

Building Integrity and Reducing Corruption in Defence

A Compendium of Best Practices



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Chapter 8

Offset Arrangements

Building integrity and reducing corruption risk in defence acquisition covers many specialist areas: from the way that technical specifications are developed, to the evaluation process, through to the way Defence Ministry procurement functions are organised. In most of these subject areas, there is increasingly a reasonable body of knowledge on what constitutes good integrity practice. Yet in one area—offsets—there is remarkably little scrutiny and very little discussion or development of good practice, despite the large and rapidly growing part that offset packages play in modern defence acquisition.

Transparency International's (TI) assessment is that offsets are a major corruption risk, even in the most developed nations. In TI's experience, defence officials from many countries also share this view, while governments are not properly managing this risk today. There is an urgent need for a concerted effort by industry and governments internationally to set and enforce a much stronger regime of transparency and integrity standards related to offsets.

This chapter starts with a brief discussion on current offsets usage. It then outlines specific corruption risks and the experience to date in examining offsets contracts. The final section presents what are currently considered minimum standards of good practice.

Current Offsets Usage

Offsets are broadly defined as compensation practices that are required as a condition of a purchase of equipment or services from a foreign company. They are separated into direct offsets, which are contractual arrangements that involve defence and articles and services referenced in the sales agreements for military exports, and indirect offsets, which are articles and services unrelated to the defence items or services in the sales agreement.

Offsets started in Europe after 1945 as one way to help restore the European economies after World War Two. They are used almost exclusively in defence deals. Nowadays, most countries require offsets to a value equivalent to 100% of the main contract value. At the upper level are, for example, Austria at 174% and the Netherlands at 118%. At the low end are countries that seek to discourage offsets, for example Taiwan at 20% or Thailand at 27%. In aerospace, countries will generally only demand that up to 20% of the offsets package be direct. Most offsets are indirect; the average from 1995 to 2005 being 60% indirect vs. 40% direct.

Their use has been growing substantially over the last ten years. The offset value has gone from an average of 49% of contract value in 1995 to 103% in 2005. Large defence companies have sizeable offset departments and extensive obligations. Lockheed Martin, for example, one of the largest defence contractors, has some US\$19 billion of offset obligations across 12 countries.¹

Furthermore, there are moves in a number of countries, e.g. India, Brazil, to extend the use of offsets outside of defence purchases to other areas of government spending.

Weighting of Offset Packages in the Tender Evaluation

There is a wide range of weightings, ranging from 60% in a country such as Turkey to 40% in Canada, down to 10–15% in countries where the Defence Ministry is seeking to limit the influence of the offset package on the choice of the defence equipment.²

Overhead Costs of Offsets

There is a dearth of information on the true costs of offsets. Offsets tenders do not require the cost to be separately broken out or identified. TI has observed data ranging from an average 5–8% uplift over the main contract costs in one Defence Ministry, through to figures of 15–30% uplift on the main contract cost for specific large contracts in other countries.

In addition to that are the costs of managing offset arrangements in the purchasing country, e.g. to sustain an offset office and its personnel.

Benefits of Offsets

There is a considerable debate among defence economists concerning the actual benefits of offsets. The dispute is rendered unanswerable by the almost total lack of economic analysis of the impact of offset packages, together with the lack of publicly available data on the performance of offset contracts. As Steve Schooner, dean of procurement law at George Washington University put it recently:

There is currently broad consensus on issues such as the need for transparency, integrity, and accountability in defence procurement. Yet on the offsets issue, consensus is a long way off. There is no agreement internationally, and countries are nowhere near reaching one. As an example of how far away agreement is, the EDA Code of Conduct comically seeks at once to increase and decrease offsets. Similarly, the World Trade Organisation says offsets are bad and bans them in other sectors, yet it says they are ac-

¹ *Building Integrity and Defence Institution Building*, Conference Report (Monterey, CA, 25-27 February 2009), 91.

² Ibid., 91–92.

ceptable in defence. Nor is there agreement at national levels. The US derides offsets, yet maintains a “buy-American” policy in defence... Therefore much of what can realistically be done is simply to try to improve the process of offset management, while slowly moving towards consensus over whether offsets should exist at all.³

There is a growing understanding that whatever the merits of offsets, a minimum and necessary first step is that they be transparent and contracted for in a way that satisfies all reasonable integrity standards.

Political Dimension of Offsets

For governments, offsets can offer an opportunity to ease the politics of major defence spending. They seem to promise technology transfers, research and development and an enlarged industrial base, alongside investment and high-skilled employment. The politics of the offset purchase can overshadow completely the need or the desirability of the military acquisition. This also creates a significant tension between the two different parts of the government involved – usually the Finance or Economics Ministry supervising the offset purchase and the Defence Ministry purchasing the military asset.

Offset Corruption Risks

Offset corruption risks are revealed in publicly available commentary and allegations in official reports, academic research and interviews conducted by Transparency International, and in newspaper articles.

EDA Report on Offsets

The European Defence Agency commissioned a team to research the phenomenon of defence offsets, with particular reference to the effect of offsets on the development of a European defence industrial base. The result was a major report on offsets, published in July 2007. While corruption risk was not the main focus of the paper, the authors discovered unease with the opportunities for corruption afforded by the opacity of offsets packages. The report states:

Finally there is an aspect that did feature in some interviews. This is the issue of corruption in relation to defence contracts and its real or alleged links to offset. This is not a property of offset *per se*, but it seems indisputable that opaque and un-professional offset implementation provides scope for corruption potentially leading to another system being chosen than would have occurred in an open and transparent market. It was a recurring story in interviews how old offset practices have been found insufficient and subsequently replaced. Even though in particular pMS [participating Member State] representatives naturally claim that their current offset practices are well functioning, it is our

³ Ibid., 97.

impression that the transparency and professionalism of offset practices vary widely between pMS and that there is considerable scope for improvement.⁴

Academic Research

The Centre for International Cooperation and Security, in its report "The impact of arms transfers on poverty and development," argued that:

Another potential avenue for corrupt practices is through "offsets." Earlier the role of offsets was considered in terms of the impact of arms transfers on military expenditure. But it is important to also consider whether offset packages can help conceal large bribes or commissions, or whether they unduly influence a country's decision when procuring weapons. Offset packages "have a reputation for raising the cost of a deal by around one-fifth; being difficult to monitor; failing to bring the benefits promised at the time of sale; and contributing to corruption." Offsets can also help feed into domestic corruption relationships as contracts can be channelled through local firms chosen for their political connections. In the South African deal, subcontracts with local firms allowed further opportunities for officials to line their pockets.⁵

There are various academic analyses of the economic impact of offsets, at least one of which considers related corruption risk.⁶ Trevor Taylor's aim was to consider whether procurement officials made decisions as to the requirement for and form of offsets packages according to economic rationale or political rationale. It is an empirical paper based on transaction-level data to estimate the models, and forms a cross-section study across a range of countries worldwide. His results suggest that while government procurement officials select offsets according to economic rationale, political economy variables are also very important. Some offsets agreements see economic variables (like price, quality, transaction costs and industrial development policy) dominate political variables (such as bureaucrat maximisation, national security considerations and interest group theory). In other circumstances, however, the attributes of the offsets package may reflect political priorities. He concludes as follows:

A recommendation to address such corruption would begin with efforts to increase the transparency of offsets. For example, each country should employ a group of

⁴ E. Anders Eriksson with M. Axelson, K. Hartley, M. Mason, A.S. Stenérus and M. Trybus, *Study on the effects of offsets on the Development of a European Defence Industry and Market* (Brussels: European Defence Agency, 2007), 46, www.eda.europa.eu/Default.aspx.

⁵ Mike Bourne, Malcolm Chalmers, Tim Heath, Nick Hooper and Mandy Turner, *The Impact of Arms Transfers on Poverty and Development*, Centre for International Cooperation and Security (University of Bradford, September 2004), 44, http://www.brad.ac.uk/acad/cics/publications/AVPI/transfers/AVPI_Arms_Transfers_and_Poverty.pdf.

⁶ Trevor K. Taylor, "Modelling Offset Policy in Government Procurement," *Journal of Policy Modelling* 25:9 (2003): 985–98.

independent, outside auditors that would assess the merits of each offsets proposal, and then perform the detailed ex post benefit-cost accounting. This benefit-cost accounting should be published and subjected to external scrutiny.

TI Public Interviews with Defence Experts

Frank Boland, director, Force Planning, Defence Policy and Planning Division, NATO:

Offsets have become popular, because at first glance they appear to be a good deal for governments. If they are spending money on imports, then offsets allow governments to try to recoup foreign exchange – so one can see the attraction... [However] it has been the case that many offsets simply do not materialise. The real problem is that offsets distort decision making. Militaries may want equipment for particular needs; offsets allow for procurements to be overridden by extraneous considerations.⁷

Ghanim Al Najjar, senior professor of political science, Kuwait University:

Offset programmes are supposed to transform new projects in Kuwait as part of the repayment. Offsets are not even nearly functioning. Nobody really knows what is happening with offsets. Most of the money that was allocated has not been spent. Is there any oversight of offset delivery? Not exactly: there isn't much money that has been spent so far. I don't think there is good supervision of it. People are waiting to see how effective the offset programme will be in terms of local projects, but often it is the case that the procedures are complex, or the programme is not paying much. Sometimes, the money which is supposedly allocated is there but not supervised.

Even when there is no suspicion of corruption, offset practices often raise a number of concerns, such as:

- Lack of clarity on how offset proposals will be evaluated;
- No clear national strategy as to what the offsets should achieve;
- With more than one ministry involved, because of the offsets, there is huge scope to lose control of the procurement and its proper evaluation;
- Offsets negotiations with bidders being initiated only after the contract is awarded;
- Inadequate offset oversight mechanisms pre and post contract award (including life of offset programme and applicable to prime and sub-contractors);

⁷ Interview published in Transparency International Defence Anti-Corruption Digest, No. 17 (June 2007), www.defenceagainstcorruption.org.

Box 8.1. Newspaper Allegations of Corruption in the Use of Offsets

Portugal: The Central Department of Investigation and Penal Action (DCIAP) is investigating the offset contract for the purchase of two submarines to the German Submarine Consortium. With a value of 1210 million, the offset contract, whose goal is to ensure the fulfilment of that value on investments made in Portugal, was negotiated with the Ministry of Defence by Escom, company of the Group Espírito Santo (GES) that was targeted in Portugal's process.

South Africa: The South African arms purchase in 1999 has been controversial both for various allegations of corruption involving European firms and senior South African politicians. While the South African government has repeatedly highlighted the offsets agreements attached to their arms purchases, the media has been far more sceptical – *Business Day* complained in February 2008 that the success of the offsets packages has been difficult to establish independently as their requests for information were rejected on the grounds of commercial sensitivity. ThyssenKrupp, who have been under investigation by South Africa's elite serious crime squad over allegations of corruption in the sale of the frigates, have been reported to have fallen behind in their offsets programme. However, the clearest links between corruption and offset have been reported in relation to the purchase of Gripen fighters from BAE and SAAB. The South African *Mail & Guardian* reported on 20 March 2008 that the defence minister at the time of the purchase, Joe Modise, secretly received shares in the Conlog/Log-Tek electronics group, which stood to benefit substantially from arms deal offset agreements.

Czech Republic: In the Czech Republic, there was another case of purchase of Gripen fighters being investigated for bribery with questions raised over the offsets package included in the deal. Investigations centred on payments to senior Czech officials allegedly made in 2001 and on the structure of the tender, which competitors for the contract withdrew after complaints that the government had intentionally drawn up a contract that would generate a victory for the Gripen fighters. The offsets deal that accompanied the package was also criticised at the time of purchase as being illusory, with two finance ministers at the time resigning for this reason.

UK and Saudi Arabia: The Al Yamamah contract negotiated in the 1980s between the UK government on behalf of BAE and Saudi Arabia is the largest export in UK history and a continuing source of controversy. The contract contained a well-known offset clause whereby some of the revenues generated by BAE from the contract were reinvested into the UK defence industry; the offset has been reported to have had few discernible benefits. Amongst the US Department of Justice's concerns, the offsets clause was reported to be part of the investigation.

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

Romania: In the Romanian purchase of two frigates in 2003, allegations emerged as to the payment of commissions. The crucial part of the investigation focused on irregularities in the contract and lost funds centred on the offsets package. In June 2006, the *Bucharest Daily News* reported that "the real stake appears to be the implementation of the off-set contract."

Under this contract, BAE Systems was to use 80% of the acquisition sum to buy products and services from Romania in a combination of direct and indirect offsets. The offsets have continued to prove controversial, as the *Jurnalul National* reported in September 2003 that the Romanian Ministry of Defence intended to take BAE Systems to court if the company did not fulfil its obligations under the offset agreement. The report also stated that the deal remains under investigation in the UK by the Serious Fraud Office.

Taiwan: In an article in *Defense News* on US concerns with defence procurement processes in Taiwan, corruption and payments paid to officials were highlighted as major problems with defence deals. Amongst the recommendations for improving processes, there was reported to be broad agreement that tackling corruption would require commissions and offsets to be either tightly controlled or ended altogether.

Sources: "Arms deal crusader is back in court," *Business Day* (25 February 2008), <http://www.armsdealvpo.co.za/articles12/crusader.html>; "Arms probe reopened," *Mail & Guardian* (20 March 2008), www.mg.co.za/article/2008-03-20-arms-probe-reopened; Jeremy Druker, "Czech-BAE corruption probe worries Prague," *ISN Security Watch* (27 February 2007); "Israel Police Raid IAI," *Defense News* (30 September 2005); "Romania Will Sue BAE Systems for Breach of Contract," *Jurnalul National* (03 September 2007); "U.S. Warns Taiwan: Clean Up Defense Procurement," *Defense News* (11 September 2006).

- Inadequate or even non-existent penalty mechanisms for not delivering agreed offset obligations;
- Inadequate processes for legal oversight, mediation, and litigation;
- Inadequate timeframe to allow bidders to prepare offset packages;
- Too diverse offset options, with no precise requirements and clear selection criteria;
- Many offset option elements fall outside the expertise of potential bidders;
- Lack of experienced personnel to evaluate offset options; and
- Members of oversight committees lack the expertise to assess offsets proposals and implementation.

Specific Corruption Risks of Offsets

There are three specific corruption risks related to offsets:

Improperly Influencing the Need for a Capability

The choice by government of what is needed—or even *whether* a capability is needed—can be influenced by the other “goodies” that can be on offer in a defence

purchase. Defence purchases are rarely a simple economic purchase. They often have an international political dimension in which the purchasing nation is also hoping to deepen political relations with the supplying nation. They also often are large enough to have an impact on the domestic political agenda. In such cases, the offer of a raft of apparent free goods can influence local politics in favour of the purchase. Further, an attractive range of additional benefits can make an otherwise unattractive product seem attractive. This was alleged to be the case in the Czech Republic, where there is ongoing questioning of the need for the fast jets in the first place, and South African arms deals, which have been dogged with suggestions of purchasing the wrong platforms and of illegality.

Influencing the Competitive Decision in Non-Transparent Ways

It can be unclear, sometimes deliberately so, just how the relative merits of the bidders offset packages are balanced against the other decision criteria. Just how are offsets merits balanced against economic, technical and other criteria? This is hard to do given the very different nature of the criteria. There have often been allegations of this having been improperly done, for example in the South African arms purchase.

Allowing Favours to be Repaid

Offsets arrangements are often commitments that are not centred on until sometime after the award of the contract. They can then take years to be fully established. Through this time delay, and the usual lessening of political and media scrutiny, there is scope for opaque deals and the return of favours that helped ensure the award of the contract. The offset contracts are also often poorly monitored, so that the chances of uncovering such corruption are poor.

Reducing Offsets-related Corruption Risk

There are two broad choices in addressing these risks: 1) abandon the use of offsets in defence contracts; or 2) greatly strengthen the controls and oversight surrounding them. Such controls need to be in place throughout the life of the offset programme, even if it is for 20 years or more.

There are some signs that the issue of corruption risks of offsets is being addressed, as the following examples indicate:

- The practice whereby offset negotiations happened only after awarding a contract has changed dramatically in the past couple of years. More and more countries are now requiring the offset agreement to be negotiated and finalized prior to the signing of the procurement contract. Industry experts anticipate that this trend will continue, where it will become the standard condition of a country's offset policy rather than an exception.

- The formal regime of penalties for non-performance is becoming stricter. In a large majority of countries, penalties range from 3%–10% of the unfulfilled balance offset obligation at the various milestone periods, at the end of the performance period or both, while a few apply the penalty to the sales contract value. What is changing is the form of these penalties. Normally they are in the form of liquidated damages – meaning that when you pay the penalty it “liquidates” or satisfies your remaining obligation. More recently, according to industry offset experts, many countries are moving toward non-liquidated damages, which means that you must pay the penalty and still fulfil your offset obligation or face possible blacklisting from future government procurements until the obligation has been satisfied. In addition, the defence contractors are normally required to issue a performance bond upfront to cover the potential penalties. The performance bond value is reduced in proportion to the receipt of offset credits by the defence contractor in satisfaction of the offset obligation.
- In May 2008 at its main annual meeting, the Global Industry Cooperation Conference—organised by the major offsets associations—started a discussion on corruption risks related to offsets and the ways to prevent corrupt practices.
- An offset workshop during a major NATO conference on “Building Integrity and Defence Institution Building” held in Monterey, California in February 2009, brought together senior defence officials and senior representatives from major European and US defence companies. They made a number of proposals to NATO that are under consideration.

These are important steps towards a more comprehensive approach to reducing corruption risks of offsets, which would be based on:

- Raising transparency and improving reporting;
- Strengthening accountability and integrity;
- Good functional processes;
- Disclosure of conflicts of interest; and
- Proactive engagement by the key players.

The suggested improvements and proposals in each of these areas, taken together, would constitute good practice. The reader should be aware though that integrity in offsets tendering is such a new subject that many of the suggestions, whilst seemingly useful and constructive, have yet to be implemented and tested on a sustained basis.

Transparency and Reporting

The bid specification should require that bids be submitted with two prices: one with the offsets package and one without the offsets package. This proposal is in line with a draft recommendation from the aforementioned "Building Integrity and Defence Institution Building" conference:

Enhancing and increasing transparency in the process of developing, implementing, and managing offsets programmes, with transparency understood to include consideration of the true cost of offsets on the part of governments, governments to seek tenders which both include and exclude proposed offsets programmes so as to allow appropriate considerations of the costs and benefits of the offsets packages, and which take into account the goals and objectives of the country's intentions for their offsets programmes.⁸

There should be a requirement by the government for a detailed report each year on the performance against the contracts of all the offsets contracts that have been entered into in relation to each major acquisition. This report should be published, which is generally not the case today.

The government should publish the criteria for the evaluation of the main contract and the offset package, including the detailed weightings given to each element and the weightings achieved by each of the shortlist bidders. This is not yet common practice.

There should be a definite requirement for an independent evaluation of the costs and expected benefits of the offsets package, to be completed some 2–3 years after the contract award. The evaluation should be published, which almost never happens at present.

Civil society scrutiny can be a good way of bringing non-transparent aspects of the proposals to light. The government should actively seek to involve civil society in a discussion of the proposed offsets packages.

Strengthening Accountability and Integrity

Defence budgets and actual defence spending are analysed by a national audit office and presented to parliament or the supreme decision-making body in most countries. The same level of independent scrutiny should be applied to all offset deals.

Given the risks of contracts being passed to companies to reward favours or to benefit related individuals, there needs to be stronger conflict of interest disclosure by all those related to the acquisitions and a requirement for wider due diligence on the agents and offset brokers involved. The defence industry associations could help by

⁸ *Building Integrity and Defence Institution Building*, Conference Report (2009), 101.

Box 8.2. Transparency in Managing Indirect Offsets

Following the introduction of the requirement for offsets accompanying large defence procurements, in 2006 the Government of Bulgaria created the “Offset Programmes” Directorate with the Ministry of Economy and Energy (MEE). The directorate is responsible for managing indirect offsets.

This directorate created and maintains a webpage at the MEE website (see: www.mee.gov.bgs/offsetp/offsetp.html). This webpage provides detailed information on:

- Offsets related regulations;
- Priority economic sectors where the government invites offsets-related investments;
- Method for factoring an offset project (in calculating its contribution—or *offset benefit*—to meeting offset obligations), depending on the economic sector and technological level;
- Registry of the companies that have expressed their interest and meet the criteria for “offset recipients.” As of July 2009, the registry includes 64 Bulgarian companies;
- A list of offsets proposals, approved by the Ministry of Economy and Energy. Twenty-four investments proposals are listed as of July 2009. The potential investment value is also available to the public. Defence contractors can pick one or more of these proposals to meet their offset obligations;
- Ongoing offset projects, with their net value and offsets benefit (the average multiplying factor for the projects, listed as of July 2009, is about 3);
- A list of offsets agreements with defence contractors, supplying weapon systems and equipment to the Bulgarian armed forces, and the respective offset projects. For each project the webpage provides the net value, the multiplying factor and the offsets benefit, deadline and interim milestones, and a short description.

In addition, the webpage provides links to relevant reports and conference proceedings. The full information on the webpage is available in Bulgarian. The most important part of the information is also available in English at www.mee.gov.bgs/eng/offsetp/offsetp.html.

producing guidance on this (see also the recommendations below on action by industry and associations).

All those involved in tendering, up to and including the tender evaluation committees and the relevant ministers, should be required to submit annual conflict of interest statements.

Good Functional Processes

The lower the percentage weight given to the offset contract in the evaluation, the lower the level of risk. A low weight, e.g. 10–15%, is considered reasonable. Where the weighting is higher, the corruption risks are correspondingly higher and more of these other measures need to be put in place.

Government procurement departments need to recognise that offset contracts are a major undertaking of their own. They are not a simple “add on” to the main contract. A dedicated team should be set up to deal with offsets and ensure that the offset contract preparation receives the same attention as the main contract. Additionally, the lead ministry needs to clarify clearly and in writing before the acquisition process begins the exact split of responsibilities between the ministries involved (if there is more than one of them). The lead ministry should also insist on clear pre-award commitments.

Proactive Action by Defence Companies

Individual companies should apply the full weight of their compliance programmes to the offset programmes and the staff and consultants involved in them. This does not seem to be the case at present.

Second, defence company standards of business conduct and business ethics should be extended to refer *explicitly* to offsets and the need for controls.

Companies may well get a supportive reception if they voice their concerns over the risks to prospective purchasers. Based on our experience, purchasing governments may well appreciate an opportunity to make specific requests and set requirements in respect to offset transparency, if they know they will have the support of at least some of the bidders.

Proactive Action by Industry and Pan-Government Organisations

TI has made a surprising observation: companies with otherwise excellent anti-bribery compliance programmes become reticent on the subject of offset programmes. The same applies to defence industry associations. The following are constructive steps that the industry could take to show its concern in this area:

- Defence Industry Associations should be ready to set standards for well-controlled offset programmes that they expect their members to adhere to;
- They could also produce guidance on the detailed due diligence requirements to be satisfied by offset brokers. This must include a requirement on the companies and the brokers to satisfy themselves that the companies receiving the offset contracts do not have any improper connection to persons in the government or political parties;
- This particularly applies to the European Defence Association (ASD) and the US Aerospace Industry Association, AIA, given the work they are already engaged in to raise anti-corruption standards in international arms sales;
- The European Defence Agency is doing excellent work in the field of opening up defence procurement across Europe. Its approach to offsets however is

contradictory, confusing and weak. Their current code of practice in this area is particularly poor, and, astonishingly, makes no reference at all to corruption risks. EDA should consider reconvening an offsets task force that looks specifically at ways to raise the integrity in the tendering and implementation of offset packages.

Proactive Action by Civil Society and Media Organisations

Offsets have remained a “hidden” topic, despite the risks outlined above. There is clearly a need for civil society organisations that promote good governance and transparency to be more active in this area. Governments that have taken measures to open up the discussion of offsets to such debate are to be encouraged.

Given the increasing scale of offsets and their expansion outside defence into other areas of commerce, it is strongly in the interest of good governance that the subject is more widely discussed in countries.

Conclusions

Offsets are a major corruption risk. They have the potential to divert proper decision making on defence needs and are an easy conduit for rewarding companies and individuals. They are remarkably unregulated and almost entirely opaque.

Industry and government readiness to address corruption risk is in the process of changing for the better. However, corruption in offset transactions remains largely untouched. Governments would best eliminate this risk, and possibly gain better value, if they decide to abandon the practice of seeking offsets. Where that is not possible, both governments and companies can relatively easily take steps to make these transactions more transparent and less at risk from corruption.