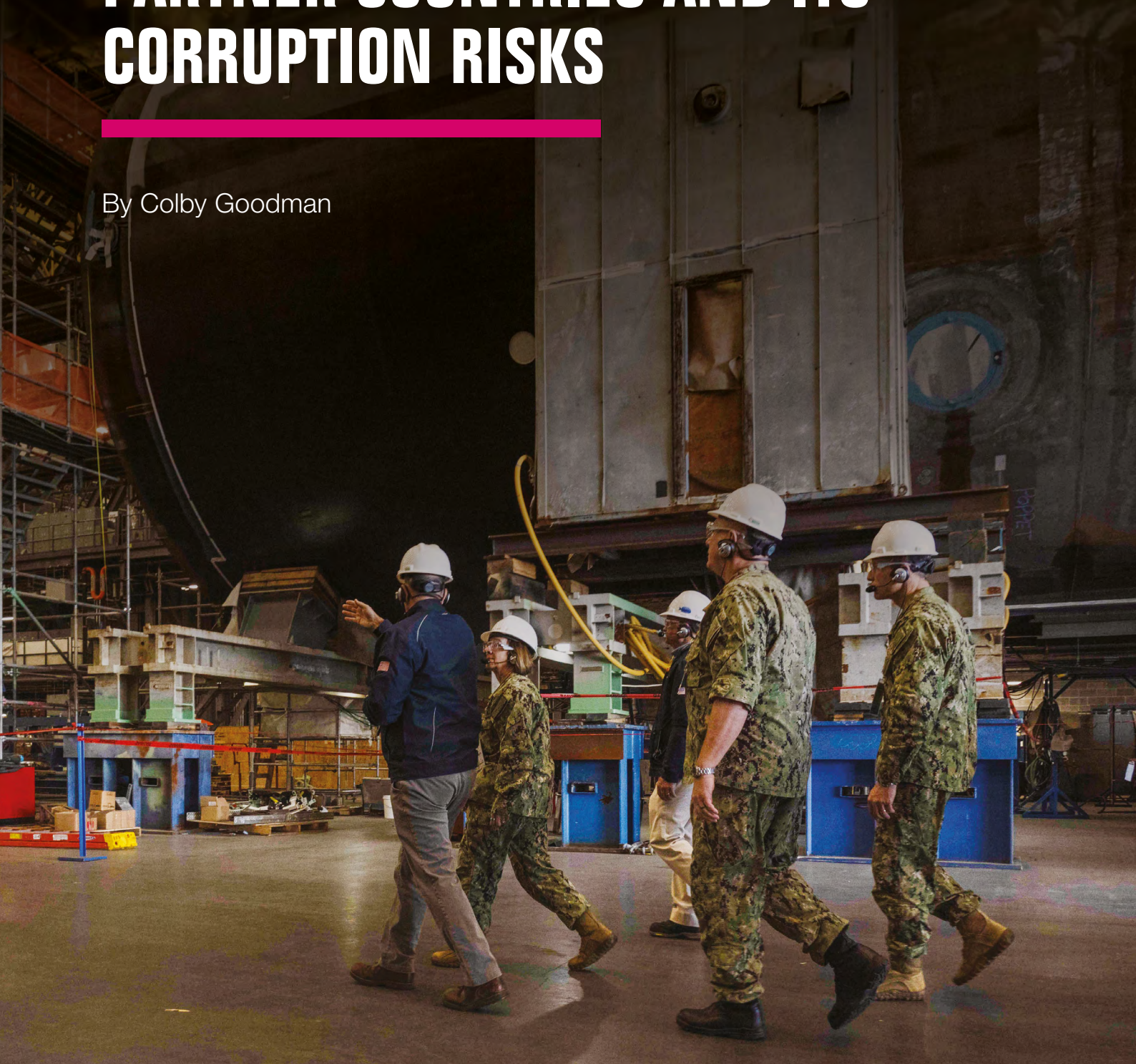


# BLISSFULLY BLIND: THE NEW US PUSH FOR DEFENSE INDUSTRIAL COLLABORATION WITH PARTNER COUNTRIES AND ITS CORRUPTION RISKS

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By Colby Goodman



**Transparency International (TI) is the world's leading non-governmental anti-corruption organisation, addressing corruption and corruption risk in its many forms through a network of more than 100 national chapters worldwide.**

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Images: Front Cover – Navy officials tour a submarine manufacturing facility in Quonset Point, R.I., Oct. 19, 2023.  
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## LIST OF ACRONYMS

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**BIS** Bureau of Industry and Security (BIS), located within the Department of Commerce

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**CBI** India's Central Bureau of Investigation

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**DCI** Defence Companies Index

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**DCS** Direct Commercial Sales program

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**DoD** US Department of Defense

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**DDTC** Directorate for Defense Trade Controls

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**DIOA** Defense Industry Offset Association

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**DSCA** Defense Security Cooperation Agency

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**DTAG** Defense Trade Advisory Group

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**FCPA** Foreign Corrupt Practices Act

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**FMS** Foreign Military Sales program

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**GDI** Government Defence Integrity Index

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**LoA** Letter of Offer and Acceptance

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**TI-DS** Transparency International Defence and Security

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# EXECUTIVE SUMMARY

## Key Findings

The rise in global insecurity is pushing many US security partner countries to reignite or revise a familiar but risky approach to expanding national defense industrial capabilities. Sometimes referred to as defense offsets or industrial participation, this approach requires foreign defense companies to invest in the local economies of countries as a condition for the purchase of major weapons systems. Defense offsets can benefit local defense industries, but they also contain many aspects that make them particularly vulnerable to corruption. US defense companies are rapidly responding to these partner demands with increasing US government support and within an incredibly lax US regulatory environment.

Many US partner countries in Asia, Europe, and the Middle East have recently adopted or are considering new offset policies to support their local defense industrial capabilities. In Europe, countries such as the Netherlands, Poland, Romania, and United Kingdom have expanded their efforts to push foreign defense companies to invest in local defense manufacturing in response to Russia's recent invasion of Ukraine.<sup>1</sup> Australia, India, Malaysia, South Korea, and Taiwan have strengthened their offset policies within the past few years due to security concerns and a desire to develop more self-reliance in defense matters. The same goes for US partner countries in the Arab Gulf states, including the United Arab Emirates (UAE) and Oman.

The growth in these new defense offset policies is driving the high global value of defense offsets, which is projected to surpass \$371 billion for the 2021-2025 period for defense companies around the world.<sup>2</sup> For just one of the US arms sales programs, we estimate the combined total value of US defense company offset obligations for Fiscal Year (FY) 2021 and FY 2022 to be at least between \$36.5 billion and \$52.4 billion. This dollar range, however, is likely a significant underestimation because of the opacity in other US arms sales programs, an increase in more flexible offset quotas, and underreporting by the Commerce Department.

For those monitoring integrity in the defense sector, this development is a serious concern. Previous research by TI-DS and others have outlined how offsets are used as a critical and uniquely flexible inducement to

win lucrative arms sales.<sup>3</sup> Government officials and defense company agents have allegedly used offsets as an important pathway for corruption with real consequences for national and global security. Offsets have reportedly hurt countries' abilities to obtain critical military capabilities and provided questionable support to political parties, campaigns, or political elites. They have likely supported natural resource laundering for armed conflict actors and wasted government funds in highly indebted countries. Offsets have also complicated US government relations with key security partners.

**The growth in these new defense offset policies is driving the high global value of defense offsets, which is projected to surpass \$371 billion for the 2021-2025 period for defense companies around the world.**

Many US partner countries have adopted approaches to offsets that make them more susceptible to corruption. Nearly all of the 14 US security partner countries TI-DS reviewed from Asia, Europe, and the Middle East as part of an update to our Government Defence Integrity (GDI) Index have very limited transparency on defense offsets. Most countries encourage defense companies to invest in local economic areas outside the defense sector to fulfill their offset obligations. These types of offsets are generally riskier because they provide opportunities for

1 Countertrade and Offsets (CTO), "The Offsets Guidelines Quarterly Bulletin," October 2023, Germany, Poland, and Portugal, online at <https://www.cto-offset.com/#product-section>.

2 Aleksandar Jovic, Alexis Strang and Riley White, Avascent, "Defense offsets expectations are considerable, but implementation is uneven". February 23, 2021.

3 Ryan Jay Lambrecht, "The Big Payback: How Corruption Taints Offset Agreements in International Defense Trade," unpublished Thesis, George Washington University Law School, August 31, 2012, online at <https://archive.law.upenn.edu/live/files/3629-lambrecht-r-the-big-payback-2012>.

government officials or defense company agents to steer funds to nearly any domestic entity or any purpose. Several countries, including Malaysia, Saudi Arabia, Taiwan, UAE, and United Kingdom have particularly weak approaches to ensuring defense companies meet their offset contract terms.

TI-DS's Defence Companies Index (DCI) consistently highlights weak US defense company controls to prevent corruption within offsets.<sup>4</sup> The majority of US defense companies do not have explicit policies and procedures to address corruption risks associated with offsets or requirements for offset partners to adhere to the firm's anti-bribery and corruption standards through appropriate contractual clauses, among other key issues. Some purchasing governments, such as Oman, South Korea, and the UAE, have also complained about defense companies hiding their offset costs in proposed arms sales.

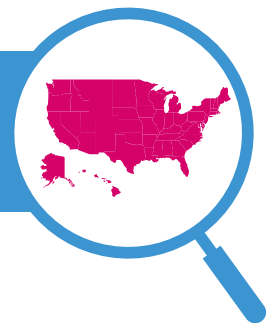
Despite these growing and serious risks, the US government takes a "hands-off" approach to overseeing US defense companies' offsets with partner countries. Both the Defense and State Departments do require US defense companies to submit information to them about defense offsets connected with a proposed major sale, which is then passed along to the US Congress. However, these departments rarely scrutinize offset deals that don't involve controlled or sensitive defense technology. We also identified eight likely cases throughout FY 2022 where the Defense Department should have notified Congress about proposed offsets, but it did not.<sup>5</sup> As one US defense company lawyer put it: the Defense Department appears to be "blissfully ignorant" in some of its offsets reporting to Congress.<sup>6</sup>

The Commerce Department requires defense companies to submit information to them on defense offset agreements and transactions once they have been finalized. The information is used to assess how offsets are impacting the US defense industrial base and other US foreign policy interests in an annual report to Congress. However, the Commerce Department no longer considers corruption concerns in offsets. It is also clear the Commerce Department is not collecting all of the US defense company offset agreements with foreign governments. While the US government has also adopted laws such as the Foreign Corrupt Practices Act (FCPA) that provides an avenue for investigating and prosecuting corruption in offsets, former FBI officials say it is incredibly difficult to investigate and enforce the FCPA in international trade.<sup>7</sup>

The US government needs to increase its oversight of US defense company offsets if it wants to demonstrate global leadership on anti-corruption and prevent some of the serious negative effects outlined above. These issues can be addressed through concerted and cooperative action. Importantly, many of these suggested changes should not seriously impact defense companies' abilities to compete for arms sales abroad if implemented in a targeted way and in consultation with defense companies. In this report, we provide a comprehensive look at the growing and changing defense offset market and related corruption risks. We also outline the key steps needed to reduce the harmful effects of corruption on US and partner countries.

## The US government needs to increase its oversight of US defense company offsets

**if it wants to demonstrate global leadership on anti-corruption and prevent some of the serious negative effects outlined above.**



4 TI-DS, Government Defence Integrity Index 2020, <https://ti-defence.org/gdi/>; TI-DS, Defence Companies Index 2020, <https://ti-defence.org/dci/>.

5 See Defense Security Cooperation Agency FMS notifications to Congress in FY2022 for Australia (LAIRCM Line Replaceable Units (LRUs) and C-130J-30 aircraft), Bulgaria, Norway, Poland (M1A1 Abrams Main Battle Tanks and M1A2 SEPv3 Main Battle Tank), Qatar, and Spain.

6 Mark J. Nackman, "A critical examination of offsets in international defense procurements: policy options for the United States". Winter 2011. *Public Contract Law Journal*. 40(2), pp.526-7.

7 Author interview with former FBI official involved in their Anti-Corruption Task Force, July 2023

## Summary Recommendations

We see four main roles that the US government can play as an exporting government to address corruption in defense offsets among US defense companies and partner countries. These roles are summarized below. Detailed recommendations are provided at the end of this report.

### 1. Increase transparency

#### *Reinvigorate US reporting on defense offsets and political contributions*

One of the best ways to improve accountability and understanding of defense offsets is to enhance internal and external reporting and transparency. US authorities should prioritize efforts to clarify and strengthen reporting on political contributions, commissions and market fees, and reporting to Congress on defense offsets. The US government should also commission an interagency task force to review other ways in which the US can enhance critical information on defense offsets for foreign governments and the public that does not cause unnecessary harm.

### 2. Assess corruption risks

#### *Proactively assess corruption risks in offsets arrangements in arms export decisions*

The United States needs to shift to a proactive stance in preventing corruption in offset arrangements. This will require risk assessments on specific transactions as well as on US partner country's offset controls. Committees in Congress need to critically consider corruption issues as part of their arms export oversight role. The US Congress should request the Government Accountability Office to review past offset agreements to identify types of corruption and compliance risks.

### 3. Penalize wrongdoing

#### *Impose penalties on firms and individuals involved in offsets-related corruption*

US enforcement agencies should specifically investigate offset arrangements because of the known corruption risks. US government authorities should further blacklist firms and intermediaries proven to have engaged in corruption in implementing US weapons programs.

### 4. Encourage stronger offset policies

#### *Push US partner countries to establish more effective policies to oversee defense offsets*

The US government has an opportunity to push for more effective partner offset policies in Asia and beyond. Some of the key items the United States should address are improved transparency on offset partners project details, limited use of particularly risky indirect offsets, and enhanced oversight of arms intermediaries or brokers.



# 1. INTRODUCTION

## 1.1 Rationale for Study

In capitals from Amsterdam to Taipei, many US strategic partner countries are urgently expanding their defense manufacturing capabilities in response to heightened global insecurity, resource competition, and changing alliances. In Europe, the Netherlands has been leading European Union (EU) efforts to enhance domestic defense industries and increase self-reliance for the EU's territorial defences following Russia's invasion of Ukraine in 2022.<sup>8</sup> This includes the EU's new €1 billion European Defense Fund to support the joint procurement of ammunition and missiles from EU and Norway-based companies or assembled in those countries.<sup>9</sup> Similarly, key US partner countries in Asia and Oceania have significantly increased their military spending over the past few years to expand their self-reliance within the defense sector and to support the development of a local arms industry, among other reasons.<sup>10</sup> A key part of these countries' strategies is direct purchases of defense equipment from domestic companies to help grow their national defense industries.

A growing number of US partner countries are also pursuing a more indirect and sometimes riskier approach to expanding local defense industries. Once considered taboo in Europe for their economic distorting effects, countries such as Denmark, the Netherlands, Poland, and the United Kingdom have developed new defense offset or industrial cooperation policies in the past few years to help build their local defense manufacturing capabilities. This is despite the fact that these countries and dozens of others have banned the use of offsets outside of the defense sector.<sup>11</sup> In Asia and the Middle East, where defense offsets have been more popular in past decades, there has been a flurry of revised offset policies announced in countries such as India, Malaysia, Oman, South Korea, Taiwan, and the UAE.

### Defense offsets definition

Defense offsets are side deals made between a purchasing government and a foreign defense company in connection with a major arms sale. They are an inducement offered by a defense company and/or a requirement by the purchasing government and would not exist without an arms sale. Offsets typically involve defense companies investing in the local defense industry or other economic sectors in the purchasing country. Offsets can be direct, that is tied to the specific equipment or service sold, or indirect, a broad investment unrelated to a specific contract.

The US government has also recently shifted its policies to be more supportive of US defense company collaboration with foreign defense industries to help ensure there are enough supplies of critical weapons systems for Ukraine and Taiwan and to strengthen ties with key US partner countries. In 2023, the Defense and State Departments announced plans to strengthen and streamline the process for reviewing proposed FMS transfers.<sup>12</sup> These plans call for reducing "barriers to the export of key [defense technology] capabilities" for defense industries in partner countries. The Defense Department will also "incorporate ally and partner requirements into ongoing efforts to expand DIB [Defense Industrial Base] production capacity".<sup>13</sup> The State and Defense Departments are also considering additional reductions in US oversight of defense company industrial collaboration with foreign countries at the request of US defense companies to support these efforts.<sup>14</sup>

The growth in demand and the increasing willingness to supply offsets, however, poses clear risks to fueling corruption and undermining many of the US goals for greater defense industry collaboration with partner countries. TI-DS has long warned about the corruption

8 Benedikt Stocki, "Netherlands eyes lead in deepening EU security within NATO", Euractiv, May 4, 2023, online at <https://www.euractiv.com/section/politics/news/netherlands-eyes-lead-in-deepening-eu-security-within-nato/>.

9 Alexandra Brzozowski and Aurdie Pugnet, "EU member states reach deal joint ammunition procurement for Ukraine", Euractiv, May 3, 2023, online at <https://www.euractiv.com/section/europe-s-east/news/eu-member-states-reach-deal-on-joint-ammunition-procurement-for-ukraine/>.

10 NanTian, Diego Lopez Da Silva, Xio Liang, Lorenzo Scarazzato, Lucie Beraud-Sudreau, and Ana Caarlina, De Olivera Assis, "Trends in World Military Expenditure, 2022," Stockholm International Peace Research Institute Fact Sheet, April 2023, online at [https://www.sipri.org/sites/default/files/2023-04/2304\\_fs\\_milex\\_2022.pdf](https://www.sipri.org/sites/default/files/2023-04/2304_fs_milex_2022.pdf).

11 World Trade Organization, Agreement on Government Procurement, online at [https://www.wto.org/english/docs\\_e/legal\\_e/gpr-94\\_02\\_e.htm#articleXXIII](https://www.wto.org/english/docs_e/legal_e/gpr-94_02_e.htm#articleXXIII).

12 US Department of Defense, "Department of Defense unveils comprehensive recommendations to strengthen Foreign Military Sales"; June 13, 2023. US Department of State, "FMS 2023: Retooling Foreign Military sales for strategic competition", May 18, 2023.

13 US Department of Defense, "Department of Defense unveils comprehensive recommendations to strengthen Foreign Military Sales"; June 13, 2023

14 Aerospace Industries Association (AIA), National Defense Industrial Association (NDIA), Professional Services Council (PSC), "FMS Modernization U.S. Industry Feedback to Department of Defense Foreign Military Sales (FMS) Tiger Team," November 29, 2022, online at <https://www.aia-aerospace.org/publications/industry-feedback-to-the-department-of-defense-foreign-military-sales/#:~:text=The%20report%2C%20%E2%80%9CFMS%20Modernization%3A,military%20equipment%20to%20its%20allies.>

risks involved in defense offset arrangements within a sector where bribes often seize nearly twice the contract value of other economic sectors.<sup>15</sup> Previous research by TI-DS and others have outlined how offsets are frequently used as a critical and uniquely flexible inducement to win a lucrative arms sale.<sup>16</sup> According to a UN Secretary General report from 2022, “the practice of defence offsets...is a particular example of non-transparent financial handlings that are prone to corruption.”<sup>17</sup> There are several other common aspects about defense offsets that make them vulnerable to corruption. First, there is often more opacity around defense offsets, especially indirect offsets, than the weapons systems being purchased. Second, foreign defense companies often use brokers with close ties to government officials to help negotiate and implement offset projects. Third, purchasing governments often use complex, vague, and hidden rules for valuing offsets projects.

### Corruption definition

Transparency International defines corruption as the “abuse of entrusted power for private gain”. In relation to defense offsets, corruption can take various forms including bribery, kickbacks, embezzlement of funds, influence peddling, conflicts of interest, political patronage, development of kleptocratic networks, and fraud.

Over the past 15 years, there have been several allegations about the use of defense offsets for corruption in a few US partner countries. Some of these cases could have seriously impacted national security. In India, the government’s Central Bureau of Investigation has been investigating at least three corruption cases where “the offsets route was allegedly used to route payments to corrupt individuals.”<sup>18</sup> One of these cases allegedly led to India buying helicopters that did not include the primary military capabilities

sought in the original purchase. In 2016 and 2017, *The Intercept* reported that offset-related cash payments to the UAE’s sovereign wealth fund, Tawazan, resulted in some \$20 million dollars reaching the DC-based Middle East Institute, which has promoted stronger defense cooperation with Gulf countries.<sup>19</sup> The US government also had to intervene as a mediator in a deal between Lockheed Martin and South Korea over friction about hidden defense offset costs in which there were suspicions of corruption (see case study 2).<sup>20</sup>

The US government increasingly recognizes the corruption risks associated with US arms transfers. In December 2021, the White House published the US government’s Countering Corruption Strategy, recognizing the role that corruption plays in undermining citizens’ faith in government and driving conflict.<sup>21</sup> This strategy specifically calls on the US government to start “reviewing and re-evaluating criteria for government-to-government assistance, including around transparency and accountability. In early 2023, the US government updated its Conventional Arms Transfer policy to “ensure that arms transfers do not fuel corruption or undermine good governance, while incentivizing effective, transparent, and accountable security sector governance.”<sup>22</sup> However, the US government has yet to incorporate defense offsets in the policy’s purview.

The lack of focus on defense offsets is surprising given the significant reductions in US government oversight of defense offsets over the past two decades. During the Cold War, the US government was directly involved in offset agreements – negotiating, designing, funding, and implementing them as a tool to enhance cooperation and cement security alliances. However, at the end of the Cold War in 1990, President George H. W. Bush implemented legislation that prohibited US government agencies from participating in offsets. The US government expressed concern about the ways in which offsets could distort markets and cause other unintended, adverse effects. The current US government regulatory approach can be best characterized as “hands-off” with limited direct oversight of offsets (see

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- 15 Ben Magahy, Francisco Vilhena da Cunha and Mark Pyman, TI-DS, “Defence offsets: Addressing the risks of corruption and raising transparency”. April 2010; Louis Fluker, Julia Muravska, Mark Pyman, “*Due diligence and corruption risk in defence industry offset programmes*”. February 2012.
- 16 Ryan Jay Lambrecht, “The Big Payback: How Corruption Taints Offset Agreements in International Defense Trade,” unpublished Thesis, George Washington University Law School, August 31, 2012, online at <https://archive.law.upenn.edu/live/files/3629-lambrecht-r-the-big-payback-2012>.
- 17 United Nations Security Council, Strengthening security sector reform, Report of the Secretary-General, S/2022/280, March 15, 2022, online at [s\\_2022\\_280\\_english.pdf \(un.org\)](https://www.un.org/press/en/2022/280-english.pdf).
- 18 Manu Pubby, “Upset over offsets: India, US to fix old problem to take ties to new heights,” *The Economics Times*, September 4, 2018, online at <https://economictimes.indiatimes.com/news/politics-and-nation/upset-over-offsets-india-us-to-fix-old-problem-to-take-ties-to-new-heights/articleshow/65664071.cms>.
- 19 Alex Emmons, *The Intercept*, “*Weapons money intended for economic development being secretly diverted to lobbying*”. August 17, 2017. Gerald M. Feierstein, US-GCC Relations: Recommendations for the Next Administration, November 9, 2016, online at <https://www.mei.edu/publications/us-gcc-relations-recommendations-next-administration>.
- 20 Jung Da-min, “Procurement agency hit for false reports on F-X fighter jet project”, *The Korean Times*, May 22, 2019, online at [https://www.koreatimes.co.kr/www/nation/2022/09/205\\_269324.html#](https://www.koreatimes.co.kr/www/nation/2022/09/205_269324.html#).
- 21 United States Office of the Press Secretary, “*Fact Sheet: U.S. Strategy on Countering Corruption*”. The White House. December 6, 2021; United States Office of the Press Secretary, “*Summit for Democracy: Summary of Proceedings*”. The White House. December 23, 2021.
- 22 United States Office of the Press Secretary, “*Memorandum on United States Conventional Arms Transfer Policy*”. The White House. February 23, 2023.

chapter 6) even though the defense companies are required to provide information on their proposed or completed offset projects to the Defense, State, and Commerce Departments.

## 1.2 Methodology and report structure

This report aims to shed light on the US role in the global defense offsets market, while identifying and setting out the key corruption concerns around these deals. It also seeks to provide clarity on the current US regulatory regime for offsets and put forward recommendations on how this could be improved. To meet these aims, we identified several guiding research questions:

1. Where are US defense companies providing offsets and what is the size of this market?
2. What aspects of defense offsets make them susceptible to corruption?
3. How effectively are US partner countries managing corruption risks related to defense offsets?
4. How does the US government currently regulate defense offsets and what are the main weaknesses in its approach?
5. How could the US government and defense companies enhance their efforts to address corruption risks in defense offsets?

The research project was initiated in 2021 and comprised several elements, namely:

- Reviews of US laws and regulations on defense offsets including a high-level review of US partner controls;
- Analysis of US defense companies' documentation and offset sales data;
- 30 interviews with leading industry experts in addition to US government officials overseeing US arms sales programs and key US partner country government officials. These included representatives of Commerce, Defense and State, the main government departments currently responsible for collecting information on offsets. It also included interviews with current or former government officials from India, Malaysia, and South Korea.

Because of the sensitivity of the subject matter, we have protected the confidentiality of interviewees by not directly citing individual interviewees in the report. We are grateful to all interviewees for their insights and the time they made available for this research.

The report has several limitations, notably:

- As disclosure requirements are weak, there is still uncertainty around the size of the defense offset market. The figures presented are therefore estimates.
- On account of the complexity and sensitivity of offset arrangements, it takes significant time for corruption cases to reach a conclusion. As a consequence, the analysis partially relies on older judicial records as well as media reporting on more recent cases.
- While the analysis will be relevant for stakeholders in other countries, the main target audience for this report is the US government. We have provided a high-level overview only of offset regulations in key partner countries as supporting evidence for our arguments.

The report is separated into five chapters. Chapter two is a short explainer on defense offsets for non-experts. Chapter three provides information on the global demand for offsets and estimates on the size and types of US offset commitments. Chapter four identifies three key characteristics of offset arrangements that exacerbate corruption risk, with supporting evidence from known cases. Chapter five provides an overview of the standard of controls to prevent corruption related to offsets in select US partner countries receiving arms. Chapter six maps out the current US regulatory regime and its principal weaknesses. The report concludes with recommendations for key stakeholders in the United States.



## 2.0 WHAT ARE DEFENSE OFFSETS?

### 2.1 Definitions

Defense offsets are arrangements or side deals made between a purchasing government and a foreign defense company in connection with a major arms sale. They are an inducement offered by a defense company and/or a requirement by the purchasing government and would not exist without an arms sale. The term offset refers to purchasing governments' efforts to recoup, or 'offset', some of the money spent in the arms sale and return it to the local economy. In turn, offsets typically involve defense companies using a portion of the payment received from the arms sale to invest in the local defense industry or other economic sectors in the purchasing country. Due to some poor associations with the term offsets, some governments have relabeled their offset policies to industrial collaboration, compensation, or participation.

### 2.2 Typical structure of an offset arrangement

The most important actors involved in offsets agreements are:

- **The purchasing government (or importing government):** They typically create the demand for offsets and may require offsets as a condition of an arms purchase. They also set domestic rules and guidelines for offsets.
- **Foreign supplier:** They are the offset obligors which supply equipment or a relevant service. They may engage others to define, negotiate or deliver elements of the offsets program.
- **Intermediaries or brokers:** Third parties may be hired by the foreign supplier to provide brokerage and/or consultancy services.
- **Exporting governments:** They approve arms sales undertaken by their national firms and in some programs may finance these arrangements.

Figure 1 on the next page, illustrates key relationship pathways for some of the above actors for arms sales and related defense offset requirements. The main recipient of offsets is the purchasing government's

defense industry or nearly any other type of economic industry or company. In some cases, the purchasing government's defense industry may co-produce components of weapons systems that are then integrated into the foreign defense supplier's complete weapons systems.

#### There are two broad categories of offsets:

- *Direct offsets* are directly linked to the defense equipment or service being sold. They can include the co-production or co-development of weapons systems; transfer of military technologies; training of engineers to use or maintain the equipment; investment in defense production facilities; and the use of in-country subcontractors or suppliers.
- *Indirect offsets*, by contrast, are investments not directly related to the equipment being sold in the contract. They can involve investment in other military industrial efforts as well as civilian, non-weapons related ventures in the procuring country. The latter can include almost anything, such as eliciting investment from third parties or providing capital for domestic enterprises or state-owned investment vehicles.

### 2.3 Defense offset funding

One of the most contentious features of offsets is how they are funded. Most importing governments require defense companies to spend between 30 and 100 percent of the overall arms sale contract on offset projects. One might assume that defense companies finance offsets since they are commonly depicted as benefits for the purchasing government. In reality, the purchasing government pays for offsets and the defense company often emerges with substantial financial gains (see Chapter 4).

Many countries also grant offset 'multipliers' as a way to incentivize some types of offset activities over others. For example, a country may place a multiplier of five for cash payments or working capital for a local company. This would mean that if a defense company invests \$1 million, it would be worth \$5 million. Countries may even include multipliers as high as 10 or greater. This brings added financial complexity to these arrangements, increasing corruption risks.

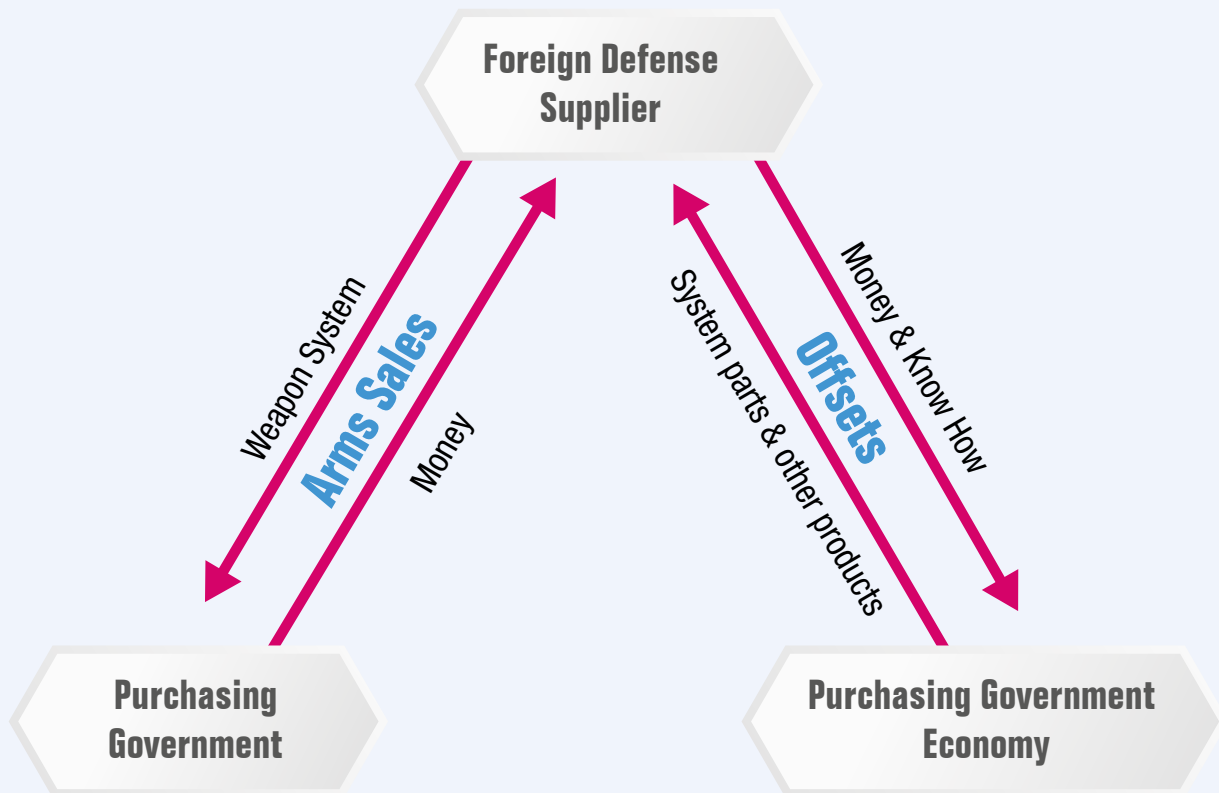


Figure 1. Relationships among key defense offset actors<sup>23</sup>

## 2.4 Economic support and critiques on offsets

From the perspective of the importing government, there are various arguments in favor or against the use of offsets. Proponents of offsets claim some of the benefits include:

- Securing investment to build-up domestic defense manufacturing capacity that would not otherwise be possible;
- Obtaining access to technologies to enhance military capabilities;
- Domestic job creation;
- Strengthened political and military ties with exporting governments.

Other have in contrast argued that these benefits are often overstated and come with a high price tag. There can be much more economically efficient ways to achieve these goals.<sup>24</sup> In a previous TI-DS report, we highlight how offsets often restrict competition and provide disincentives to efficiency on the part of beneficiary companies, which further increases the costs of offsets.<sup>25</sup> Where these contracts are affected by corruption, it is much less likely that they will achieve the types of benefits listed above. Offsets can instead be manipulated by business and political elites for their own gain and to the detriment of the wider population.

23 Figure adapted from Peter Platzgummer, "Arms trade offsets and cases of corruption: The usage of anti-corruption tools in special forms of arms acquisitions". International Public Management Review (IPMR) Vol.14, Iss.2, 2013.

24 or an overview of the economic debates relating to offsets see Ben Magahy, Francisco Vilhena da Cunha and Mark Pyman, TI-DS, "Defence offsets: Addressing the risks of corruption and raising transparency". April 2010; Louis Fluker, Julia Muravska, Mark Pyman, "Due diligence and corruption risk in defence industry offset programmes". February 2012.

25 Ben Magahy, Francisco Vilhena da Cunha and Mark Pyman, TI-DS, "Defence offsets: Addressing the risks of corruption and raising transparency". April 2010.



Eurofighter Typhoon (Photo credit: SaiKrishna Saketh Yellapragada, Unsplash)

## Case Study 1



### AIRBUS IN AUSTRIA

In 2020 Airbus paid \$3.9 billion in penalties to France, UK and US authorities to settle corruption allegations.<sup>26</sup> The settlement covered misconduct by the firm in several jurisdictions, including in relation to a €1.5 billion deal to sell 15 Eurofighter Typhoon combat aircraft to the Austrian Air Force.<sup>27</sup> Alongside bribery of key decision-makers through third-party consultants, offset arrangements for the contract allegedly provided an important mechanism for corruption.

Case analysis by Tufts University refers to broad suspicion that a former Finance Minister with influence over the contract award, sought to extract offset commitments from bidders.<sup>28</sup> Grasser had previously worked at a defense supplier called the Magna Group, which reportedly went on to benefit from offset contracts under the deal. In 2017 the Austrian Ministry of Defense launched legal action against Airbus and its consortium partners on the Eurofighter (BAE Systems and Leonardo) claiming that it had been fraudulently overcharged on offset arrangements. The Ministry claimed that the consortium had illegally charged 10 percent of the purchase price on offset deals. Airbus and the consortium denied this claim and an Austrian court threw out the case in 2020.<sup>29</sup>

26 Office of Public Affairs, US Department of Justice, "[Airbus agrees to pay over \\$3.9 billion in global penalties to resolve foreign bribery and ITAR case](#)". January 31, 2020.

27 At the time of the deal the firm operated under the name European Aeronautic Defence Company (EADS). The company changed its name to Airbus Group in 2014 and Airbus in 2017.

28 The Fletcher School, "[Airbus Eurofighter sales to Austria](#)". Accessed November 9, 2023.

29 Reuters, "[Austrian court ends fraud probe of 2003 Eurofighter deal, bribery case continues](#)". April 27, 2020.

## 3.0 OVERVIEW OF THE GLOBAL MARKET FOR US OFFSETS

The global defense offset market is large and undergoing notable shifts. In 2023, the consulting firm Avascent estimated that defense companies from around the world would agree to \$371 billion in offsets globally between 2021 and 2025.<sup>30</sup> The region with the most offsets will likely be Europe (\$172 billion) followed by Asia (\$88 billion), Middle East and Africa (\$60 billion), and the Americas (\$50 billion). These defense offset values are driven by major changes in global and economic security. Many of the countries in these regions are key US partner countries. We estimate the combined total value of US defense company offset obligations for FY 2021 and 2022 to be at least between \$36.5 billion and \$52.4 billion for just one of the US arms sales programs, though the lack of transparency in the United States and in partner countries means that US defense offset obligations will be much higher than the estimates above. At the same time, US partner country offset policies are becoming more flexible and implicit, which makes it harder to estimate the value of US defense company offset obligations to a country. In the sections below, we briefly outline the main drivers of demand and provide estimates on offset commitments for top recipients of US major arms sales.

### 3.1 Drivers of demand for US defense offsets

The increasing demand for US defense offsets is fueled by rising geopolitical conflict and tensions, weakening security partnerships, and pandemic economic distortions. Within Europe, the Russian government's invasion of Ukraine has been a key catalyst to expand local production of critical weapons systems, particularly munitions and missiles. The Netherlands has been pushing for the increased use of defense offsets from companies outside of Europe in the short-term to quickly build-up European defense production capabilities to support Ukraine and European defense against Russia.<sup>31</sup>

Countries such as Germany, Poland, Portugal, and Romania have been increasingly requesting foreign defense suppliers to support local defense industrial capabilities as part of a major arms sale after Russia's invasion of Ukraine in early 2022.<sup>32</sup> In Asia, Japan for the first time called for defense industrial participation with foreign countries in its new national security strategy, which is in response to territorial threats from China and North Korea.<sup>33</sup>

Some US partner countries have also been encouraged to use offsets because of questions about US or other partner country commitments to their national security. Saudi Arabia and the United Arab Emirates are examples of countries that have sought to strengthen their defense production capabilities out of concern that the United States may not fulfill security guarantees.<sup>34</sup> Countries often choose defense offsets to increase self-reliance within their defense industries and national security, in addition to avoiding a shift in supplier country policies. These reasons have helped push many countries in Asia and Oceania to support some form of defense offsets to make their defense sectors more self-reliant. India's 'Make in India' and Malaysia's 'Make in Malaysia' policies encourage foreign defense companies to partner with domestic defense companies for local defense production.<sup>35</sup>

Interest in offsets has equally been driven by concerns around supply chain disruption and budget shortfalls created by the COVID-19 pandemic.<sup>36</sup> This has put general pressure on defense spending. It has also added to the economic arguments for offsets as countries can argue that major defense purchases support local jobs and spur economic growth in a wide array of economic sectors. Many US security partners inside and outside of Europe support the use of defense offsets for economic sectors outside of defense. In the UAE, defense companies are encouraged to invest in food and water

30 Aleksandar Jovic, Alexis Strang and Riley White, Avascent, "Defense offsets expectations are considerable, but implementation is uneven". February 23, 2021. An earlier white paper by the same firm estimated \$376 billion in offsets between 2010 and 2020.

31 Benedikt Stöckl, Euractiv, "Netherlands eyes lead in deepening EU security within NATO". May 4, 2023.

32 Countertrade and Offsets (CTO), "The Offsets Guidelines Quarterly Bulletin," October 2023, Germany, Poland, and Portugal, <https://www.cto-offset.com/#product-section>.

33 Watanabe Tsuneo, "What's New in Japan's Three Strategic Documents," Center for Strategic and International Studies (CSIS), February 13, 2023, online at <https://www.csis.org/analysis/whats-new-japans-three-strategic-documents>.

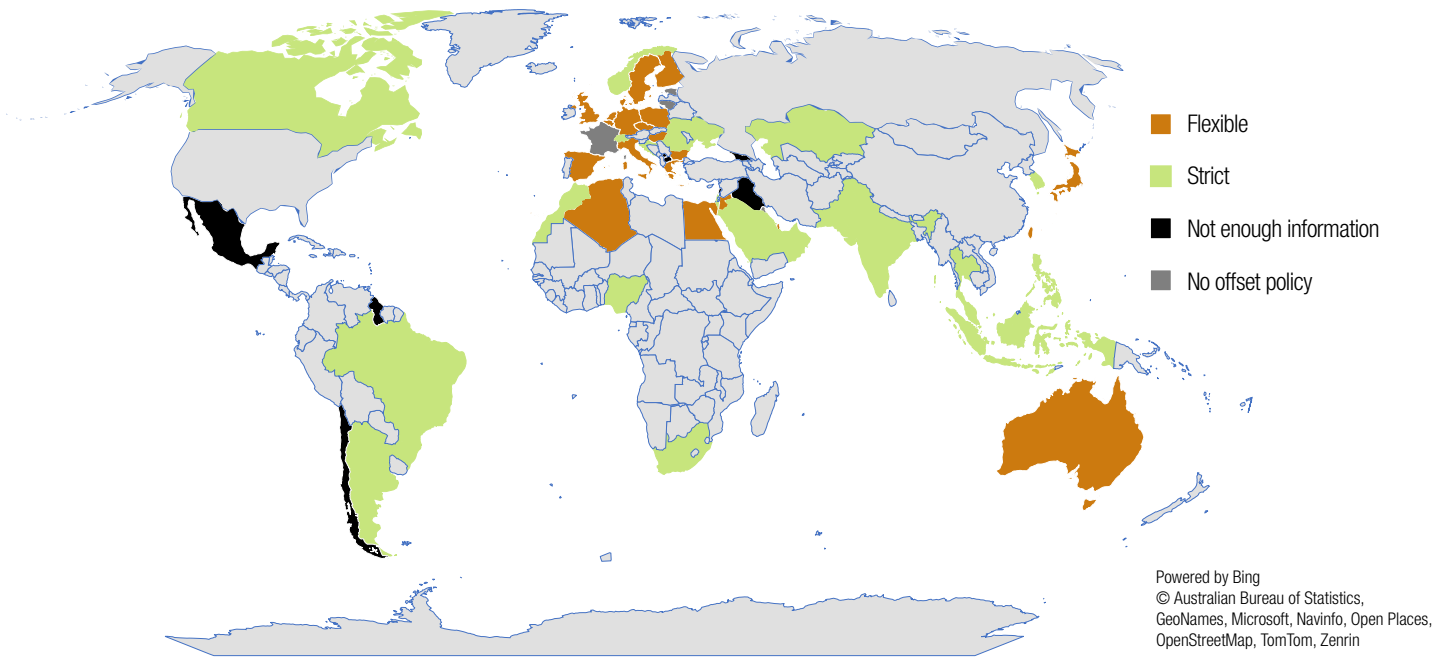
34 Anthony H. Cordesman, "The Biden Administration's Security Challenges in Gulf," January 27, 2021, online at [https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/210127\\_Cordesman\\_Security\\_Challenges.pdf](https://csis-website-prod.s3.amazonaws.com/s3fs-public/publication/210127_Cordesman_Security_Challenges.pdf).

35 India's Ministry of Defence, "Defence Offset Guidelines," Acquisition Wing Secretariat, Amended Draft DAP-2020, July 27, 2020. Malaysian Technical Depository Agency, "Industrial Collaboration Program". Accessed November 9, 2023

36 Aleksandar Jovic, Alexis Strang and Riley White, Avascent, "Defense offsets expectations are considerable, but implementation is uneven". February 23, 2021.

Figure 2: US Partner Country Offset Policies by type

## US partner country offset policy by type



Source: Countertrade and Offsets (CTO), "The Offsets Guidelines Quarterly Bulletin," October 2023, and the Forum on the Arms Trade's Major Arms Sales (via FMS) Notifications Tracker

security, education, communications, and sustainability.<sup>37</sup> They can also fulfill their offset obligations by providing temporary or permanent jobs for Emirati citizens. The United Kingdom urges defense companies to invest in local projects that add a 'social value' to the country, such as for the environment.<sup>38</sup> In some countries, such as Saudi Arabia, defense companies are rewarded for providing cash payments or working capital to nearly any type of local company.<sup>39</sup>

### 3.2 US defense offset partners

Most countries that receive US major arms sales have some sort of defense offset or industrial cooperation policy. In the last two fiscal years, the US government approved sales of major defense equipment (valued at \$14 million or above for non-NATO and five countries, and \$25 million for NATO and five countries and that require congressional notification)<sup>40</sup> through Foreign

Military Sales (FMS) to 47 countries that require defense offsets through a formal or implicit government policy.<sup>41</sup> Twenty-four countries, many from the Middle East and Asia, apply a strict quota or percentage for determining the total value of the offset obligations for an arms sale (see map above). These countries are generally considered to have more formal or rigid offset policies. In South Korea, the government requires foreign defense suppliers to provide defense offsets valued at least 50 percent of the main arms sale contract if the proposed sale is between \$10-100 million.<sup>42</sup> By contrast, 23 countries, mostly European, have a more flexible approach to defining the total value of defense offset projects connected with an arms sale. This flexibility allows government officials or defense company representatives much more latitude in defining offset projects. The remaining 15 countries on the map do not have a specific offset approach or policy, or there is not enough information available to make a determination.

37 Countertrade and Offsets (CTO), "The Offsets Guidelines Quarterly Bulletin," October 2023, UAE, <https://www.cto-offset.com/#product-section>.

38 Ibid., United Kingdom.

39 Countertrade and Offsets (CTO), "The Offsets Guidelines Quarterly Bulletin," October 2023, Saudi Arabia, <https://www.cto-offset.com/#product-section>

40 The five additional countries include: Japan, Australia, Israel, Jordan, South Korea, and New Zealand. Colby Goodman, TI-DS, "Holes in the net: US arms export control gaps in combatting corruption". 2019.

41 Forum on the Arms Trade, Major Arms Sales (via FMS) Notifications Tracker, online at <https://www.forumarmstrade.org/major-arms-sales-notifications-tracker.html>.

42 South Korea's Defense Acquisition Program Administration (DAPA), "DAPA Offset Program Guidelines," December 19, 2022, online at <http://www.dapa.go.kr/dapa/main.do>.



### 3.3 US defense offset agreements estimations

The US defense companies' offset obligations for many US partner countries are significant and regularly under-reported. We estimate the total value of US defense company offset obligations for FY 2021 to range from \$26.1 to \$34.5 billion and for FY 2022 to range from \$10.3 to \$18 billion for the FMS program alone. These estimates are calculated by using the recipient country offset quota percentage and the total value of the proposed FMS to determine the offset obligations. However, these numbers are likely much higher as many US partners use a flexible quota for determining the overall offset obligation and do not regularly publicize the values for offset agreements. US defense companies also regularly provide offsets through the less transparent Direct Commercial Sales and 600 Series programs, meaning that the overall estimated value for US defense offset obligations each year could be double the dollar ranges stated above. In comparison, the Commerce Department reported in May 2023 that US defense companies signed defense offset agreements with foreign countries valued at only \$1.41 billion for 2021.<sup>43</sup> The report states that the dollar

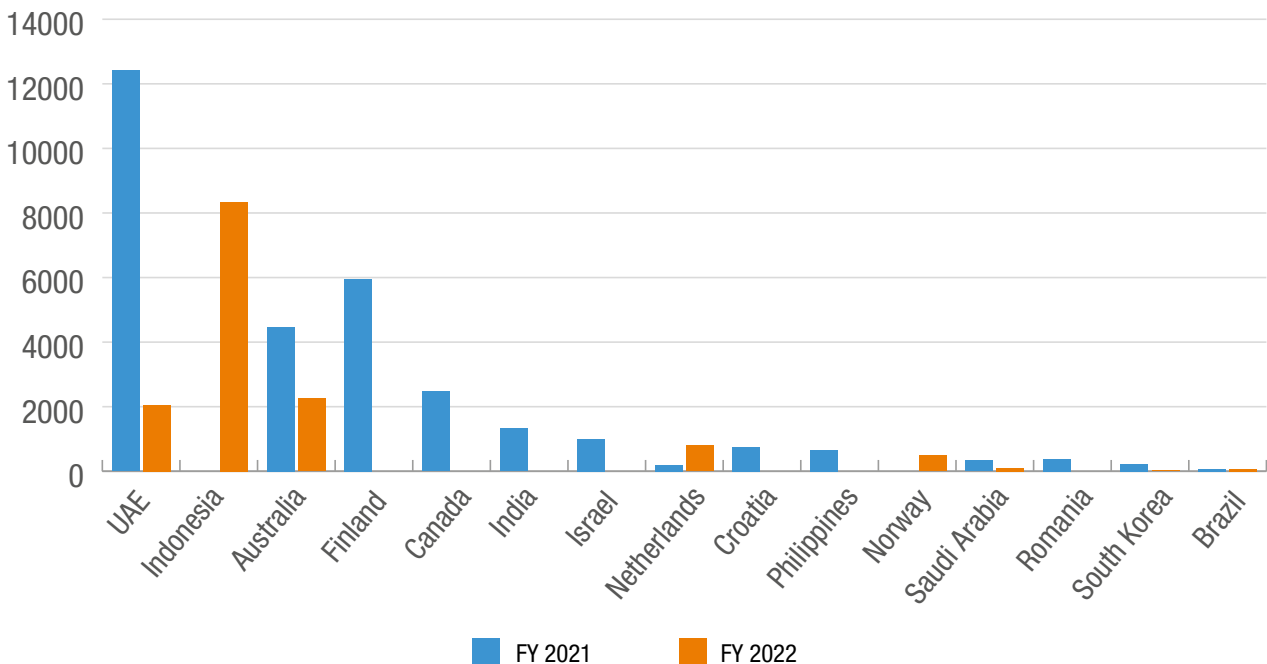
value for offset agreements was low in part because of the COVID-19 pandemic. However, it also highly suggests that the Commerce Department is not receiving all of the agreements required from defense companies.

**Some of the countries that were expected to receive the most US defense company offsets for FY 2021 and FY 2022 through the FMS program include Australia, India, Indonesia, Israel, the Netherlands, Poland, South Korea, and UAE.**

Some of the countries that were expected to receive the most US defense company offsets for FY 2021 and FY 2022 through the FMS program include Australia, India, Indonesia, Israel, the Netherlands, Poland, South Korea, and UAE. In FY 2022, the US government approved a \$13.9 billion fighter jet sale with Indonesia, which is why the offset value is so high for that country.<sup>44</sup> In Australia, Lockheed Martin committed to establishing a new Integrated Air and

Figure 3: US defense offset country estimations FY21 and FY22

#### US Defense Offset Country Estimations for FY 2021 and 2022



43 US Department of Commerce's Bureau of Industry and Security, "Offsets in Defense Trade Twenty-Seventh Study," May 2023, online at <https://www.bis.doc.gov/index.php/documents/sies/3269-public-version-27-annual-offsets-report/file>.

44 Voice of America, "US Approves Major \$14 Billion Arms Sale to Indonesia," February 10, 2022, online at <https://www.voanews.com/a/us-approves-major-14-billion-arms-sale-to-indonesia-/6436765.html>.



Lockheed Martin employees work on the F-35 Lightning II joint strike fighter production line in Fort Worth, Texas (Photo credit: Defense Contract Management Agency)

Missile Defence Centre in the Newcastle region, which appears to be part of its offset for the sale of High Mobility Artillery Rocket Systems (HIMARS).<sup>45</sup> The US company General Dynamics is in discussion with Poland about the possibility of establishing a service center for its purchase of Abrams tanks, which could potentially service the US-made tanks used by other European countries and possibly manufacture new tanks.<sup>46</sup> Lockheed Martin is apparently partnering with the German defense company Rheinmetall in connection with Germany's purchase of F-34 fighter jets to set-up an assembly line for F-35 fighter jets.<sup>47</sup> Outside of the countries mentioned in the above chart, US defense companies are expected to sign offset deals with countries such as Japan, Taiwan, and Ukraine.

### 3.4 Direct vs indirect offsets

US defense companies regularly provide more indirect offsets than direct offsets in fulfilling their contract obligations. In 2021, the Commerce Department reported that direct offsets "accounted for 32.93 percent of the actual value of reported offset transactions" whereas "indirect offsets accounted for 66.64 percent of the actual value of reported offset transactions."<sup>48</sup> The most popular type of the defense company offset transaction was investments, with \$2.1 billion, in 2021. Defense company investments can include working capital for a foreign company or to expand a US defense company subsidiary or joint venture. This analysis is based on 14 US defense company reports of 558 offset transactions in 21 countries. The Commerce Department reported that 2021 witnessed the "highest number of offset transactions reported since 2015, and a 74.38 percent increase from the number of offset transactions reported in 2020."<sup>49</sup>

45 Lockheed Martin, "Working in partnership to deliver the Australian Guided Weapons and Explosive Ordnance Enterprise," July 20, 2023, online at <https://www.lockheedmartin.com/en-au/features/australian-guided-weapons-and-explosive-ordnance-enterprise.html>.

46 Evan Ochsner, "BAE to partner with Polish firm as ground combat vehicle demand heats up," November 28, 2022, online at <https://insidedefense.com/insider/bae-partner-polish-firm-ground-combat-vehicle-demand-heats>.

47 Rheinmetall, "High tech transfers Rheinmetall plans to build state-of-the-art F-35 fuselage factory in Weeze, Germany," Press release, July 3, 2023, online at <https://www.rheinmetall.com/en/media/news-watch/news/2023/7/2023-07-04-rheinmetall-f35-fuselage-factory>.

48 US Department of Commerce's Bureau of Industry and Security, "Offsets in Defense Trade Twenty-Seventh Study," May 2023, online at <https://www.bis.doc.gov/index.php/documents/sies/3269-public-version-27-annual-offsets-report/file>.

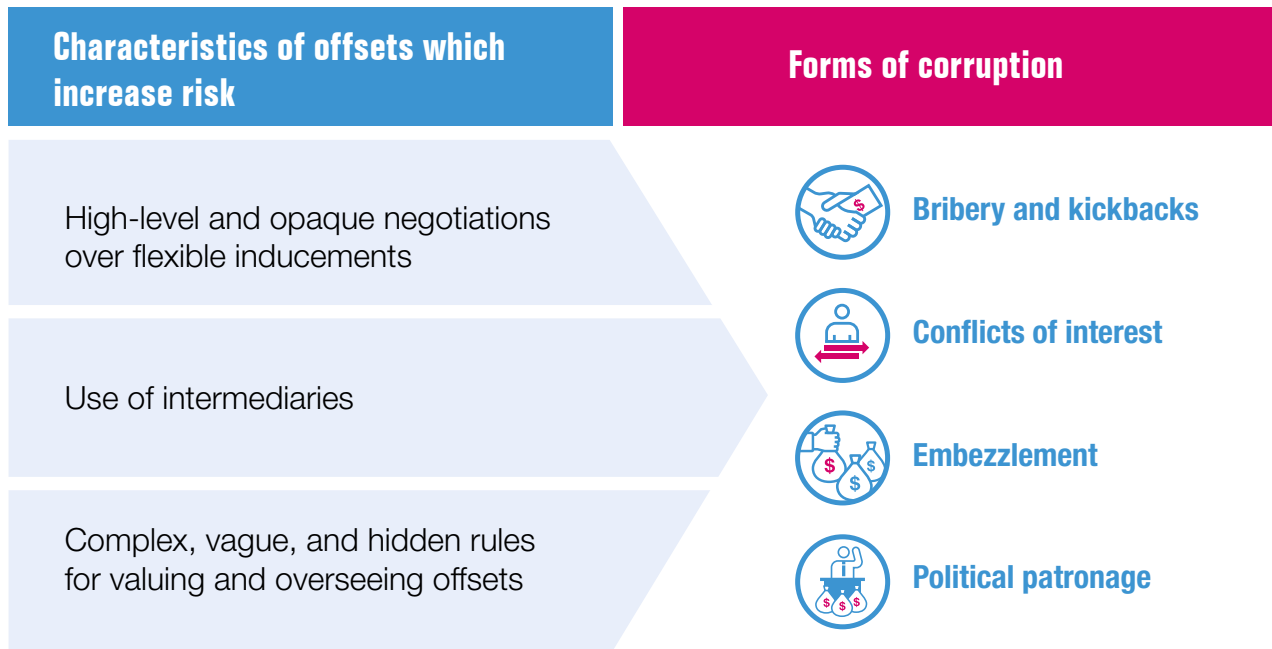
49 Ibid.

## 4.0 DEFENSE OFFSETS CORRUPTION VULNERABILITIES

Defense offsets have proven particularly vulnerable to corruption. Over the years, many government officials, brokers, or defense company personnel have been accused of using offsets for corrupt purposes. Defense offsets can be exploited for many illicit purposes, but there are three main ways in which offsets can enable corruption: improperly influencing the sale for an arms deal; allowing favors to be given to corrupt government officials or politically important entities via offset contracts; and unduly swaying decision-making by government officials in order to satisfy defense offset obligations. These pathways have reportedly led to the waste of government funds and failure to acquire appropriate weapons systems needed for important military missions. Defense companies may have lost weapons supply chain partners after the partners were investigated by national government anti-corruption commissions. There are also cases where offsets may have indirectly financed ruthless armed groups in Africa.

One of the reasons that defense offsets have been featured so prominently in corruption schemes is the high risk of corruption within defense procurement globally. Some scholars have highlighted that bribes account for nearly twice the contract value of other economic sectors.<sup>50</sup> A culture of secrecy, close relations with political elites, and the defense sector's size all help to enable an environment where corruption can thrive. There are also specific aspects about how governments and defense companies use and manage offsets that make them particularly risky (see figure 4). Offsets are frequently used as a critical inducement to win a major arms sale and are much more flexible than the types of arms for the perspective buyers. The below chapter discusses these characteristics in more detail and provides examples of how defense companies, government officials, and brokers have used offsets for corrupt or questionable purposes.

Figure 4: Corruption vulnerabilities of defense offsets



50 Cole, Shawn, and Anh Tran. 2011. "Evidence from the Firm: A New Approach to Understanding Corruption." In *International Handbook on the Economics of Corruption: Volume Two*, edited by Susan Rose-Ackerman and Tina Søreide, 408–427. Cheltenham, UK, and Northampton, MA, US: Edward Elgar.

## 4.1 Risk One: High-level and opaque negotiations over flexible inducements

In connection with major arms sales, defense companies often negotiate lucrative offset packages with high-ranking, politically appointed officials with even less transparency on the proposed offsets than the proposed arms. In our interviews, we heard of cases where negotiations for offset projects did not even include the government officials responsible for offset oversight.<sup>51</sup> Most governments purchasing arms do not publicize the details of the proposed offset projects, especially related to indirect offsets. Increasingly, this lack of transparency includes the total dollar amount for all offset projects associated with a particular arms sale (see section 3.2). The existence of politically appointed officials such as Prime and Defense Ministers in the closed-door negotiations provides fertile ground for politicians to promote offset projects that benefit their political or private interests rather than national and international security.

There have been allegations of high-ranking government officials from Europe to the Middle East using offsets to benefit their political interests. During the Polish negotiations for the F-16 jet fighters, for example, “the Polish offices of the President and Prime Minister interjected themselves into the negotiation process to promote favorite offset projects and to seek assurances that their political districts would become offset beneficiaries.” Similarly, in Portugal, a German submarine consortium allegedly used a UK broker to inappropriately earmark funds for offsets for the center-right CDS-PP (Centro Democrático Social-Partido Popular), led by the defense minister who negotiated the arms deal.<sup>52</sup> The prosecutors later dropped the case for a number of reasons, including after a key piece of evidence disappeared. In procuring countries such as UAE, the political leadership has disbursed offset projects to the wealthiest and most political connected families to maintain their power and influence.<sup>53</sup> This is achieved without the apparent stain of favoritism, since (on paper) the financing appears to be coming from the foreign defense company.

Unlike the weapons in a proposed arms sale, defense offsets can be easily shaped by governments or defense companies to provide tailor-made support for a range of influential domestic actors or to support other questionable commercial or political goals. The use of offsets disconnected from the arms sale (otherwise known as indirect offsets) are generally riskier because it provides opportunities for governments or defense companies to steer funds to nearly any domestic entity or purpose. In 2009, an Italian defense company agreed to a joint production project to build a gold and silver refining plant in the UAE as part of its offset deal.<sup>54</sup> Gold trade experts have raised concerns about the central role played by the UAE in allowing gold acquired illicitly by African armed groups to be refined and resold to European and US markets, masking and reinforcing conflict dynamics and death in Central and Eastern Africa.<sup>55</sup> Defense companies have provided indirect offsets to industries such as “motor vehicle parts, mining machinery, industrial chemicals, machine tools, wine and food products, and computer software.”<sup>56</sup>

At the same time, some defense companies price the expected cost of offsets into the main arms sales contract in full while obscuring the total or specific costs to procuring governments. Many procuring country officials and industry professionals are well aware of these financial dynamics. According to the former director of the UAE’s offset program:

**“If we look at the procurement and try to find the offset cost you will not find it. There are a lot of ingenious ways to hide that cost. They are charging also for offset fees from countries that don’t have offsets for their procurements, just to take that extra money and try to invest it in a country that does have an offset program.”<sup>57</sup>**

51 Interview with former Malaysian government official in charge of defense offsets (August 2023)

52 Tufts University, “German Submarine Sales to Portugal,” May 5, 2017, online at <https://sites.tufts.edu/corruptarmsdeals/german-submarine-sales-to-portugal/>.

53 Dr. Shana Marshall, “The New Politics of Patronage: The Arms Trade and Clientelism in the Arab World,” Crown Center for Middle East Studies Brandeis University, October 2012, online at <https://www.brandeis.edu/crown/publications/working-papers/pdfs/wp4.pdf>.

54 Emirates News Agency-WAM, “Al Mansoor and Electronica partner to build Abu Dhabi’s first gold-silver refinery, February 18, 2009, online at <https://wam.ae/en/details/1395228295887>.

55 Mathew T. Page, Jodi Vittori, “Dubai’s Role in Facilitating Corruption and Global Illicit Financial Flows,” Carnegie Endowment for International Peace, July 7, 2020, online at <https://carnegieendowment.org/2020/07/07/dubai-s-role-in-facilitating-corruption-and-global-illicit-financial-flows-pub-82180>.

56 Ryan Jay Lambrecht, “The Big Payback: How Corruption Taints Offset Agreements in International Defense Trade,” unpublished Thesis, George Washington University Law School, August 31, 2012, online at <https://archive.law.upenn.edu/live/files/3629-lambrecht-r-the-big-payback-2012>

57 Comments of Saif Al Hajeri, Director of the UAE’s Offset Venture Group at the 2007 Middle East Regional Offset Conference held in Abu Dhabi. CTO Newsletter. 12 March 2007. 25(5).

The US government is aware of this US defense company practice, but it does not regularly assess offset costs in proposed arms sales (see section 6). This practice can generate high volumes of surplus funds that can be employed for corrupt purposes. When countries do find out how much firms charge to provide offsets, this often creates tension. In 2017, for example, Oman terminated a contract with the US defense firm Raytheon after it became aware that an offset premium had been built into the procurement contract.<sup>58</sup> As noted above in case study 1, the Austrian Ministry of Defense launched legal action against Airbus and its consortium partners on the Eurofighter (BAE Systems and Leonardo) claiming that it had been fraudulently overcharged on offset arrangements.<sup>59</sup>



Defense Satellite Communications System (Photo credit: US Space Force)

## Case Study 2



### LOCKHEED MARTIN IN SOUTH KOREA

In 2014, the South Korean government surprised many experts when it reversed its decision to buy F-15 fighter jets from Boeing and instead purchased F-35s from Lockheed Martin in a \$6.2 billion deal after then-Defense Minister Kim Kwan-jin intervened. The government reportedly made its decision based on “technical conditions, price, and offsets”, even though military leaders raised serious concerns about some of the F-35’s technical challenges.<sup>60</sup> Several years later, South Korean government officials began to suspect governmental abuse of authority and potential conspiracy surrounding the deal.<sup>61</sup>

Lockheed’s proposed offset package included the possible transfer of 25 military technologies and help with building one military and two civilian satellites with the assistance of a broker and Airbus. However, the US government later blocked four of these proposals, which generated suspicions about the use of offsets as an improper inducement. Some South Korean government officials later discovered that it would have to pay for a significant amount of the offset costs, perhaps 20 percent of the \$6.2 billion, which could have altered its original decision to buy the F-35 if known at the time of the award.<sup>62</sup> These facts sparked an investigation by South Korean authorities into the offset costs, including by questioning Korean and US government personnel and defense companies connected with the sale.<sup>63</sup>

A South Korean audit report in 2019 found that Korean government officials had provided false claims to Defense Minister Kwan-jin about offsets in the negotiations and delivery of the sale that favored Lockheed. Further details about the claims, however, remain classified.<sup>64</sup> The accused officials received only small financial penalties.<sup>65</sup> Two years later, Lockheed Martin’s broker, Blenheim Capital Holdings Ltd., sued Lockheed, Airbus, and the South Korean government for conspiring to exclude it from the sale.<sup>66</sup> The case is pending before the US Supreme Court.<sup>67</sup>

58 Ron Matthews, “The rise and demise of government-mandated offset policy” in Ron Matthews (ed.) *The political economy of defense*. 2019. Cambridge: Cambridge University Press.

59 Reuters, “[Austrian court ends fraud probe of 2003 Eurofighter deal, bribery case continues](#)”. April 27, 2020.

60 Reuters, “[Former US air chief says S. Korea needs F-15 and F-35 fighters](#)”. November 5, 2013.

61 CTO Newsletter, October 8, 2019.36 (19)

62 Ibid.

63 Ibid. One of the former US government officials the South Korean government reviewed was Derek Gilman. Gilman was the general counsel and principal director for the US Defense Security Cooperation Agency at the time the F-35 sale was being negotiated with South Koreans and would have likely assisted in approving the deal. Soon after the sale was concluded with South Korea, Gilman joined Blenheim Space Luxembourg.

64 Jung Da-min, The Korea Times, “[Procurement agency hit for false reports on F-X fighter jet project](#)”. May 22, 2019

65 Ibid.

66 CTO Newsletter, June 21, 2021, 39(12).

67 Miah Danney, “Justices Ask For Input On Review of #3.1B Arms Sale Case.” LAW 360, October 2, 2023, online at <https://www.law360.com/articles/1727945?scroll=1&related=1>

## 4.2 Risk Two: Use of Intermediaries

The commonplace use of commercial intermediaries, also called brokers, agents, or middlemen, to design, negotiate, and implement offset arrangements significantly increases corruption risk. While many brokers provide services with integrity, there is a long history of intermediaries being used in the defense sector to facilitate corrupt transactions. Intermediaries provide an additional layer of secrecy around negotiations. Many are deeply connected with local political networks, and some may even work for both defense companies and the purchasing government negotiating an offset package.<sup>68</sup> It is also harder for defense firms to monitor their conduct. According to a Washington DC compliance lawyer for defense companies:

**“I’ve seen circumstances where an offset advisor knowingly recommended that my client provide funding to a company that turned out to be merely a shell, with no ongoing business operations. After a little digging, it became clear that the offset support funds would flow directly into the coffers of a foreign official.”<sup>69</sup>**

Intermediaries can fulfill legitimate and illegitimate functions. Sometimes defense companies may not have the local knowledge to fulfill certain offset obligations, such as requirements to use local suppliers or subcontractors. Intermediaries may help to connect firms to suitable partners. Alternatively, an intermediary may advise on local procurement processes, providing local expertise. In other cases, however, intermediaries simply sell access to key bureaucratic and political decision-makers. They may play a role in channeling corrupt payments to these decision-makers, or brokering arrangements which benefit those actors.

In a 2017 blog, the same compliance lawyer provided further insight on how these arrangements work, writing:

*“In other cases, the offset advisor proposed economic support for a legitimate project, but where the profits flowed to a foreign official. In one example, the offset advisor recommended that my client provide funds for the construction of an industrial park. The good news is that my client was able to verify that the construction company was a bona fide business, and [it] was indeed in the process of building the site. The bad news is that the construction company was beneficially owned by a local defense procurement official.”<sup>70</sup>*

Intermediaries are especially common in indirect offsets because defense firms lack the contacts and expertise to make investments. The same lawyer referenced above provided examples of suspected corruption in a separate post:

*“A client with a hefty indirect offset obligation in an African country agreed to provide financial support for the construction of a new tourist hotel...[b]ecause the host government sought to boost the tourism industry, every dollar my client spent would result in five dollars’ worth of offset credit. There was only one catch. The local company building the hotel was owned by the spouse of the country’s sitting chief executive.”*

*“[A]nother client considered providing funds to a conservation group establishing a wildlife refuge in Eastern Europe. Not only was the nonprofit spearheading the effort managed by a senior government official, there were no plans to actually develop the refuge. Instead, the official planned to line her pockets with every single dollar.”*

*“One of my clients identified an opportunity to provide funding for a scholarship program in a Gulf state for high school students who excelled in science, technology, engineering and math. After a little digging, we discovered that the program had been manipulated so that only the children of senior defense officials could participate.”<sup>71</sup>*

US defense companies have also faced corruption or fraud challenges in working with brokers to implement offset project obligations and strengthen weapons

68 In at least one instance, Blenheim (now defunct) partnered with a UAE company (Waha Capital, which itself was established with offset funds from BAE) in order to form an investment vehicle (Waha Financial Services) that was then used to finance the purchase of \$3 billion in additional defense equipment in January 2009 - a deal that would have generated significant fees for the company, whose revenues increased nearly 37% from 2009-2010. CTO Newsletter, 9 March 2008, 27(5). Also see Ivan Gale, 13 January 2010, “Waha Capital Builds on Strengths.” *The National* (UAE). Zawya Business profile. (subscription required).

69 Bill Steinman, FCPA Blog, “[Can you trust your offset advisor?](#)” August 3, 2017.

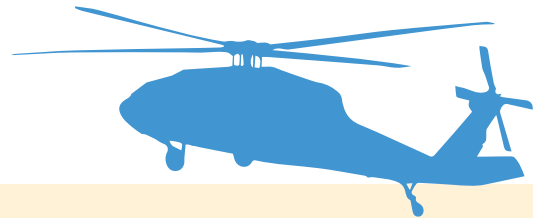
70 Ibid

71 Bill Steinman, FCPA Blog, “[Compliance alert: Another reason life is hard for defense contractors](#).” September 6, 2017.

supply chains with foreign countries. In 2012, Raytheon announced it had selected the offset vehicle Contraves Advanced Devices (CAD) Sdn. Bhd., a joint venture between Malaysian government-owned Boustead Heavy Industries Corporation (BHIC) and Rheinmetall Air Defence (RAD), for the production and supply of components for the US Evolved Sea Sparrow Missile (ESSM).<sup>72</sup> Raytheon likely selected CAD to fulfill offset obligations it had with the Malaysian government after an earlier sale of AIM-9X-2 SIDEWINDER Block II All-Up-Round Missiles to Malaysia.<sup>73</sup> At the time though, one of CAD's key partners, DCNS, was allegedly connected to a bribery scandal in Malaysia.<sup>74</sup> CAD was later embroiled in a scandal after a BHIC official notified the Malaysian Anti-Corruption Commission and hired a forensic auditor to investigate possible irregularities, including overcharging the Malaysian government in the delivery of components for the Malaysian Navy's Littoral Combat Ships.<sup>75</sup>

RAD denied these claims.<sup>80</sup> Raytheon is no longer listed as a partner with CAD on its website.<sup>81</sup>

The use of intermediaries in corrupt transactions often goes hand-in-hand with the use of offshore financial centers, areas attractive for both legitimate and illegitimate activities. Entities incorporated in jurisdictions where there are limited corporate transparency requirements can be used to conceal the beneficiaries of offsets arrangements. Entities based in these jurisdictions can also be used to shield movements of corrupt funds from investigators. Firms may use these types of jurisdictions to provide legal and financial security for investments, however, too often the loopholes are exploited for corrupt purposes. This allows the real beneficiaries of offsets contracts to go hidden.



### Case Study 3



## AUGUSTAWESTLAND IN INDIA

In 2022, India's Central Bureau of Investigation (CBI) expanded an investigation into an offset scheme that occurred in 2010.<sup>76</sup> Offset brokers have been accused of bribing Indian military officials to rig the purchase of 12 transport helicopters in favor of AgustaWestland. Several of the brokers were accused of receiving tens of millions of dollars from AgustaWestland and then creating companies to provide fictitious offset projects in India to hide or launder the bribes. One company, IDS Infotech, allegedly obtained approval from the Ministry of Defense to begin an offset project that had already been completed.<sup>77</sup>

India had originally sought to procure helicopters capable of flying in the Himalayas. However, the officials involved in this scheme removed this requirement to pave the way for AgustaWestland to win the \$605 million contract. As a result, India ended up with helicopters unable to fly at the required altitudes; the helicopters procured were eventually removed from service.<sup>78</sup> Outside of the arms brokers, Indian authorities are now investigating the former Defense Secretary and Comptroller Auditor General as well as six other people.<sup>79</sup>

72 PR Newswire, "Raytheon Engages Malaysian Industry for Missile Work," February 11, 2012, online at <https://www.prnewswire.com/news-releases/raytheon-engages-malaysian-industry-for-missile-work-139317483.html>.

73 Defense Security Cooperation Agency, "Malaysia-AIM-9X-2 Sidewinder Missiles, November 8, 2011, online at <https://www.dsca.mil/press-media/major-arms-sales/malaysia-aim-9x-2-sidewinder-missiles>.

74 Tufts University, "The Malaysian Scorpene Submarine Affair," May 5, 2017, online at <https://sites.tufts.edu/corruptarmsdeals/the-malaysian-scorpene-submarine-affair/>.

75 CTO Newsletter August 26, 2022. FMT, "Boustead's LCC audit report made public," August 22, 2022, online at <https://www.freemalaysiatoday.com/category/nation/2022/08/22/bousteads-lcc-audit-report-made-public/>. Nile Bowie, "Najib-era ship scandal resurfaces to sink UMNO," Asia Times, August 25, 2022, online at <https://asiatimes.com/2022/08/najib-era-ship-scandal-resurfaces-to-sink-umno/>.

76 Deepitman Tiwary, The Indian Express, "AgustaWestland case: CBI chargesheets ex-Defence Secretary Shashi Kant Sharma Premium AgustaWestland case: CBI chargesheets ex-Defence Secretary Shashi Kant Sharma". March 16, 2022.

77 Comptroller and Auditor General of India, "Report No.10 of 2013 – Defense Services Air Force on acquisition of helicopters for WIPs". August 13, 2013.

78 Ibid

79 Deepitman Tiwary, The Indian Express, "AgustaWestland case: CBI chargesheets ex-Defence Secretary Shashi Kant Sharma Premium AgustaWestland case: CBI chargesheets ex-Defence Secretary Shashi Kant Sharma". March 16, 2022.

80 Tim Bartz, Martin Heese and Clare Rewcastle Brown, "Rheinmetall is involved in a dubious arms deal in Malaysia," Spiegel Business, August 26, 2022, online at <https://www.spiegel.de/wirtschaft/rheinmetall-ruestungskonzern-ist-in-ein-dubioses-geschaef-in-malaysia-verstrickt-a-940edf96-8e55-4613-84f6-b4ec0402e053>.

81 Contraves, "Spotlight," online at <https://www.contraves.com.my/Spotlight.html>.

### 4.3 Risk three: Complex, vague, and hidden rules for valuing and overseeing offsets

Many procuring governments also use vague, complex, and hidden rules for valuing and overseeing offset projects, which makes it easier for unscrupulous actors to use offsets to hide bribes, kickbacks, and fraud. They may measure a proposed or completed project using broad formulas instead of just the costs and assign a specific number of credits for the project's value. The decisions on the valuation of an offset project are rarely made public. In some countries, governments use more vague notions, such as an offset project's 'credibility' or 'value' to the country, without providing details on what these terms mean or how an official should accurately assess them. These practices, compounded by the fact that many government officials evaluating offsets do not have the expertise needed to properly evaluate pricing and costs associated with a wide array of different types of offsets, opens the door for private actors to propose and win fictitious projects like the one in Case Study 3 above or to hide kickbacks through offsets.

Over the years, some defense companies have tried to manipulate offset valuation systems in their favor, including potentially through bribery. In the 1990s and 2000s, for instance, the UK aerospace and defense firm BAE Systems came under substantial scrutiny regarding allegations of corruption in multiple countries, including Czech Republic, Hungary, Saudi Arabia, South Africa and Tanzania.<sup>82</sup> As reported by the South African newspaper, *The Mail & Guardian*, BAE Systems used the company, Red Diamond, to make over 1,000 covert payments to brokers and marketing advisors. One of the recipients of these payments was Fana Hlongwane, a former advisor to the then South African defense minister, Joe Modise.<sup>83</sup> *The Mail and Guardian* alleged that part of the rationale for these payments was to help BAE Systems secure a success fee from the South African government for meeting a highly ambitious set of offset commitments. The South African government commission that investigated this deal did not pursue charges against

Fana; although, the "commission's credibility has been questioned given the resignation of two of its original members."<sup>84</sup> In connection with the Portuguese case mentioned above in Section 4.1, prosecutors alleged that consortium of companies colluded to inflate the value of its offset projects, which reportedly wasted EUR 34 million in taxpayer funds in the heavily indebted country of Portugal.<sup>85</sup>

Similarly, government officials often use a range of multipliers to determine the value of an offset project, which adds complexity and flexibility for assessing the value of projects. Governments frequently offer greater offset credits for investments or partnerships in sectors deemed strategically important by the country. For example, a defense company could receive double the offset credits for a project that the procuring government deemed to have a multiplier of two. Some governments may even allow multipliers of 10, 30, or more. In 1999, South Africa awarded a Saab/BAE Consortium \$1.5 billion in offset credits for a \$6.6 million investment (a multiplier of 192) in a joint venture with the South African defense manufacturer Denel.<sup>86</sup> An independent external audit of this award found that Saab had not delivered on its offset obligations. The BAE sale and the associated offset program – along with sales to the Czech Republic, Tanzania, and Saudi Arabia made during the same period – were investigated by both the UK's Serious Fraud Office and the US Department of Justice over alleged bribes paid to procuring country officials.<sup>87</sup> BAE eventually paid a fine of \$400 million and "plead guilty to one count of conspiring to make false statements about having an internal program to comply with antibribery laws."<sup>88</sup>

Further layers of complexity and risk are added to offset arrangements when procuring governments offer defense companies a range of tools to manage offset credits. Third-party offset consultants and brokers – typically headed by individuals with a background in secondary financial markets – introduced these models in the 1990s. They offered firms unconventional solutions to meet ever-greater demand for offset requirements and complicate government oversight and transparency. Examples of arrangements with high complexity are shown in the table below.

82 Office of Public Affairs, US Department of Justice, "BAE Systems Plc pleads guilty and ordered to pay \$400 million criminal fine". March 1, 2010.

83 Sam Sole and Stefaans Brimmer, *The Mail & Guardian*, "BAE's bribery channel". June 24, 2011.

84 World Peace Foundation, *The South African Arms Deal*, Corruption Tracker, updated on October 26, 2022, online at <https://corruption-tracker.org/case/the-south-african-arms-deal#allegations>.

85 Tufts University, "German Submarine Sales to Portugal," May 5, 2017, online at <https://sites.tufts.edu/corruptarmsdeals/german-submarine-sales-to-portugal/>. Compliant to the EC Commission Regarding Infringement of Community Laws online at <https://www.anagomes.eu/PublicDocs/66e9cd99-93f0-481a-8306-1e78d84cb8dc.pdf>. Transparency International, "Dealing in the Dark: Portugal's Defence Contracts," September 3, 2012, online at <https://blog.transparency.org/2012/09/03/dealing-in-the-dark-portugals-sad-case-study-on-defence-procurement/>.

86 Paul Holden, "Offsets in practice: The Experience of South Africa," *The Economic Peace and Security Journal*, Vol15, No 1 (2020), online at <https://www.epjournal.org.uk/index.php/EPSJ/article/view/328>.

87 BBC News, "BAE Systems handed £286m criminal fines in UK and US". February 5, 2010.

88 Christopher Drew and Nicola Clark, *BAE Settles Corruption Charges*, *New York Times*, February 5, 2010, online at <https://www.nytimes.com/2010/02/06/business/global/06bribe.html>.



Table 1: Forms of complexity in offset arrangements

Arrangement	Description
Offset Banking	Some governments allow defense companies to ‘bank’ their offset credits when they are awarded more credits than is required by the offset agreement. Companies can then use these ‘banked’ credits for future offset obligations.
Leveraging of offset credits	Defense firms can increase the credit they receive for offset investments through leveraging – a sort of quasi-multiplier effect. <sup>89</sup> As an example, a firm can combine an initial investment of \$1 million in capital with investments from third parties (foreign investors, domestic firms, etc.) and borrow against this investment. When the borrowed money is re-invested, firms in effect “multiply” their original investment.
Offset swapping	Offset swapping allows firms to transfer an excess of offset credits in one country to another country where they have not met their obligations. This practice makes it harder to keep track of firm commitments and the different parties connected to the transactions.

These government approaches to assessing the value and overseeing offset projects can also complicate their efforts to understand defense company costs for doing these projects. As mentioned in Risk One, information on offsets can be held back from government scrutiny by defense firms, as this candid quote from an industry trade executive at a 2008 offsets conference suggests:

**“My industry probably has billions of dollars of offset obligations. They don’t show anywhere on our balance sheets because no auditor knows what to do with an offset. When you start asking us for performance bonds and penalty clauses, that’s going to show, and that makes people [ie, investors and shareholders] very nervous. I am aware of some recent cases where companies simply weren’t willing to put that on their books.”<sup>90</sup>**

Without this information it is not only harder to judge if firms have met their obligations but corruption may also go undetected.



89 CTO Newsletter. 15 January 2007. 25(2).

90 CTO Newsletter. 23 May 2008. 26 (10).

## 5.0 US PARTNER OFFSET POLICY CORRUPTION RISKS

US partner countries from Asia and Oceania, Europe, and the Middle East all have some type of policy to oversee defense offsets. These policies often layout government efforts to monitor and enforce contracts associated with offset projects. However, many of these countries have significant shortcomings in their defenses to prevent corruption in offsets. According to the 2020 TI-DS Government Defence Integrity (GDI) Index, which assessed the quality of institutional controls to manage the risk of corruption in defense and security institutions in 86 countries, “53% of countries have no law or policy in place to regulate offset contracting, and a further 59% do not impose any form of due diligence requirements for these deals.”<sup>91</sup> Some of these weaknesses stem

from their approaches to ensure defense companies fulfill their offset obligations as well as the types of offsets they offer to defense companies. This chapter provides an overview of common weaknesses in 14 US partner systems for supervising offsets. It covers four areas: offsets transparency; policies and procedures for reporting and monitoring offset projects; indirect offsets and credit multipliers; and enforcement of penalties for breach of contract. It also highlights an additional corruption-related risk to defense offsets, namely foreign governments redirecting offset investments into foreign influence campaigns (see case study 4 below). The findings update data and information gathered for the TI-DS’s 2020 GDI related to defense offsets.<sup>92</sup>

### 5.1 Transparency

#### Elements of good practice:

The government makes public a list of the offset contracts (including details of the investments and the supplying companies), details of the current performance of offset program, and copies of the contracts themselves. It also makes public the details of planned offsets contracts to enable public and civil society comment before contract award.

Table 2: Offsets transparency in partner countries based on the above elements of good practice.

Region	Asia and Oceania						Europe				Middle East			
Country	Australia	India	Indonesia	Malaysia	South Korea	Taiwan	Netherlands	Poland	Ukraine	UK	Israel	Oman	Saudi Arabia	United Arab Emirates
Offset transparency	*			*	*	*			*	*				*

<b>Key:</b>	<b>Very low corruption risk</b>	<b>Low corruption risk</b>	<b>Moderate corruption risk</b>	<b>High corruption risk</b>	<b>Very high corruption risk</b>
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Notes: These results are based on new analysis of select TI-DS Government Defence Integrity Index (GDI) indicators with data covering the period 2020-2023. The main sources for the analysis were government offset guidelines, government websites, laws and regulations, interviews with government and industry representatives, and corporate intelligence publications. Results marked with an asterisk (\*) indicate a score which has been updated from the GDI 2020 on the basis of this new analysis.

91 Transparency International Defence and Security, “GDI 2020 Global Report: Disruption, Democratic Governance and Corruption Risk in Defence Institutions, 2021, online at <https://ti-defence.org/gdi/downloads/>.

92 Please note this is a summary only of commonly identifiable weaknesses across countries. It is not a complete assessment of each country’s offset regime.



Skyline of Abu Dhabi, UAE (Photo credit: Nick Fewings, Unsplash)

The findings reveal widespread opacity regarding offset arrangements in US partner countries globally. Only two of the 14 countries (Australia and Poland) publish more than basic details of offsets programs. Australia is a leader in that it publishes the overall value of planned offset projects, project goals, and the names of the local partners implementing the projects.<sup>93</sup> In April 2023, for instance, the Australian government published Boeing Defence Australia's Industrial Capability Plan, which stated that \$296 million of the \$465.3 million contract to sell helicopters to the country could be delivered by 11 local companies, including maintenance, training, repair, and project management.<sup>94</sup> Australia's Auditor General also publishes a report every two years that includes assessments on the progress of industrial capability projects.<sup>95</sup> As with all the other countries reviewed, Australia still does not meet the GDI criteria for the highest scores. This would entail making offset plans public and open to comment prior to award and publishing the original offsets contracts with foreign defense companies.<sup>96</sup>

In other countries reviewed, the governments either publish no details regarding offset contracts, or the information available on offsets is very limited. India, Indonesia, Israel, Malaysia, the Netherlands, South Korea, UAE, and the United Kingdom publish limited or broad, unuseful information on offsets.<sup>97</sup> At the same time, the Netherlands, South Korea, and Taiwan publish more details on the weapons they procure.<sup>98</sup> South Korea shares certain summary data and analysis on defense offsets in its defense business statistical yearbook. Earlier this year, the South Korean government stated that it oversaw 42 offset projects worth \$771.8m from 2018-2022, based on data from the 2023 yearbook.<sup>99</sup> Of these projects, 58.1 percent focused on export support, 27.2 percent on acquisition of equipment, and 14.6 percent on technology transfer. The remaining countries provide no regular public information on offsets.<sup>100</sup> In Saudi Arabia, interviewees consulted for the country's 2020 GDI assessment revealed that even many senior commanders were not aware of the details of these contracts until the final days before their agreement.<sup>101</sup> This leaves citizens in the dark about these arrangements and who is benefiting from them.

93 Australian Government Defence, "Australian industry capability plans". Accessed November 9, 2023. TI-DS GDI, "Poland assessment," Data collection April 2018 – September 2019, <https://ti-defence.org/gdi/countries/poland/>.

94 Boeing, "Australian Industry Capability Plan," Helicopter Air Crew Training System Support Contract, online at [https://www.defence.gov.au/sites/default/files/2023-07/Public%20AIC%20Plan%20%E2%80%93%20Boeing%20Defence%20Australia%20Ltd%20%E2%80%93%20Support%20Contract%20-%20Helicopter%20Aircrew%20Training%20System%20%28HATS%29\\_2.pdf](https://www.defence.gov.au/sites/default/files/2023-07/Public%20AIC%20Plan%20%E2%80%93%20Boeing%20Defence%20Australia%20Ltd%20%E2%80%93%20Support%20Contract%20-%20Helicopter%20Aircrew%20Training%20System%20%28HATS%29_2.pdf)

95 Australia's Auditor General, "2021-22 Major Projects Report Department of Defence," Report No. 12 2022-23, online at [https://www.anao.gov.au/sites/default/files/2023-02/Auditor-General\\_Report\\_2022-23\\_12.pdf](https://www.anao.gov.au/sites/default/files/2023-02/Auditor-General_Report_2022-23_12.pdf)

96 TI-DS, "2020 GDI questionnaire". November 29, 2019.

97 TI-DS, Government Defence Integrity Index 2020, <https://ti-defence.org/gdi/>. UAE's Tawazun Council, "News & Events," accessed on December 20, 2023 at <https://www.tawazun.gov.ae/news-events/page/2/>. Malaysian Technology Depository Agency (TDA), "TDA Headlines," accessed on December 20, 2023 at <https://www.tda.my/tda-headline/>. Ron Matthews and Jonata Anicetti, "Offsets in a Post-Brexit World," January 6, 2022, <https://rusi.org/explore-our-research/publications/rusi-journal/offset-post-brexit-world>.

98 TI-DS, Government Defence Integrity Index 2020, See question 61a, online at <https://ti-defence.org/gdi/>.

99 South Korean's Defense Acquisition Program Administration (DAPA), 2023 Defense Business Statistical Yearbook, accessed on December 20, 2023 at <https://www.dapa.go.kr/dapa/na/ntt/selectNttInfo.do?bbsId=246&nttSn=44314&menuId=693>

100 TI-DS, Government Defence Integrity Index 2020, <https://ti-defence.org/gdi/>. Taiwan had produced reports with basic information on offsets in the past, but there is no evidence it has continued to publish such reports. TI-DS GDI, "Taiwan assessment," Data collection April 2019 – November 2020, <https://ti-defence.org/gdi/countries/taiwan/>.

101 TI-DS GDI, "Saudi Arabia assessment". Data collection July 2018 – September 2019.

## 5.2 Offset policies and procedures on reporting, monitoring, and penalties

### Elements of good practice:

There are formal policies and procedures that outline the reporting and delivery obligations for offset contracts. This includes procedures for reporting on completed work, for addressing inadequate work, for sanctioning, and for following the chain of command.

Table 3: Basic offset policies and procedures on reporting and penalties based on the above elements of good practice.

Region	Asia and Oceania						Europe				Middle East			
Country	Australia	India	Indonesia	Malaysia	South Korea	Taiwan	Netherlands	Poland	Ukraine	UK	Israel	Oman	Saudi Arabia	United Arab Emirates
Offset reporting & penalties					*	*	*	*	*	*		*		*

<b>Key:</b>	<b>Very low corruption risk</b>	<b>Low corruption risk</b>	<b>Moderate corruption risk</b>	<b>High corruption risk</b>	<b>Very high corruption risk</b>
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Notes: These results are based on new analysis of select TI-DS Government Defence Integrity Index (GDI) indicators with data covering the period 2020-2023. The main sources for the analysis were government offset guidelines, government websites, laws and regulations, interviews with government and industry representatives, and corporate intelligence publications. Results marked with an asterisk (\*) indicate a score which has been updated from the GDI 2020 on the basis of this new analysis.

Nearly all the US partner countries TI-DS reviewed for this study require defense companies to submit regular reports on the progress and/or completion of their offset projects. There is no information that Saudi Arabia regularly requires such reports through formal policies, but there are anecdotes that the government follows up on some offset projects.<sup>102</sup> These progress reports are critical tools for governments to identify potential corruption or fraudulent schemes within offset projects that can last 10-20 years and are essential for any

potential government audits of the projects. In Malaysia, the government may even fine defense companies for failing to submit their progress reports on time.<sup>103</sup> Oman requires defense companies to report on the completion of offset projects.<sup>104</sup> Except for Saudi Arabia, United Kingdom, and UAE, all countries have strict penalties in place for defense companies that fail to meet the terms of their contracts for the offset projects (see section below on for more information).<sup>105</sup>

102 TI-DS GDI, "Saudi Arabia assessment". Data collection July 2018 – September 2019.  
 103 Malaysia Technology Depository Agency, "Collaboration Program Foundations and Guidelines Industry (Industrial Collaboration Program –ICP) In Royal Acquisition," 2022, online at <https://www.tda.my/dasar-icp/>.  
 104 TI-DS GDI, "Oman assessment," Data collection July 2018- September 2019, <https://ti-defence.org/gdi/countries/oman/>.  
 105 See section 6.4 in this chapter.



Twin Towers from Titiwangsa Park, Malaysia (Photo credit: Hafizh Sallam, Unsplash)

Outside of the scoring for the above chart, there is evidence of some but not all governments using these reports to monitor the implementation of offset projects. In Israel, the Industrial Cooperation Authority produces offsets monitoring reports based on annual submissions from suppliers.<sup>106</sup> In the Netherlands, the Commissariat for Military Production submits a report to parliament on industrial participation once every two years. This report includes details on the results of agreements; however, the results are in aggregated form and are purely financial in nature.<sup>107</sup> Australia and India have policies in place to regularly audit a company's offset project performance.<sup>108</sup>

However, in Oman, the government's receipt of company reports has become a bureaucratic (superficial) process for many types of offset projects rather than a step to ensure credibility and an anti-corruption measure.<sup>109</sup> In the past, Malaysia's monitoring procedures and lack of standards for executing offset projects made it easier for defense companies to fulfill offset obligations without completing the work.<sup>110</sup> Similarly, Indonesia's efforts to monitor offsets have been inconsistent, sometimes relying on the beneficiaries of offsets rather than the foreign defense companies for progress reports.<sup>111</sup>

106 TI-DS GDI, "[Israel assessment](#)". Data collection July 2019 – April 2021.

107 TI-DS GDI, "[Netherlands assessment](#)". Data collection March 2020 – June 2021.

108 India's Ministry of Defence, "Defence Offset Guidelines," Acquisition Wing Secretariat, Amended Draft DAP-2020, July 27, 2020. Australia Government, Australia Industry Capabilities Program online at <https://www.defence.gov.au/business-industry/industry-capability-programs/australian-industry-capability-program>.

109 TI-DS GDI, "Oman assessment," Data collection July 2018- September 2019, <https://ti-defence.org/gdi/countries/oman/>.

110 TI-DS interview with former Malaysian government official that oversaw offsets, September 2023.

111 Countertrade and Offsets (CTO), "The Offsets Guidelines Quarterly Bulletin," Indonesia, January 2024, TI-DS GDI, "Indonesia assessment," Data collection June 2019-December 2020, <https://ti-defence.org/gdi/countries/indonesia/#overview>.

## 5.3 Indirect offsets and multipliers

### Elements of good practice:

The government prohibits or severely limits the use of indirect offsets and offset credit multipliers.

Table 4: Countries use of indirect offsets and credit multipliers

Region	Asia and Oceania						Europe				Middle East			
Country	Australia	India	Indonesia	Malaysia	South Korea	Taiwan	Netherlands	Poland	Ukraine	UK	Israel	Oman	Saudi Arabia	United Arab Emirates
Indirect Offsets	✓	✓	✓	✓	✓	✓		✓	✓	✓	✓	✓	✓	✓
Credit Multipliers		✓	✓	✓	✓	✓					✓	✓	✓	✓

Notes: The main sources for the analysis were government offset guidelines, government websites, laws and regulations, interviews with government and industry representatives, and corporate intelligence publications.

Most governments support the use of indirect offsets and multipliers in their offset or industrial cooperation policies. As described in chapter 5, the use of indirect offsets is generally riskier because they provide opportunities for governments or defense companies to steer funds to nearly any domestic entity or any purpose. The European Commission has also pushed European Union states to ban the use of indirect offsets because of their economic distorting effects.<sup>112</sup> However, all of the countries reviewed allow indirect offsets in their policies except the Netherlands. The United Kingdom’s new draft industrial participation policy encourages defense

companies to propose offset projects that provide “social benefits” without providing any clear definition on what these benefits mean.<sup>113</sup> Defense companies have reportedly stated described the social benefits push as “haphazard, uncoordinated and inconsistent”.<sup>114</sup>

Some types of indirect offsets and ranges of offset credit multipliers are particularly risky. Malaysia, Saudi Arabia, and the UAE allow defense firms to provide cash payments or working capital to nearly any type of local company to satisfy offset requirements.<sup>115</sup> This is a high-risk indirect offset, which can be exploited to channel bribes in the form of multi-layered investments.

112 Ron Matthews and Jonata Anicetti, “Offsets in a Post-Brexit World,” January 6, 2022, page 52, online at <https://rusi.org/explore-our-research/publications/rusi-journal/offset-post-brexit-world>.

113 Countertrade and Offsets (CTO), “The Offsets Guidelines Quarterly Bulletin,” October 2023, United Kingdom, <https://www.cto-offset.com/#product-section>.

114 Ibid.

115 Malaysian Technical Depository Agency, “Industrial Collaboration Program”. Accessed November 9, 2023; Countertrade and Offsets (CTO), “The Offsets Guidelines Quarterly Bulletin,” October 2023, United Arab Emirates and Saudi Arabia, <https://www.cto-offset.com/#product-section>.

Separately, many governments use offset credit multipliers to encourage defense companies to provide certain types of offsets. In Malaysia, the government offers defense companies a credit multiplier of five for indirect offsets of working capital investments into local entities.<sup>116</sup> Some countries, such as the Netherlands and Taiwan, have a range of possible multipliers up to tenfold the original contract value.<sup>117</sup> This wide range of multipliers gives government officials significant flexibility on how it values offset projects, which can be used to hide corrupt or fraudulent activities.

**The United Kingdom's new draft industrial participation policy encourages defense companies to propose offset projects that provide "social benefits" without providing any clear definition on what these benefits mean.**

#### Case Study 4



### UAE FUNDS US-BASED THINK TANK THROUGH OFFSETS

In 2016, the UAE offered defense companies the temporary option of providing cash payments to the UAE offset program's (Tawazun) Accelerated Project Funding option to meet some offset obligations.<sup>118</sup> Defense companies would only support UAE companies that are funded by Tawazun. In 2017, however, *The Intercept* reported that funds from this option were instead diverted to a US-based think tank that favored better cooperation with Arab Gulf states.<sup>119</sup>

According to leaked emails obtained by *The Intercept*, the UAE sent \$20 million in funds from the Accelerated Project Funding to a local think tank called the Emirates Centre for Strategic Studies and Research.<sup>120</sup> The Washington, DC-based think tank Middle East Institute then received the funds, which was more than its annual budget. The latter institute has produced research that favors closer military and economic cooperation between the United States and Arab Gulf states, in a possible effort on behalf of the UAE to use US defense company offsets as a way to influence US foreign policy.<sup>121</sup>

The US Department of Commerce and Congress have previously criticized the use of such investment funds as they can facilitate systems for granting favors and delivering bribes to procurement officials.<sup>122</sup> These types of investments can also now be a way for countries to launder money for foreign influence campaigns.

116 Malaysian Technical Depository Agency, "Industrial Collaboration Program"

117 Countertrade and Offset Quarterly Bulletin. April 2023.

118 Countertrade and Offset (CTO) Newsletter, "UAE: Tawazun Introduces Temporary 'Get Out of Trouble' Option, Vol. XXIV, No. 21, November 7, 2016.

119 Alex Emmons, *The Intercept*, "Weapons money intended for economic development being secretly diverted to lobbying". August 17, 2017.

120 Ibid.

121 Ibid. Gearld M. Feierstein, US-GCC Relations: Recommendations for the Next

Administration, November 9, 2016, online at <https://www.mei.edu/publications/us-gcc-relations-recommendations-next-administration>.

122 Marshall S. Money for Nothing? Offsets in the U.S.—Middle East Defense Trade. *International Journal of Middle East Studies*. 2009;41(4):551-553. doi:10.1017/S0020743809990055.

## 5.4 Penalties and enforcement

### Elements of good practice:

If defense companies fail to sufficiently complete offset projects, governments impose penalties on companies for breach of contract.

Table 5: Penalties for breach of contract based on the above elements of good practice

Region	Asia and Oceania						Europe				Middle East			
Country	Australia	India	Indonesia	Malaysia	South Korea	Taiwan	Netherlands	Poland	Ukraine	UK	Israel	Oman	Saudi Arabia	United Arab Emirates
Enforcement of offset penalties	NEI		NEI	*	*	*	NEI	NEI	NEI	*				

Key:

<b>Very low corruption risk</b>	<b>Low corruption risk</b>	<b>Moderate corruption risk</b>	<b>High corruption risk</b>	<b>Very high corruption risk</b>
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Notes: These results are based on new analysis of select TI-DS Government Defence Integrity Index (GDI) indicators with data covering the period 2020-2023. The main sources for the analysis were government offset guidelines, government websites, laws and regulations, interviews with government and industry representatives, and corporate intelligence publications. Results marked with an asterisk (\*) indicate a score which has been updated from the GDI 2020 on the basis of this new analysis. Results marked with "NEI" indicate that there was not enough information available to make a determination for this country.

Many countries require some type of penalty for defense companies that fail to meet their offset obligations, but countries differ on the enforcement of such penalties. These penalties are important tools for governments to help ensure defense companies use government funds for the intended offset projects and not some other questionable purpose. Across the countries reviewed, it is common for governments to have a policy of fining a defense company 5-10 percent of the outstanding offset project obligation.<sup>123</sup> India has taken an aggressive approach to ensuring defense companies comply with offset obligations by regularly imposing penalties

on companies for non-compliance. However, other countries, such as Malaysia and Taiwan, have preferred to seek resolution with defense companies rather than penalize them for any contractual non-compliance.<sup>124</sup> The United Kingdom does not appear to impose any penalties on defense companies for failure to meet their offset obligations.<sup>125</sup> Instead, the country will not work with the defense company in the future if it fails to meet such offset obligations. There is no information to suggest that Saudi Arabia and UAE impose penalties.<sup>126</sup> This approach carries the risk that corrupt practices can go under-reported.

123 Countertrade and Offsets (CTO), "The Offsets Guidelines Quarterly Bulletin," October 2023, Malaysia, Oman, and South Korea for instance, <https://www.cto-offset.com/#product-section>.

124 Countertrade and Offsets (CTO), "The Offsets Guidelines Quarterly Bulletin," October 2023, Taiwan, <https://www.cto-offset.com/#product-section>, Malaysian Technical Depository Agency, "Industrial Collaboration Program". Accessed November 9, 2023

125 Ron Matthews and Jonata Anicetti, "Offsets in a Post-Brexit World," January 6, 2022, page 56-60, online at <https://rusi.org/explore-our-research/publications/rusi-journal/offset-post-brexit-world>.

126 Countertrade and Offsets (CTO), "The Offsets Guidelines Quarterly Bulletin," October 2023, Saudi Arabia and United Arab Emirates, <https://www.cto-offset.com/#product-section>.



## 6.0 THE US REGULATORY REGIME FOR DEFENSE OFFSETS

Despite the corruption related risks of defense offsets, the United States has been gradually reducing its involvement in and oversight of offsets. During the Cold War, the US government was directly involved in offset agreements – negotiating, designing, funding, and implementing them as a tool to cement security alliances. However, at the end of the Cold War in 1990, President George H. W. Bush implemented legislation that prohibited US government agencies from directly participating in offsets, in part because of the market distorting and other adverse effects of offsets.<sup>127</sup> Instead, the US government has sought to play more of a role in overseeing US defense company offsets connected with major arms sales to ensure they do not harm the US defense industrial base and other risks to national interests. To support this oversight, the United States requires defense companies to provide information on its offset agreements connected with arms sales overseen by the Defense, State, and Commerce Departments.

The current US government regulatory approach can be best characterized as “hands-off” with limited direct oversight over these risky arrangements. Over the past two decades, the United States has increasingly weakened this already “hands-off” approach. US defense firms have largely been left to manage their own affairs in indirect offsets. The Defense and State Departments no longer review defense company indirect offsets. Defense companies are not effectively reporting on potential political contributions and commissions that could help mitigate corruption risks in offsets. These pre-export reviews are critical to identifying corruption risks, and as a former FBI official in charge of the agency’s Anti-Corruption Task Force has said, it is extremely difficult to catch bribery after it has happened. The Commerce Department has also limited its analysis and reporting on offsets that could be useful in identifying corruption risks. This section provides details on the existing US regulatory regime and the gaps in overseeing offsets.

### 6.1 Department of Defense

The Defense Department’s Defense Security Cooperation Agency manages and implements the FMS program. Under this government-to-government program, the US government enters into an agreement with a foreign government to sell certain weapons systems. The Defense Department then may contract with a US defense company separately to provide the weapons to the foreign government. Many foreign government purchasers favor the FMS system because of the US government support from the negotiations of the arms sale (including assessing whether the defense company’s costs are fair and reasonable), all the way through the delivery of the weapons. It also provides the US government robust insights into the foreign purchaser, which allows the Pentagon to more closely assess the military justification of the proposed sale, foreign brokers, and any irregularities in contracts and payment. However, the Pentagon’s current approach to offsets limits internal and external government assessments of offsets risks and has complicated relationships with key US partner countries.

**The current US government regulatory approach can be best characterized as “hands-off” with limited direct oversight of these risky arrangements.**

As part of the negotiations for the arms sale, the Defense Department is required to request information on estimated offset costs from defense companies. This information could be used by the Pentagon to identify any questionable costs connected with offsets as well as any suspicious offset projects and beneficiaries. Though over the last decade, the Defense Department has nearly eliminated oversight of indirect offset costs after pressure by the defense industry. In 2015, the

127 The Defense Production Act of 1992 (Pub. L. 102-558, Title I, Part C, § 123, 106 Stat. 4198).

Pentagon issued an emergency, interim rule change to US regulations stipulating that **“indirect offset costs may be deemed reasonable without further analysis in accordance with the Defense Federal Acquisition Regulation Supplement”** if defense companies provided the indirect offset agreement with the foreign government to US officials.<sup>128</sup> Some US defense companies supported this change because they claimed that Defense Department officials were asking uneducated or irrelevant questions about indirect offsets, and these questions could complicate their chances of obtaining arms sales.<sup>129</sup> The rule was finalized in 2018 with only minor changes to the definitions after the US Congress made similar changes in its annual National Defense Authorization Act.<sup>130</sup>

The Defense Department restricts its engagement with foreign governments on defense offsets. According to US regulations, “any offset arrangement is strictly between the Purchaser and the U.S. defense contractor. The U.S. Government is not a party to any offset agreement that may be required by the Purchaser in relation to the sales made in this LOA [Letter of Offer and Acceptance].”<sup>131</sup> US regulations further state “any purchaser requesting offset arrangements in conjunction with FMS should be informed that the responsibility for negotiating offset arrangements and satisfying all related commitments resides with the US firm involved.” The Defense Department “may not discuss with the purchaser the nature or details of an offset arrangement.”<sup>132</sup> This ‘hands-off’ approach, however, has complicated US relationships with key partner countries. When some South Korean officials became aware of some unknown indirect offset costs in their purchase of F-35s, they were reportedly frustrated with US officials’ unwillingness to provide them with details (see case study 2).<sup>133</sup>

The Defense Department’s policies on defense offset also appear to limit congressional oversight of offsets connected with major arms sales that require congressional notification (see chapter 4 for description of which arms sales require congressional notification). US defense officials are required to collect information on “whether or not a known offset requirement exists, whether the country has a standard offset requirement, and whether offsets provided will be direct or indirect and the estimated percentage of each” for major arms sales that require congressional notification.<sup>134</sup> However, TI-DS identified eight likely cases among the Defense Department’s FY2022 public notifications to Congress on proposed FMS sales that should have indicated defense offsets were required for the sale, but instead the Pentagon stated there were no known offsets.<sup>135</sup> Mark J. Nackman, a lawyer for General Dynamics (one of the largest US defense firms), commented on the lack of reliability of the Defense Department to notify Congress on defense offsets:

**“This language [“there are no known offsets”] seems to imply that the U.S. Government, as the broker for the Foreign Military Sales case, has special insight into the transaction and is almost certifying that there are, in fact, no offsets. Nothing could be further from the truth...[O]ffset discussions take place outside of government earshot...[A]nd the U.S. Government supposedly remains blissfully ignorant of their [offsets] existence.”<sup>136</sup>**

128 US Federal Register, “Defense Federal Acquisition Regulation Supplement: Offset Costs (DFARS 2015-D028)”, Department of Defense, June 29, 2018, online at [https://www.federalregister.gov/documents/2018/06/29/2018-14045/defense-federal-acquisition-regulation-supplement-offset-costs-dfars-case-2015-d028#:~:text=DoD%20published%20an%20interim%20rule.and%20Acceptance%20\(LOA\)%20\(indirect.](https://www.federalregister.gov/documents/2018/06/29/2018-14045/defense-federal-acquisition-regulation-supplement-offset-costs-dfars-case-2015-d028#:~:text=DoD%20published%20an%20interim%20rule.and%20Acceptance%20(LOA)%20(indirect.)

129 Countertrade and Offsets (CTO) Newsletter, “Huge Relief as DoD Waves Indirect Offset ‘Cost Analysis’ on FMS Contracts,” Vol. XXXIII No. 12, June 22, 2015, online at [file:///C:/Users/colby/Downloads/CTO\\_XXXIII\\_No\\_12\\_22-06-2015.pdf](file:///C:/Users/colby/Downloads/CTO_XXXIII_No_12_22-06-2015.pdf).

130 US Federal Register, “Defense Federal Acquisition Regulation Supplement: Offset Costs (DFARS 2015-D028)”, Department of Defense, June 29, 2018.

131 Defense Security Cooperation Agency, “Letter of offer and acceptance. Standard terms and conditions”. Accessed November 9, 2023.

132 Defense Security Cooperation Agency, Security Assistance Management Manual, C6 – Foreign Military Sales Case Implementation and Execution, <https://www.samm.dsca.mil/chapter/chapter-6.>

133 Countertrade and Offsets (CTO) Newsletter, October 8, 2019.36 (19)

134 <https://samm.dsca.mil/sites/default/files/C5.F10.pdf>.

135 See Defense Security Cooperation Agency FMS notifications to Congress in FY2022 for Australia (LAIRCM Line Replaceable Units (LRUs) and C-130J-30 aircraft), Bulgaria, Norway, Poland (M1A1 Abrams Main Battle Tanks and M1A2 SEPv3 Main Battle Tank), Qatar, and Spain.

136 Mark J. Nackman, “A critical examination of offsets in international defense procurements: policy options for the United States”. Winter 2011. Public Contract Law Journal. 40(2), pp.526-7.

## Box 1 Defense industry compliance standards

Transparency International's Defence Companies Index (DCI) (2020) indicates that companies are falling far short of the necessary standards to mitigate corruption risks. The DCI, which assesses the levels of public commitment to anti-corruption and transparency in the corporate policies and procedures of the world's largest defense companies<sup>137</sup> includes 41 of the largest US-headquartered defense firms of which 36 are engaged in offset arrangements. Seventy percent of these 36 firms scored 0/100 for the standard of their anti-corruption controls for offsets. Only six US firms scored 50/100 or higher. As a result, the majority of US defense firms could not provide public evidence of adequate corruption controls related to offsets. The types of controls most firms lacked included:

- Explicit policies and procedures to address corruption risks associated with offsets;
- Requirements for offset partners to adhere to the firm's anti-bribery and corruption standards through appropriate contractual clauses;
- Evidence of a dedicated body, department or team responsible for oversight of offset activities;
- Policies for conducting risk-based anti-bribery and corruption due diligence on all aspects of the firm's offset obligations;
- Public transparency on the offset agents and brokers contract to act with and/or on behalf of the firm;
- Public transparency on the beneficiaries of indirect offset projects.

## 6.2 State Department

The State Department manages the Direct Commercial Sales (DCS) program. Unlike the FMS program, it is US companies instead of the US government that work directly with the foreign government from the initial discussions about their weapons requirements to the delivery of the arms. Defense companies must obtain authorization or a license from the State Department's Directorate for Defense Trade Control (DDTC) to export defense articles or services on the US Munitions List (USML). Foreign governments purchasing weapons may prefer the DCS program if they don't require US government support in identifying the specific weapons systems for their defense needs or additional support in negotiating the purchase. US government regulations for DCS require DDTC to conduct thorough checks on exporters, brokers, buyers, recipients, and political contributions and gifts, which can help reduce corruption risks connected with commercial arms sales.<sup>137</sup> However, there are clear gaps in US efforts to review defense offsets and related political contributions, commissions, and marketing fees.

Defense companies must report to the State Department whether there are any offsets connected with major arms sales that require congressional notification if known at the time of the license request.<sup>138</sup> US law also requires defense companies to provide a description of any such offset agreement to the State Department.<sup>139</sup> However, the State Department has indicated that they rarely look at these offset agreements unless the specific offsets require an export license (such as the export of controlled defense technology, weapons maintenance, or training).<sup>140</sup> Similar to the Defense Department, State Department officials view offset arrangements as something just between foreign governments and US defense companies. As result, DDTC is not regularly assessing the prices or costs of offsets agreements that don't include defense equipment or services on the USML, the beneficiaries of offsets, or offset brokers to identify the risk of corruption or fraud. The State Department does not make public whether they are aware of any defense offsets connected with proposed arms sales that require congressional notification through the DCS program.

137 Colby Goodman, TI-DS, "Holes in the net: US arms export control gaps in combatting corruption". 2019.

138 Arms Export Control Act, P.L. 90-629, Sec. 36, (c)(1), Updated as of January 9, 2023, page 36, online at <https://www.govinfo.gov/content/pkg/COMPS-1061/pdf/COMPS-1061.pdf>.

139 Ibid.

140 Author interview with State Department officials throughout 2023.

The State Department also requires defense companies to disclose whether they have provided any political contributions, marketing fees, and commissions in connection with proposed arms sales valued at \$500,000 or more for foreign armed forces, which can be used to identify any suspicious payments in connection with defense offsets.<sup>141</sup> Former US government officials involved in overseeing commercial arms sales under the Clinton administration said they have used these disclosures to stop violations of the US Foreign Corrupt Practices Act or other questionable activities one or two times a year.<sup>142</sup> However, the State Department's external Defense Trade Advisory Group (DTAG) reported

in 2021 that many defense companies were confused about when they should provide such disclosures. Thirty percent of the defense companies surveyed by DTAG stated they had "no documented process" for managing submission requirements to the State Department.<sup>143</sup> Almost all of the defense companies that responded to DTAG survey indicated that "despite good faith efforts, their process resulted in some combination of estimations, potential misrepresentations, and a requirement to later reconcile payments."<sup>144</sup> According to DTAG, defense companies have struggled to meet this requirement because it wasn't always easy to connect specific contributions with specific arms sales.

## Box 2 Which offset entities are subject to the Foreign Corrupt Practices Act?

One of the most important international legal instrument in fighting corruption internationally is the US Foreign Corrupt Practices Act of 1977 (FCPA). 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 program
- 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 process

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 bookkeeping 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.

*Source: The above text is excerpted from TI-DS's 2010 report entitled "Defence Offsets: Addressing the Risks of Corruption & Raising Transparency."*

141 International Traffic in Arms Regulations, "Part 130 Political Contributions, Fees and Commissions, <https://tinyurl.com/vfwfjpn>.

142 Author interview with former State Department official in March 2014.

143 Defense Trade Advisory Group (DTAG), Plenary Session-May20, 2021, Working Group 2 White Paper, Part 130 Reporting, online at [https://www.pmdtc.state.gov/ddtc\\_public/ddtc\\_public?id=ddtc\\_kb\\_article\\_page&sys\\_id=1902fc7bdbb8d300d0a370131f9619eb](https://www.pmdtc.state.gov/ddtc_public/ddtc_public?id=ddtc_kb_article_page&sys_id=1902fc7bdbb8d300d0a370131f9619eb).

144 Ibid.



Military helicopters (Photo credit: Juli Kosolapova, Unsplash)

## 6.3 Commerce Department

Similar to the State Department's DCS program, the Commerce Department's oversight of arms exports on the Commerce Control List (CCL) – often referred to as 600 Series – is largely focused on regulating US defense companies and individuals exporting types of military equipment and related defense technology that can be used by the military, police, or the intelligence communities. Procuring governments and defense companies prefer exporting arms through this program as the requirements for obtaining a US license to export 600 Series items are less stringent compared to the DCS program. There is no requirement for defense companies to provide information on any defense offsets when they request a license to export 600 Series arms or for brokers to register and apply for a license to engage in brokering activities.<sup>145</sup> The Commerce Department also takes a more limited approach to preventing bribery. However, the Bureau of Industry and Security (BIS) within the Commerce Department does play a key role in collecting, analyzing, and reporting on US defense company offset arrangements. Though the utility of this reporting and its assistance to help curb corruption has significantly diminished over the last two decades.

**This report showed that US defense companies offset requirements in Greece reached up to 300 percent of the underlying contract value.**

The Bureau of Industry and Security (BIS) used to highlight information that could be useful for understanding corruption or other risks in its annual reports to Congress on US defense company offsets. In 2007, the Commerce Department's annual report included data on the total US defense company offset obligations for each country. This report showed that US defense companies' offset requirements in Greece reached up to 300 percent of the underlying contract value.<sup>146</sup> It also reported that "subsidizing interest groups" was primary among the political rationales for countries requiring offsets.<sup>147</sup> As mentioned earlier, the Commerce Department has also highlighted the risk of US defense companies supporting corruption by discharging offset obligations through sovereign wealth investment funds.

145 Colby Goodman, TI-DS, "[Holes in the net: US arms export control gaps in combatting corruption](#)". 2019.

146 BIS, "[Offsets, 11th Annual Report](#)", p 41. 2007

147 Ibid, p182. 2007

The Commerce Department no longer includes the above information in its annual reports because of defense company concerns and the Department's mandate on offsets. In interviews with BIS officials, they indicated some defense companies had expressed concerns that publishing country-level information on defense offset obligations could complicate their ability to compete in the marketplace.<sup>148</sup> In particular, it was relatively easy for the public to identify the specific defense company that had obligations with the foreign government. However, it is unclear how releasing information on the total dollar value of offset obligations to a country could hurt a company's ability to compete. BIS officials also stated that their focus is on analyzing whether defense offsets are hurting the US defense industry or defense jobs, and as a result, they do not review corruption risks.<sup>149</sup> It also appears that the Commerce Department does not share such information with other US departments, including the Justice Department, that could identify corruption related concerns.

Equally concerning, it does not appear that the Commerce Department is effectively collecting the majority of US defense company's offsets arrangements for its reports to Congress. As noted in chapter 3, we identified a significant gap between what we calculated and what the Commerce Department reported as the total dollar value of US defense company offset agreements for 2021. In an interview with BIS, they are aware of missing some US defense company agreements.<sup>150</sup> In certain cases, BIS has requested certain companies to submit the required reports. BIS officials, however, have not taken the steps to penalize any defense company for failure to provide these reports as required by law. They also do not have access to key corporate intelligence publications, such as Countertrade and Offsets, which could help them identify companies that have not successfully reported their offset agreements or transactions.

**There is no requirement for defense companies to provide information on any defense offsets when they request a license to export 600 Series arms or for brokers to register and apply for a license to engage in brokering activities**

<sup>148</sup> Author interview with Commerce Department officials in August 2023.

<sup>149</sup> *Ibid.*

<sup>150</sup> *Ibid.*

## 7.0 CONCLUSION

The growing demand of the defense offsets market marks a critical moment to ensure effective oversight of this practice. This report has outlined how demand for defense offsets is increasing across US partner countries to protect defense supply chains, increase defense capability self-reliance, and grow economic opportunities. The corruption risks around this practice, which have long been known, remain persistent and significant.

There are multiple features of offset arrangements that enhance risk, not least the unusual secrecy around these arrangements. There is surprising US partner government support for allowing defense companies to invest in all sectors of the economy and nearly any company. The ever-increasing complexity of offset deals also complicates the effective monitoring of these transactions and verification that defense companies are meeting their commitments.

This corruption and opacity can and has had real consequences for national and global security. It has reportedly hurt countries' abilities to obtain critical military capabilities and provided questionable support to political parties, campaigns, or political elites. It likely supported natural resource laundering for armed conflict actors and wasted government funds in highly indebted countries. It has also complicated US government relations with key security partners and negatively affected US defense company efforts to win sales and strengthen supply chains.

Some of these risks can be lowered by more effective oversight. The United States, however, must reevaluate its current "hands-off" approach to overseeing offsets if it wants to address these risks. This needed change must start with halting any new defense company efforts to further weaken US oversight of offsets, including efforts to limit State Department oversight of indirect offsets connected with Foreign Military Sales. Instead, the US government needs to find a better balance between oversight of defense offsets and support for stronger defense industrial cooperation with partner countries.

This challenge, of course, is a collective responsibility requiring action from importing and exporting governments. However, many US partner countries are falling short. In the leading countries receiving US arms exports, there are significant gaps in their institutional defenses to prevent corruption. Some countries such as Australia appear to have found a better balance on transparency.



## 8.0 RECOMMENDATIONS

The below recommendations provide an overview of the key areas the US government should address first to improve oversight of defense offsets. Importantly, many of these suggested changes should not seriously impact defense companies' abilities to compete for arms sales abroad if implemented in a targeted way and in consultation with defense companies.

### 8.1 Increase transparency: reinvigorate US reporting on defense offsets and political contributions

One of the best ways to improve accountability and understanding of defense offsets is to enhance internal and external reporting and transparency. The below recommendations highlight a few key areas to improve these anti-corruption efforts:

- **Prioritize State Department efforts to clarify and strengthen defense company private reporting on any political contributions, marketing fees, and commissions connected with Direct Commercial Sales.** In order to help prevent significant acts of corruption, companies should report on such contributions when they request an export license valued at \$14 million or greater. It would also be critical for companies to provide annual reports on such contributions, including planned and delivered contributions. This clarification should include a specific reference to political contributions made through defense offsets.
- **Strengthen Defense Department reporting to Congress on Foreign Military Sales to ensure that each notification contains accurate information on defense offsets.** The Defense Department should include information on the expected beneficiaries of offset projects and well as details on any indirect offsets. This information will help Congress assess any corruption risks associated with the arms sale. The **State Department** should explore providing such information on expected offsets in its public reporting to Congress on major arms sales through Direct Commercial Sales.
- **Commission an interagency task force to examine ways to improve transparency on offsets.** The lack of transparency between the US and foreign governments and with the public is seriously impeding effective oversight of defense offsets. It has also complicated US government relations with foreign partners and the ability for US defense companies to obtain arms sales. This task force should explore ways in which the United States can enhance transparency without causing unnecessary harm. Some of the key items to consider include:

  - Removing restrictions on Defense Department officials from providing information to foreign governments on offset costs connected with Foreign Military Sales;
  - Making public the offset quotas for proposed major arms sales;
  - Reinstating Commerce Department reporting on total defense company offset requirements for each country and region in its annual reports to Congress. These reports should include the actual value and credit value (where applicable) of the defense company offset agreements and obligations for each country and region to assist with public and foreign government oversight of offsets.
- **Require US defense companies to report to the US government on their anti-corruption compliance standards on defense offsets for governmental study on such standards.** This study should examine the extent to which defense companies have explicit policies and procedures to address corruption risks associated with offsets, require offset partners to adhere to the company's anti-bribery and corruption standards through appropriate contractual clauses, and maintain key records of all related financial transactions. It should also provide recommendations on how to effectively encourage defense companies to adopt and maintain stronger compliance standards.



## 8.2 Assess corruption risks: proactively assess corruption risks in offsets arrangements in arms exports decisions

The United States needs to shift to a proactive stance to prevent corruption in offsets arrangements in arms exports. This will require an assessment of risks around specific transactions as well as the quality of controls at US partner countries. We recommend the following actions to improve these risk assessments:

- **Review offset agreements, especially indirect offsets, connected with major arms sales through the Direct Commercial Sales program.** This State Department review should include an assessment of offset project details, companies or brokers implementing projects, projected costs, and beneficiaries. The above chapters on offset corruption vulnerabilities and offset policies highlight several red flags to watch for in such assessments. The State Department may need to add regulations to provide more details on the offset arrangements.
- **Initiate a study by the Government Accountability Office or an inter-departmental group (including the Defense, State, Justice, and Commerce Departments) to examine the last three to five years of US defense company offsets arrangements for any potential violations of the Foreign Corruption Practices Act or other corruption concerns.** This study should also explore the corruption risks to defense companies as an increasing number of US partner countries demand are demanding offsets, including indirect offsets.
- **Revive the Defense Department's review of prices and costs of indirect offsets connected with Foreign Military Sales.** This review should incorporate assessment items from the above bullet as well as the general price and cost assessment for Foreign Military Sales contracts. The US Congress will likely need to pass a new law to revive this assessment of indirect offsets. The Defense Department could narrow these assessments to sales that require congressional notification or sales to countries that consistently rank high in corruption or poor defense governance from independent indexes such as TI-DS Government Defence Integrity Index.

- **Require the Commerce Department to assess offset corruption risks connected with defense company export license requests for 600 Series arms and in its annual reports on defense offsets.** At the moment, the Commerce Department does not even require defense companies to provide information on offset agreements connected with 600 Series arms sales, even though these sales can easily reach foreign governments dollar thresholds requiring offsets. The US Congress should explore remedies including adding in requirements similar to what is stipulated for the State Department.

## 8.3 Penalize wrongdoing: impose penalties on defense companies and individuals involved in offsets-related corruption

The best approaches to reducing corruption in defense offsets mean little if the United States is unwilling to impose real penalties and consequences on individuals and companies that violate contractual provisions, laws, or regulations. High-profile cases can prompt changes in industry behavior. We recommend the following key actions:

- **Investigate and prosecute cases of corruption in defense offsets in a more thorough and transparent way.** In conversations with former FBI officials from anti-corruption units, it appears that the FBI and the Justice Department more broadly are not regularly investigating corruption-related issues in defense offsets. This may in part be because the Defense and State Department are not sharing information with the Justice Department on offset arrangements. However, there is a strong likelihood that some of the recent indictments of US defense companies related to bribery could include offsets. An exemplary recent case is Raytheon, which is currently under investigation by the Security Exchange Commission and Justice Department for funneling \$1.9 million through Digital Soula Systems, a Qatar-based consulting firm that was part-owned by a brother of the country's emir. Digital Soula Systems/DSS is tied to at least two other firms, including Avyara information systems, itself a prior offset partner of Raytheon.<sup>151</sup>

151 Dylan Tokar, "U.S. Probes Examine Raytheon's Dealings With Qatari Defense Contractor" <https://www.wsj.com/articles/u-s-probes-examine-raytheons-dealings-with-qatari-defense->

- **Place companies and brokers that have proven to engage in corruption-related actions connected with offsets on US government private and public watchlist.** These lists should include a State Department's private watchlist associated with Direct Commercial Sales, the Commerce Department's various public watchlist associated with the Commerce Control List, and the Defense Department's watchlist.
- **Penalize companies for failing to provide information to the State, Commerce, and Defense Departments on defense offset agreements and political contributions, commissions, and marketing fees.** Defense companies need to know that the US government expects them to have the compliance measures in place to adhere to these reporting requirements and provide accurate information.
- **Enhance restrictions and oversight of key risk areas.** This includes the use of wider ranging multipliers to assess the value of proposed or completed offset projects, and the ability for defense companies to provide cash payments or working capital to any type of local company. At the same time, governments should do more to enhance oversight of individuals and companies engaged in brokering arms sales and offset projects. This should include a requirement for individuals to obtain government authorization to engage in offset projects and to provide regular reports on income derived from such activity.
- **Improve enforcement in relation to companies and brokers.** Governments should bar any company or broker that has broken corruption-related laws or regulations from participating in arms sales or offset projects. They should also require regular audits of offset projects and make at least a summary of them public.

## 8.4 Encourage stronger offset policies: push US partner countries to establish more effective policies to oversee defense offsets

- **Increase offset transparency.** This includes publishing details of offset obligations (including the deliverable, contract value, number of offset credits received, and beneficiaries), and disclosing the names and details of agents, brokers, or consultancy firms associated with a particular offset contract. It is possible to do this in a way which protects proprietary information and classified defense technology: Australia has found an effective way to approach this and provides a useful model for other governments to replicate. Governments should also consider publishing summaries of offset project progress reports and results.



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