

ARMS TRADE OFFSETS AND CASES OF CORRUPTION: THE USAGE OF ANTI-CORRUPTION TOOLS IN SPECIAL FORMS OF ARMS ACQUISITIONS

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ABSTRACT

Because of a lack of transparency and the high complexity of administrative processes, arms acquisition is an area with a high risk of corruption. The aim of this paper is: 1) to provide a typology of cases of corruption in compensatory trade agreements, so called arms trade offsets, that have become integral parts of most arms trades; and 2) to analyze tools possessed by government agencies concerned to prevent or detect corruption. Based on an analysis of all major English-speaking newspaper articles between 1980 and mid-2012, the results show that only a few different types of corruption typically exist in arms trade offsets. Also, the lack of transparency leads to an unusually high amount of questionable allegations. Contrary to most other scholarly articles on corruption, this paper argues that there may be no need for new and stricter anti-corruption policies in this area, but that the usage of basic performance management and already existing due diligence tools could be helpful.

Keywords – *Corruption in Arms Acquisition and Offsets, Due Diligence, Performance Management, Tools to Fight Corruption, Transparency*

INTRODUCTION

Fighting corruption has become one of the major topics in public management. On one hand, a theoretical discussion on drivers of corruption, based on Robert Klitgaard's renowned book *Controlling Corruption* (1991) has been going on for almost 20 years. And even though these theoretical frameworks have been discussed and widely rearranged (see for example Hors 2001 or McLinden 2005) the main ideas that corruption is driven by a lack of efficient control, discretionary power, and the possibility to work within a network still remain the same. On the other hand, many researchers have been dealing with concrete strategies that states use against corruption, especially the relatively extensive research on the initiation of anti-corruption-agencies (see for example DeSousa 2006, Klemencic & Stusek 2007, or Quah 2011). Other aspects, such as the necessity for administrative reforms (Fjeldstad 2003), or the question of interrelation-

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ships between a reform such as New Public Management and corruption (von Maravic & Reichard 2003), have been discussed broadly. What can be seen is that most research and discussions on corruption are held on a national level and end relatively quickly, with recommendations to introduce either new national strategies and policies (Bryane & Polner 2008), or new audit systems (Baltaci & Yilmaz 2006 or Cantens et al. 2010).

While an introduction of a specific strategy or the change of the audit system may have a positive effect on the fight against corruption, they are both rather medium-term options for a governmental organization. Instead, this paper focuses on already existing tools within governmental agencies which could limit repercussions arising from Klitgaards' drivers. It therefore approaches the following question:

'Does a public agency have already existing tools to detect and fight possible cases of corruption?'

The objective of this paper is to show that a high amount of cases of corruption could be uncovered by tools a public manager has at hand. The problem is often not at the strategic- but rather the operational level, where a lack of resources, knowledge or motivation ease corrupt practices. This will be exemplified by anecdotal cases of corruption in compensatory trade agreements within larger weapon system procurements, so called arms trade offsets. This choice has been made for two reasons. First, offsets are "carrying high corruption risks" (Magahy et al. 2010, 2), but only a few cases of corruption have been discussed so far. This paper is aimed to prompt further discussion in Public Management by addressing the need for concrete data with an extensive international overview of corruption cases in offsets. Second, offsets are coordinated by one, relatively small and specialized agency per country which makes cases well comparable and delimitable.

The first part of this paper is a directed qualitative content analysis (Hsieh & Shannon 2005) of allegations of corruption in major newspaper articles between 1980 and 2012. Newspaper articles were coded based upon stakeholders involved and at which stage of the offset-process the allegations occurred, and were compared to Heidenheimer & Johnston's typology of corruption (2001). What can be seen is that a relatively small number of different types exists and that even this small number can be combined into only two major scenarios: a governmental employee is bribed to favor one of the stakeholders in the process, or the employee is personally linked to a company and is therefore favoring it. The second part of this paper discusses usages of three already existing anti-corruption tools: concepts of due diligence, performance management, and general aspects of transparency. The paper argues that the above mentioned major corruption scenarios in arms trade offsets could be identified with already existing management tools but that the identification of corruption often lacks the usage of even basic instruments of anti-corruption policies. An additional finding is that the lack of transparency in arms trade offsets leads to a relatively high amount of misunderstandings or even wrongful allegations, these force agencies to focus on areas less important for anti-corruption efforts.

DEFENSE PROCUREMENT AND OFFSETS

According to a recent report from the Stockholm International Peace Research Institute, 40 percent of all corruption in international transactions occurs in the arms trade (SIPRI 2010, 1), moreover the Trade Promotion Coordinating Committee of the US Department of Commerce claimed in a March 2000 report that the defense sector was responsible for more than 50 percent of all bribery allegations between 1994 and 1999 (Magahy et al. 2010, 14). Key reasons for this concentration in arms trade corruption include the high value, and therefore the importance, of single trades for individual countries and defense suppliers. Additionally, security-relevant transactions increase in complexity because of the high amount of stakeholders involved in the process and the secretiveness of the area as such. This makes it harder and harder for public managers to control and communicate information to superior authorities and the public.

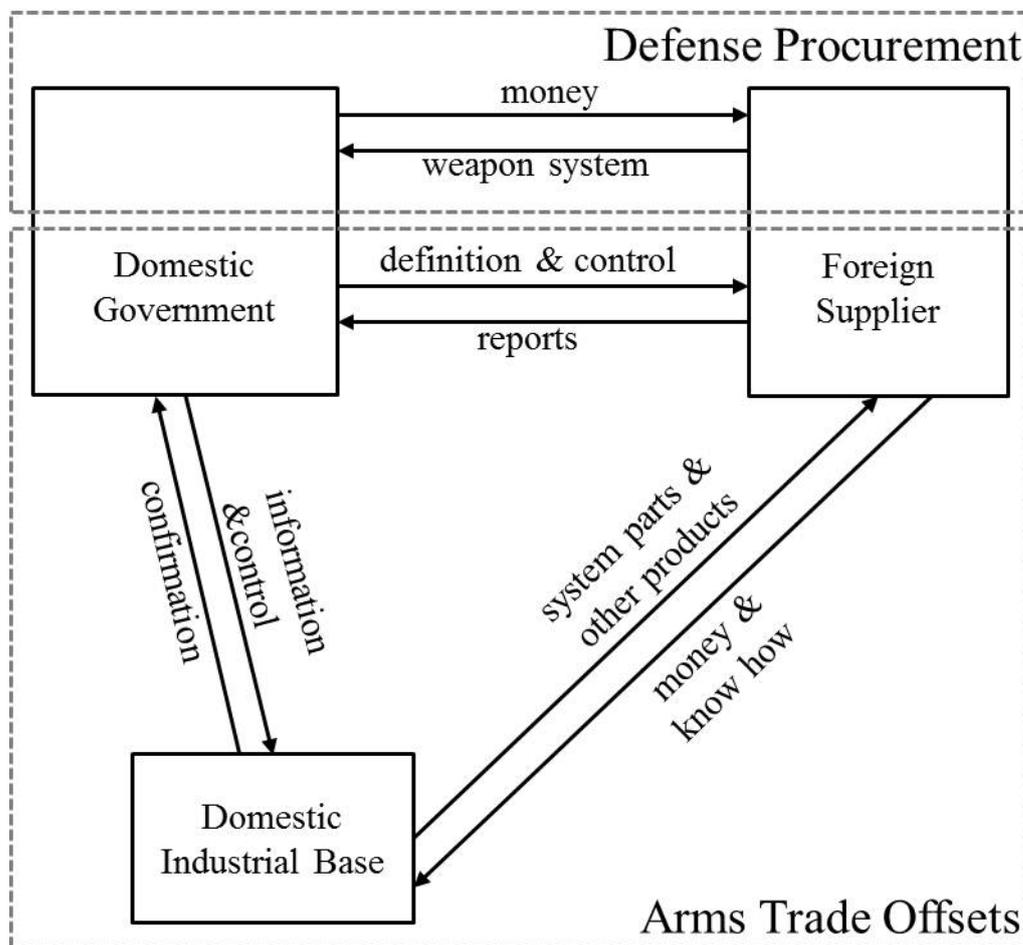
When procuring armaments, a country must decide if a weapons system, or a component thereof, can be developed domestically or should be purchased off-the-shelf from a foreign supplier. Beyond these two options lie other alternatives, such as licensed production or shared development projects wherein the development or production of an item is shared between the companies of the vendor and supplier countries. On one hand, domestic development would theoretically strengthen a country's defense industrial base and secure jobs and technological know-how, therefore satisfying the specific needs of the domestic armed forces. Yet this is "also likely to be the most expensive option" (Martin 1996a, 1) for maintaining the country's military capability. On the other hand, off-the-shelf purchasing, though potentially less expensive, means getting a system that is developed for another country's armed forces' needs, producing only jobs abroad and comporting a danger to the secure supply of required parts and technical assistance. However, it is likely to be significantly cheaper. In order to overcome this dilemma, many states link their defense purchases to compensatory trade agreements, often referred to as 'arms trade offsets', 'countertrade' or 'industrial participation'. Offsets mean that a country buying off-the-shelf military equipment forces the foreign supplier of the product to reinvest an amount of the product price into the domestic industrial base¹. By adopting these practices a country can get a foreign military system without paying initial development costs, and theoretically still generate some domestic industrial benefits. These offsets are usually defined as some percentage of the purchasing contract price, and a time period is set for the fulfillment of them. Additionally, when procurement with an offset contract is signed, the foreign company works directly with domestic companies to fulfill the offset obligation. A specialized governmental agency monitors these processes and also evaluates the performance of these offset deals. As these additional processes and the coordination of several new stakeholders lead to far more complex transactions than a basic outright purchase, as well as to additional (transaction) costs of up to 20 percent of the original system price (Friedli et al. 2009), the probability for corruption increases as well.

Since the 1970s the number of countries using countertrade practices has steadily risen. While countertrade originally consisted mainly of barter agreements exchanging goods rather than using a currency, to ease transactions with countries of the Soviet Union and other countries with 'weak' currencies, this is no longer the case. Today, the vast major-

ity of countertrade transactions include offset agreements to maintain the defense industrial base and increasingly the dual-use and civilian industry. More than 75 countries worldwide apply offset policies regularly and several additional countries use offsets for some specific procurements (CTO Data Services 2012). Most of these countries possess only a single governmental body with usually a small staff of approximately five to twenty employees to govern these deals. Thus the functions of these agencies are relatively similar and, most importantly, they share the common problem of controlling the different offset deals between foreign vendors and domestic industries, making them an interesting case for further research.

As Figure 1 shows, an offset agency (within a domestic government) has three major functions.

Figure 1: The relation between the main stakeholders in arms trade offsets



Source: Own research.

First, it defines the offset contract with the foreign supplier. As offsets are based on the procurement of a large weapon system, the contract is discussed parallel to the procurement contract. It usually defines the overall amount of offsets and the division between direct offsets, where domestic companies are producing parts of the actual system ordered, and indirect offsets, all transactions between the foreign vendor and the domes-

tic beneficiaries that are not directly linked to the weapon system. The offset contract is often considered in the overall tender process. For example, in Switzerland offsets are incorporated in the cost/benefit analysis and account for 8 per cent of the result (EFK 2007, 17). The reason for the consideration of offsets within the selection of the weapon system is that the offset agreements can influence the technical specifications of the good procured. This is especially the case when a country wants to use offsets not just for economic reasons but also to maintain or even develop own defense technological capabilities² and therefore demands for changes of the existing system produced by domestic companies considered important for national security. Second, the agency is responsible for monitoring the implementation of the offset agreement. The foreign supplier has to hand in proofs for the quality and quantity of transactions with the domestic industrial base. The agency is verifying these proofs with the vendor but also autonomously with the large group of beneficiaries. For example, the 1.1 billion dollar procurement of combat vehicles in Switzerland led to more than 1000 offset transactions between the foreign supplier and more than 250 Swiss companies within 10 years (Platzgummer & Gonzales Lozano 2013). Third, the foreign supplier often lacks the specific insights needed to find the best partners in the contracted country. Therefore, the offset agency is not just controlling but also informing companies from the domestic defense industrial base about possible cooperation with the foreign vendor. Also, in some countries, agencies can suggest or request that specific companies produce parts of a weapon system. This is especially done, when the company is considered relevant for maintaining the defense industrial capability of a country.

What has become evident is that even though offsets are a rather exceptional activity for a government, the functions of an offset agency are relatively similar to other governmental agencies. For example industrial promotion activities or R&D projects require comparable control- or monitoring functions.

While the overall economic effects of offsets have been extensively addressed in academic literature (Brauer 2004, 54), corruption and the role of public agencies, and therefore aspects of Public Management, have not been subject to closer examination. This is particularly unfortunate given the sheer volume of trades and money controlled by these governmental offset agencies. In 2006 the overall volume of offsets in participating member states of the European Defence Agency was estimated at 5.6 billion euros, which would correspond to 200-400 million euros per annum for each member country (Eriksson et al. 2007, 4). Even a small and neutral country such as Switzerland, with no membership to the EDA or NATO, finds itself within these same average volumes of about 300 million euros per annum (Friedli et al. 2009). Although the data is unavailable for countries outside of Europe, the volume for other continents is likely in a similar if not even higher range, considering the fact that some countries tend to have offset obligations far beyond 100 percent, and are not facing the same defense procurement budget cuts as European countries have in recent years (Marshall 2012). What makes offset deals even more prone to corruption is the impossibility to compare costs between countries. First, this is because of the different military requirements within the same weapons system, and second, because of additional coordination expenses between the foreign vendor and domestic companies.

Unfortunately, quantitative data on corruption in offsets is lacking, and only a handful of examples are used in (academic) discussions thus far³. The reason is that, aside from speculations about the potential corruption risk claimed by most authors, only a few cases of corruption have been discussed in public.

TYPES OF CORRUPTION IN OFFSETS

Usually, offsets are seen as a part of defense procurement and are seldom of higher interest to the general public. This also holds true for discussions of corruption in offsets. While corruption in arms trade in general has always been of high interest for researchers and specialized media, broader discussions of corruption in offsets are a relatively recent phenomenon. In 1999 the corruption within a South African defense acquisition came to public attention because of the sheer number of allegations and high volume of the procurement and offsets (Crawford-Browne 2009). Bringing further general awareness, Transparency International, an NGO specifically fighting against corruption, published a noteworthy report and started a campaign against corruption in offsets in 2010 (Magahy et al. 2010).

One of the major problems when studying corruption in offsets is the fact that it is difficult to narrow down any research to specific types of corruption because “definitions are controversial, and solid evidence is often elusive” (Johnston 1991, 9). To have the maximum number of possibilities for further analysis, this paper used the relatively broad definition provided by Transparency International: “[corruption is] the abuse of entrusted power for private gain”(Magahy et al. 2010) This definition is even broader than the definition of the *United Nations Development Programme*, which defines corruption as “the misuse of public power, office or authority for private benefit– through bribery, extortion, influence peddling, nepotism, fraud, speed money or embezzlement” (UNDP 1999, 7).

To give an overview of types of corruption in offsets, a directed qualitative content analysis of newspaper and specialized magazine articles was conducted. The selection was based on a LexisNexis major world publication search, which is also the reason for the limitation to articles written in or translated into the English language. Even though it is possible that some of the corruption allegations have not been discussed in non-English written media, it is likely that all major cases of corruption in the area of armament and defense have at least been mentioned in the prominent publications available via LexisNexis, such as *Jane’s Defence Weekly*, *Defense News* or *Aviation Week* which have the resources to report on all major foreign defense news items. In an initial collection set, all articles published between 1980 and June 2012 containing the words “defense”, “offsets” and “corruption” or important synonyms⁴ in the full text were selected. The 990 resulting articles were filtered by hand to ensure that the remaining articles explicitly dealt with corruption in arms trade offsets. The final sample contained 250 articles from 12 countries⁵. The sample was supplemented by academic papers and reports from the same timeframe that specifically discussed questions regarding corruption in offsets⁶.

More than half of the articles (153) dealt with the aforementioned South African case, a case also included in all academic papers used for the data collection. The reason for this may be the uniqueness of the procurement as such (it involved an exceptionally high amount of offsets and a number of different allegations⁷) but there is a high probability that it is also due to the fact that South Africa, as an English-speaking country, would be more frequently discussed in English-language print media. Similarly, India (30), Saudi Arabia (15) and Australia (12) were highly represented in the data, while all allegations in other countries were mentioned between one to eight times in the articles. One set of 20 articles consisted of texts where offsets were associated with corruption but no example was given, therefore these articles were not used for the categorization scheme, but will be referred to in the overall discussion in the second part of this paper⁸. It is important to mention that the number of articles pertaining to a country did not offer valuable clues on the specific number of offset deals, as a majority of the articles summarize several offset deals within a country throughout the article. A quantitative analysis of cases of allegations was insofar not possible. But, it seems that most corruption in a country happened within the same procurement. This could be explained by the fact that corruption implies a certain legal and economic risk for a company and that a company which has already crossed this threshold is more likely to repeat a so far successful practice⁹.

Instead of a quantitative analysis the focus therefore shifted to a qualitative definition of different types of corruption in offsets based on the allegations in the newspaper articles. While several very general categorizations of corruption exist (e.g. Heidenheimer & Johnston 2001), a specific typology for corruption with offsets has not yet been developed. For a further discussion of specific tools a governmental agency has to detect and fight corruption, it seems inevitable to specifically define what types of corruption the agency has to face. Even though the first report on offsets of Transparency International had several quasi categorizations for portions of offset processes, for example pathways from tender to winning the award (Magahy et al. 2010, 18), they were not sufficient to encompass the range of corruption cases examined.

A qualitative content analysis was used to utilize a broader but more exhaustive method of categorization. Common typologies for corruption need data about the interests of the corrupt actors, which cannot be derived solely from the data set used. Therefore the initial coding of the 250 relevant articles was only based on most obvious stakeholders and the sequences within the offset process. A directed content analysis was used to be able to adapt the coding to new findings¹⁰. This led to an extension of the number of stakeholders during the coding.

First, the allegations were split up according to the main stakeholders involved. As mentioned earlier, the increasing number of stakeholders is one of the reasons for a decreasing level of transparency. The next division extends beyond the two most obvious groups - those of foreign suppliers and the national importing government - to include national beneficiaries (the domestic defense industrial base but also research institutions) that play a major role in the offset business as they are the recipients of the offset obligations, as well as third-party entities such as brokers or consultants (Magahy et al. 2010, 13). It could be reasonable for future in-depth studies to further break down the

categories of government and the national beneficiaries into subcategories. So far, the category of government includes the offset agency, as well as the decision-makers (generally politicians, or higher-ranking officials on a ministerial level). National beneficiaries could at least be divided into state-owned and private companies, as there is a high chance that state-owned companies are favored over privatized ones, as the case of India shows (Raghuvanshi 2005). The separation of defense companies from dual-use and civilian companies could also be of further interest, as depending on legal interpretation by different governments, the WTO/GATT offset contracts only allow for security-related deals which are sometimes thereby restricted to defense companies. Alternatively, the legal interpretation could stretch to purely civilian beneficiaries¹¹. The reason for this different interpretation lies in the exception of defense procurement in free trade agreements due to its effects on the security of a country (Young 2007, 315-318). The majority of countries include offsets (as part of the defense procurement) to this exception. But, countries with a relatively weak defense industrial base tend to allow civilian offsets, while countries with a stronger defense industry exclude civilian or even dual-use products to make sure that important domestic defense companies can benefit accordingly.

Second, the allegations were divided according to the course of action within the offset process. This level of analysis has already been used in an earlier study (Magahy et al. 2010, 15–17), but the process after the signing of the contract has been ignored so far by scholars. It is true that one major scenario for corruption within the arms trade as a whole is as good as done at this point, mainly the means by which one foreign company wins the procurement over its competitors. However, other possible scenarios, such as national companies attempting to become beneficiaries, still remain as opportunities for corruption. As the offset contract as such still seems to be the major turning point within the process, the categorization has only been divided into pre- and post- contract agreement phases.

Relatively similar allegations have been combined here in order to provide a good overview of the different types of corruption within offsets. Additionally, the geographical locations of these cases of corruption are listed. The articles were not analyzed statistically due to the fact that multiple examples of the same case have no impact on the severity or the type of the corruption and that a clear differentiation of different cases was often not possible based on the newspaper articles. To give an overview of existing cases (and to broaden up the academic discussion to more than the so far used examples), anecdotal evidence is used in further discussions. Also, the long period of investigation between 1980 and 2012 would imply a time-series analysis. This has not been done because of two reasons. First, an increase of allegations could be found but this increase is alleageable with the overall increase of the use of offset practices, especially after the end of the Cold War and in Arab countries in the beginning of the 21st century. Second, offsets will only occur when a country has to import a weapon system. Therefore, especially larger high-tech weapon system procurements include offset agreements. With an average lifespan of about 30 years for most of these systems, and very different domestic industrial partners for the different systems (e.g. land systems, combat jets, etc.)

there were not enough cases that highlight specific trends over time. Also, the types of corruption were distributed relatively evenly over time.

Table 1: Overview of cases of corruption

		Pre contract agreement	Post contract agreement
Foreign	Supplier	Government bribed to manipulate tender (-process) (ID, IN, ZA)	<ul style="list-style-type: none"> • Incorrect claim of offsets (AU, PT, ZA) • Bribe is claimed as offset (KR, ZA)
	Third-Party E.	Politicians bribed to influence decision-makers (IT, PT, ZA)	
Domestic	Government	Overassessment of benefits in offset proposal (CZ, GR, PL, PT, ZA)	High ranking officials own/work for offset receiving company (ID, ZA)
	Beneficiaries	Agency bribed to receive share of offset obligation (AU, CZ, ZA)	

Source: Own research.

What can be seen in Table 1 is that the number of countries with allegations is relatively small and that only seven different types of corruption could be identified based on the data collected. All pre-contract-agreement cases represented instances of corruption where one of the stakeholders tried to influence the competition between potential suppliers to its own benefit, or in other words, where the government favored a specific stakeholder who provided more incentives, usually in the form of bribes. All these cases can be defined as public-interest-centered types of corruption according to Arnold Heidenheimer (Heidenheimer & Johnston 2001, 9). In these cases, the tender process was manipulated in a variety of ways. For example, one of the South African procurement decisions was based on a shortlist that excluded the price of the arms purchase and therefore favored the proposal with the best offset offer (Pressly 2011). Another example was the bypassing of the Minister of Defense by the Chief of the Air Force in Indonesia (Roundup: Trade deal 2003) or the temporary loss of all offset proposals by an Indian official (Antony warns defence 2011). This latter case, though no evidence could be found for corruption, can still be seen as an example of how a tender process could be potentially manipulated. Cases where politicians or high-ranking officials were bribed to influence decision-makers have been cited in South Africa (AFP 1999), in

Italy (Pubby 2012), and in Portugal. The Portuguese case refers to an allegation in which an intermediary received 30 million euros for brokering the procurement and the offset contract, using portions of the deal to bribe others, including officials of the offset agency (Magahy et al. 2010). By far the most media attention was received by a case in South Africa because of the proposed (and never completely realized) creation of 65,000 new jobs (Crawford-Browne 2009). Several companies also tried to ensure business with the offset supplier by becoming compulsory partners for the foreign supplier. This has happened for example in Australia ('Richo' cleared 1995) and in the Czech Republic (Kominek 1998).

Other allegations of corruption can be seen in the second phase of the offset process after the selection of the supplier and the signing of the contract. Multiple cases exist especially where a company benefits from being personally associated to the high-ranking officials or politicians who organized the offsets. For example, this was the case in South Africa where a minister took up a position in an offset benefiting company directly following his political term (Mitchell), or where politicians were shareholders of such companies (February & Calland 2011). These cases can be defined as market-centered corruption (Heidenheimer & Johnston 2001, 8). The last two types are those mentioned most often in the media, but they remain the least explained cases: offset deals being used as bribes, and incorrect claiming of offset deals. Unfortunately, there is only one article that gives an explanation on how the use of offset deals as bribery could have happened: In Korea a deal was claimed as an offset but the service in return by the national company never occurred, and thus clearly equates to a bribe situation (Summer 1998). This type of case could be defined as public-office-centered corruption even though the payments seem to be to private companies rather than to public officials (Heidenheimer & Johnston 2001, 8). The last type includes cases where the foreign supplier tried to claim several offset deals incorrectly, usually by overestimating the value of the deal. Allegations about such cases have been made in Australia (Richardson 1995) and in Portugal (Pop 2010).

It is important to mention at this point that all of the types discussed here are primarily allegations of corruption. All of the articles have been concerned with allegations that led to criminal proceedings, but only a few of these cases resulted in the conviction of a specific person. Additionally, even though the categories proposed represent, in some cases, a risk of corruption, a relatively large portion of the examples from the newspaper articles do not. In several cases the fact that the proposed offset benefits were extraordinarily high was a reason for corruption allegations. For example, a U.S. company offered new jobs worth three billion U.S. dollars to the Polish government. This led to political statements such as: "Critics call it what it is: bribes and corruption" (Jackson 2003). The problem with this allegation is that arms trade offsets are often in a legal gray area. As already discussed, the WTO/GATT allows offset for security related deals. It is argued that arms trades do not always follow clear measures of free trade and competition as the decision is most often based on other criteria, strategic partnerships with other nations for example. The same is true for arms trade offsets, where additional costs of up to 20 percent of the original price of a system are justified by the possibility of maintaining a nation's own defense industrial base and defense technology transfers.

The question is whether a focus on additional employment is within the boundaries of these exceptions. A report by the order of the European Defence Agency came to the conclusion that 26 percent of all offset deals were awarded to civilian industries (Eriksson et al. 2007, 20) and were therefore not defense related. While this was legal at that time in the participating member countries of the European Defence Agency¹², one could argue that the decision for arms trade offsets were not based on issues of defense but were efforts by public officials “without regard for the public interest in order to achieve a specific kind of private gain – re-election to public office” (Yingling 2013, 263). While this could therefore be defined as unconventional corruption (in contrast to conventional corruption where illegality is a necessary condition)¹³, it is also true that additional employment is an ancillary effect of most trade interactions and - though used to promote a public support for arms trade - is not per se the main reason for these deals. Also, the focus on aspects where the public opinion is more likely to be positive is very common in general and not considered illegal. The previously mentioned allegation in the Polish procurement is insofar questionable as politicians in the United States use the same arguments within their own campaigns for arms deals¹⁴.

TOOLS TO FIGHT CORRUPTION

Based on the comprehensive analysis of articles, a typology of different allegations of (conventional) corruption in defense offsets was made. The question that remains to be answered is whether or not governmental agencies employ tools that would be useful in identifying or fighting these types of corruption. A growing number of academic papers have focused on aspects of how to fight corruption, and different strategies have been widely discussed in academia, however the majority of this topic occurs in the policy papers of international organizations such as the World Bank or the OECD, indicating that more comprehensive non-partisan studies must be conducted.

The overview of cases of corruption in Table 1 shows that two possible scenarios in particular seem to happen when a governmental agency is involved. Either, a civil servant is privately linked to a company and is therefore favoring it over other competitors, or, the civil servant gets a bribe from a company and is misusing his power usually by misinterpreting or manipulating performance data. These findings are concordant with two of Robert Klitgaard’s drivers of corruption (1991): the possibility to work within a network (private linkage) and the absence of accountability (misusage of performance data).

Most of the cases of corruption in offsets exhibit the problem of lack of transparency. Klitgaard’s discretionary power is insofar a real problem for corruption in arms trade as it leads to a complexity that does not allow for explicit verdicts. Therefore the question of transparency has to be further discussed as well.

Networks and Due Diligence

As the analysis of cases shows, the usage of arms trade offsets to bribe public officials has been one - if not the - major allegation in recent years. While there are several newspaper articles that do not explain the process of bribery, and overall prompt more

befuddlement than deep insight, they do identify some very specific problems. This is especially the case when a company, personally associated with public officials, is a beneficiary in the second phase of the offset process. This has for example been the case in South Africa, where politicians have not just been shareholders of offset beneficiaries (February & Calland 2011), but where public officials have taken over a leading position in a defense company right after their term in office and during the fulfillment phase of the offset obligations (Mitchell 2008). In a very recent report, Transparency International, together with one of the biggest arms trade offsets industry associations, explicitly tackled the importance of due diligence (Fluker et al. 2012). Based on a survey of 27 defense suppliers, the report gives a short overview of due diligence practices of companies that have offset obligations. While most of the mentioned aspects, such as the use of questionnaires for prospective partners or the role of due diligence for offset brokers, target the role of companies, the interviews with suppliers showed the need for a stronger use of due diligence instruments on the side of the government. The report does not define the term due diligence as such, but it especially mentions aspects of corruption risk awareness within companies. Transparency International's first report on corruption in offsets gives a recommendation specifically for governments, stating that they "should require due diligence to be carried out to ensure that no member of the government or official will benefit improperly from any offset contract, and to ensure that all potential conflicts of interest by officials, military officers and Parliamentarians are disclosed" (Magahy et al. 2010, 4). The problem seems to be the reactionary approach by governments when it comes to the use of such practices within a procurement rather than during the hiring process of public servants. First, even though the linkage of public officials to specific defense companies that could become offset beneficiaries may be widely known within the government, it is not proactively examined or required pre-employment information. Second, while a growing number of companies exist that do conduct very strict due diligence processes, this is not the case for all companies. As a due diligence process is not a required part of most offset proposals, companies which voluntarily or by legal restrictions (such as U.S. companies under the Foreign Corrupt Practices Act) invest additional resources for these aspects are not rewarded for their anti-corruption efforts. Also the very small number of academic literature on due diligence in public management focuses only on the audit portion and does not discuss earlier aspects of due diligence within procurement processes overall¹⁵.

Absence of Accountability and Performance Management

One of the main allegations of corruption in South Africa, as well as other countries, has been the promise of additional jobs for the domestic industry. For example, in the South African case the foreign supplier offered offset obligations worth 104 billion Rand (approximately 17 billion in 1999 USD), which equates to a sum three times as high as the procurement contract volume. It was suggested that this sum would create approximately 65,000 jobs. While this number implies an extreme example of overestimation, this is hardly the case when realizing that each of these jobs was projected to cost more than 20 times as much as an average job in South Africa's defense industry at that time (Dunne & Lamb 2004, 288). Due to a lack of data, it is not possible to calculate the exact number of jobs created with the industrial participation program in South Africa, but

the number is most likely not even a third as high as estimated. Several articles have claimed that the proposed number of jobs has been a “sweetener” (Unnithan 2005) for the procurement act and a “key motivation” (February & Calland 2011) for the entire deal. Unfortunately, this analysis is based solely on newspaper articles, and it is not evident if the proposed number of created jobs was part of the South African contract. For a country with an unemployment rate of approximately 30 percent at that time (Dunne & Lamb 2004, 288) such an offer was certainly more than welcome, but usually an offset contract only contains a defined financial volume. Moreover, it is possible that this number was defined and used by the government to promote the arms procurement by explaining not only the strategic military reasons, but also a positive economic side effect. In reality, the supplier was not able to fulfill the public’s expectations.

Another allegation in South Africa was the usage of multipliers from an original investment to accrue the offset credits (Ensor 2012). Unfortunately, this case is also not defined any further in the articles, but the potential allegation is/was that the company did not need to invest the complete offset obligation into the country. While to the public this seems to be a clear manipulation, it is a common practice in most offset transactions. A majority of countries use multipliers up to the factor ten (Friedli et al. 2009). This means that an investment of one million is counted as offset deals worth ten million. The reason for this is that offsets happen most often with companies that lack the specific knowledge of how to produce a commissioned part. Multipliers are then used to award the technology transfer or the production support of the domestic company by the foreign supplier.

Both given examples, employment creation and multipliers, contain estimates that can be used, in the worst case, to misleadingly overestimate the value of offset deals and, in the best case, to further complicate the process and decrease transparency. While it could be said that some allegations were nothing more than misunderstandings by the media, they also show that the usage of indicators is always dangerous. In both cases, the allegations led to further (parliamentarian) investigations with, unfortunately, unreported conclusions.

A recent study of a specific offset example in Switzerland (Platzgummer & Gonzales Lozano 2013) suggests that companies tend to overestimate their offset obligations especially after a phase of underestimated obligations claiming. The reason for this is likely due to the company realizing that the country’s generally weak defense industrial base can only handle a specific amount of offsets at the same time,¹⁶ and that the fulfillment is to be at risk overall. The foreign company is often put under pressure by severe penalties of up to ten percent of the whole offset obligation (Friedli et al. 2009) which increases the risk of corruption. Even with very basic performance evaluation tools that only provide an analysis of the claimed financial volumes, phases of achievements below the average could be detected very easily. The governmental agency should not only have an overview of the already achieved volume but should also be willing to warn the foreign company in such cases. This could prevent cases of corruption.

These cases show that even a very simple performance management and audit system, containing only input and output measures, would allow an agency to detect the majori-

ty of corruption scenarios. So there is not really a need to develop new frameworks or performance management systems. Instead, efforts are best spent to ensure that a basic performance management system is used and that the results are audited internally. One possible problem with the use of performance management tools could be the personnel structure of the offset agencies. While contracting requires a high knowledge of legal aspects, performance management would require managerial know-how. Yet, it is more likely that within budgetary restrictions in governments, contracting – as the ultimate base of every offset deal – seems to be more important. So hiring lawyers is favored over hiring managers.

A more fundamental aspect of performance management that should be discussed further is the prioritization of politically adequate objectives. While the use of additional employment numbers as a major benefit seems understandable, especially from a politician's point of view, it can be seen as unconventional corruption, as mentioned previously. Additionally, these objectives are very hard to measure correctly and are – as shown in the case of South Africa – ignored by the agency responsible for the performance management. This is especially the case when the agency is already understaffed.

Transparency and Media

The biggest problem with offsets seems to be the fact that they lack transparency and increase the level of complexity. More than once, unspecified allegations were made that may or may not be seen as cases of corruption. An example of such a case is an allegation in Portugal stating that offsets were claimed for already existing investments worth 34 million Euros (February & Calland 2011). While this seems to be a perfectly clear case of corruption on the surface, it does not necessarily constitute one. Most countries offer the possibility of 'banking' offset credits. This means that a company is allowed to claim a specific amount of deals that have been contracted with offset beneficiaries before the offset agreement is signed. The reason for this is that government procurements can be postponed due to tax cuts or political changes. Also, due to tight production schedules and a high probability that national companies need some time to build up the specific necessary knowledge, governments tend to award first offset contracts to national companies as soon as the competition ends, but before the offset agreement is discussed and signed. For example, Switzerland is allowing 20 percent of banking credits in the current jet fighter procurement due to a political adjournment of the procurement process (Maurer erwägt Verzicht 2012). Again, this is a possible excuse for the allegation but it does not have to be the ultimate reason. Chances are that the acceptance of this offset claim by the governmental agency in Portugal can still be a case of corruption.

While these cases lead to a lot of discussions, the solution to increase transparency is relatively easy. In 2008 the European Defence Agency launched the Code of Conduct on Offsets (EDA 2011). While the document does not include important political aspects on offsets, it has at least increased transparency. For example, all 25 participating member states have to publish their offset policies on the EDA webpage. With this, future cases, such as the aforementioned Portugal banking case, could be clarified quickly.

A second allegation that is frequently made in the media is that offsets are “not bribes, but pretty damn close” as U.S. Senator Russ Feingold mentioned in a speech asking the U.S. Justice Department to investigate on McDonnell Douglas Corp. offset practices (Sennott 1996). Even though offsets are used as marketing tools within procurement competitions, most countries demand them very actively. One of the major accomplishments of EDA’s code of conduct was the confinement of offset obligations to no more than 100 percent. Prior to this code, several countries in the European Union were demanding up to 200 percent offset obligations in defense procurements. These volumes were so high that some of the companies could hardly implement them in the few defined years of the offset agreement. An additional problem here is the double standard provided to foreign suppliers, especially from the United States. While actively asking for political support to ban arms trade offsets at home, they have to promote the advantages of their own offset packages within their proposals abroad. In a globalized world, this leads to a situation where the company is sometimes confronted with allegations of bribery overseas, allegations that they were themselves using to ban offsets at home.

Also, the lack of knowledge regarding offsets and the dishevelment of the allegations imply the need for an increased transparency. In several cases, the terms *offsets* and *barter*¹⁷, or *direct* or *indirect* offsets (Pubby 2012) were confused or ambiguous definitions were used. One allegation went so far as claiming that in “Bulgaria, one of the EU’s most corrupt countries, the government set up a special offset office in the Ministry of Economy” (EU code 2009), suggesting that this is in and of itself a case of corruption. Also the report by Transparency International includes several aspects where a differentiation between corruption in the ‘normal’ procurement and corruption in offsets is not possible¹⁸, which decreases instead of increases transparency within the report.

Another main factor of confusion is the United States government. From the point of view of the biggest weapons exporting country, it is comprehensible that offsets are everything but favored as they force U.S. companies to alter already existing supply chains and invest in less competitive foreign countries. It seems that members of the U.S. government use the terms “offset” and “corruption” in the same sentence as a matter of principle, for example: “Offsets are nothing more than economic bribe” (Hunter 2004), they seem to be “a way to bribe other countries to do something” (Tolchin 1987) or they “foster corruption” (Intelligence Online 2008). These arguments would be taken more seriously without a Buy American Act, which include the same goals and principles as offsets.

What this part of the analysis shows is that governments should increase transparency within offsets. This could be accomplished through explicitly dedicated information portals, such as that of the European Defence Agency, which offers at least transparent policies and some basic information. It could also be provided through specialized education in the form of workshops for journalists or special interest groups who focus on defense and security topics. Both options would lead to increased transparency even within tight budgetary restrictions of such governmental agencies.

A more general question that should be asked is whether there is really such a “big lack of transparency in offsets” (Pressly 2011). The problem with this allegation is that there

are very different notions of transparency. Regarding the fact that offsets are part of a governmental procurement that involves defense goods, offsets are not more or less transparent than the rest of the procurement. Taking into consideration that private companies are not usually asked to disclose their complete supply chain to everyone (including their competitors), the lack of transparency seems to be relatively small. Also from the WTO's point of view, a view that clearly supports free trade and competition in a market, transparency is not really missing. According to article XVII of GATT, both contracting partners can request information about the specific operations that can impact procurement¹⁹.

CONCLUSIONS

This paper had the intention to give an overview of known types of corruption in offsets and analyze whether tools exist to identify or even fight some of the previously defined types.

What can be seen so far is that a relatively manageable number of different (known) types of corruption in arms trade offsets exist. Furthermore, a narrow focus on the first part of the offset process from the earliest request for proposal to the date of the contract agreement cannot highlight all cases of corruption and should therefore be reconsidered. So far, the discussion of corruption in offsets has generally focused on the problems concerning the transparency and complexity of arms trade offsets. Still, by using already existing management tools, a better part of potential cases of corruption can at least be observed. The main problem is that more or less all of these specific governmental agencies do not even use basic performance management and are highly influenced by other stakeholders, especially political actors, to use immeasurable indicators such as additional employment factors. Additionally, offsets agencies need to deal with a very negative prejudice. It is important that government officials responsible for offsets know that there is a danger of corruption, and it is even better when they are able to flag potential risks within the process, but a closer cooperation with journalists or special interest groups such as Transparency International could also help defuse the negative connotation offsets have to face. Governments could increase transparency and also encourage the use of performance management tools for offsets without the implementation of new tools and with relatively low costs. The introduction of due diligence, another relatively low cost anti-corruption tool could – in combination with performance management – also ameliorate the situation for governments as well as for companies.

As the main intention of the paper was to give an overview of the usage of anti-corruption tools, some other aspects were only discussed superficially. With the introduction of stricter rules and regulations of offsets within the European Union, the discussion of conventional and unconventional corruption could be of further interest. It

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seems that the containment of offsets with the civilian industry is an attempt to decrease forms of unconventional corruption.

Also, the literature review for this paper showed that there is a lack of comparative studies within the area of performance management. While a number of single case studies on the implementation of performance management instruments exist, hardly any research has focused on case-comparison. Additionally, public management is focusing – at least in this area – on successful cases, and is ignoring closer looks at the failures of performance management.

NOTES

- ¹ A good definition can be found in Martin (1996b).
- ² See Hartley (2008) for a discussion of technological benefits from offsets in the case of Eurofighter Typhoon.
- ³ Specific discussions have only been held on the case of South Africa (see for example Dunne & Lamb 2004) and (partially) on Saudi Arabia (Marshall 2012).
- ⁴ An advanced Boolean search was conducted with the following keywords and Boolean connectors: (offset* OR countertrade OR barter OR “industrial participation”) AND (defen*e OR military) AND (corrupt* OR bribe)
- ⁵ Australia AU, Czech Republic CZ, Greece GR, India IN, Indonesia ID, Poland PL, Portugal PT, Saudi Arabia SA, South Africa ZA, South Korea KR, Thailand TH, United States of America US.
- ⁶ For example: Kilaz & Hayri (2011), Magahy et al. (2010), or Dunne & Lamb (2004)
- ⁷ South Africa bought 70 JAS Gripen from BAE/Saab and got offered 110 billion Rand, an equivalent of roughly 16 billion USD, in offsets that were said to lead to 65'000 new jobs.
- ⁸ This was especially the case for articles on political discussions in the United States.
- ⁹ The term “threshold” should not be confused in this context with “threshold effects of corruption” (e.g. Bose et al. 2008) which is a more common use in academic discussions.
- ¹⁰ See Hsieh & Shannon (2005) for a good introduction to this method.
- ¹¹ WTO/ GPA Article XVI-1: Entities shall not, in the qualification and selection of suppliers, products, or services, or in the evaluation of tenders and award of contracts, impose, seek, or consider offsets.
- ¹² The European Commission has since then published the new *Directive (2009/81/EC) for defence and security procurement* which excludes non-defense related offsets in Europe and in contrary to so far existing non-binding agreements such as EDA’s *Code of Conduct on Offsets*, “the question of whether or not the provisions contained in Article 346 TFEU are fulfilled may be decided in court” (Weiner 2012, p. 17).
- ¹³ For further discussion see the very interesting article by M. Patrick Yingling (2013)

- ¹⁴ See for example the U.S. KC-X program in which Boeing argued that the decision for their aircraft would lead to the creation of 50'000 new jobs (Martinez 2011).
- ¹⁵ See for example: Glynn & Murphy (1996, 133).
- ¹⁶ For example with on average 300 million Swiss Francs offset obligations are responsible for more than ten percent of the annual volume of the entire defense industrial base in Switzerland (Eisenecker et al. 2012). Regarding the fact that most offset suppliers are not able to work with the whole industrial base from air system to land- or even sea system producer, suppliers should try to achieve a relatively balanced allocation of annual obligations.
- ¹⁷ See for example: Pressly (2011), AFP 1999 or Copley 1985.
- ¹⁸ See for example the case of Taiwan in Magahy et al. (2010).
- ¹⁹ For a further discussion see the very interesting article from Robert Howse (2010).

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