



# **NAVAL POSTGRADUATE SCHOOL**

**MONTEREY, CALIFORNIA**

## **THESIS**

**WHAT ISSUES DOES THE CZECH REPUBLIC FACE  
CONCERNING OFFSETS IN THE CONTEXT OF  
MILITARY PURCHASES**

by

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September 2006

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<b>REPORT DOCUMENTATION PAGE</b>			Form Approved OMB No. 0704-0188	
Public reporting burden for this collection of information is estimated to average 1 hour per response, including the time for reviewing instruction, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington, VA 22202-4302, and to the Office of Management and Budget, Paperwork Reduction Project (0704-0188) Washington DC 20503.				
<b>1. AGENCY USE ONLY (Leave blank)</b>		<b>2. REPORT DATE</b> September 2006	<b>3. REPORT TYPE AND DATES COVERED</b> Master's Thesis	
<b>4. TITLE AND SUBTITLE:</b> What Issues Does the Czech Republic Face Concerning Offsets in the Context of Military Purchases			<b>5. FUNDING NUMBERS</b>	
<b>6. AUTHOR(S)</b> PETR PARGAC				
<b>7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)</b> Naval Postgraduate School Monterey, CA 93943-5000			<b>8. PERFORMING ORGANIZATION REPORT NUMBER</b>	
<b>9. SPONSORING / MONITORING AGENCY NAME(S) AND ADDRESS(ES)</b> N/A			<b>10. SPONSORING / MONITORING AGENCY REPORT NUMBER</b>	
<b>11. SUPPLEMENTARY NOTES</b> The views expressed in this report are those of the author(s) and do not reflect the official policy or position of the Department of Defense or the U.S. Government.				
<b>12a. DISTRIBUTION / AVAILABILITY STATEMENT</b> Approved for public release; distribution is unlimited			<b>12b. DISTRIBUTION CODE</b>	
<b>ABSTRACT (maximum 200 words)</b> <p>The word "offset" in the broad sense represents reciprocal economic advantages that result from trade agreements. However, as a result of increasing competition among suppliers due to the reduced global defense market, declining military budgets, and other aspects, buyers are able to influence the conditions under which major defense programs are obtained. Not only unions, defense industries, trade associations, and public, but also EU is involved. The Czech Republic as a member of both organizations has to follow their rules as well, and their views and policies regarding offsets might be different. The objective of this project is to examine what issues, if any, the Czech Republic faces concerning offsets implementation in international trade. This study will discuss briefly the history of the Czech Republic's participation in offsets, and its current policy, if any, towards using offset practices. The Czech Republic's goals in offset practices, and government support for them, would be another area of research. The Czech Republic is an EU member and therefore is obliged to follow policies implemented by these institutions. Whether there is any connection between the Czech government policy and EU policies will also be examined. Specifically, the project will focus on what should be done in future offsets implementation, and what to be aware of.</p>				
<b>14. SUBJECT TERMS</b> Offsets, International Trade, Czech Government Policy			<b>15. NUMBER OF PAGES</b> 103	
			<b>16. PRICE CODE</b>	
<b>17. SECURITY CLASSIFICATION OF REPORT</b> Unclassified	<b>18. SECURITY CLASSIFICATION OF THIS PAGE</b> Unclassified	<b>19. SECURITY CLASSIFICATION OF ABSTRACT</b> Unclassified	<b>20. LIMITATION OF ABSTRACT</b> UL	

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**WHAT ISSUES DOES THE CZECH REPUBLIC FACE CONCERNING  
OFFSETS IN THE CONTEXT OF MILITARY PURCHASES**

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Submitted in partial fulfillment  
of the requirements for the degree of

**MASTER OF BUSINESS ADMINISTRATION**

from the

**NAVAL POSTGRADUATE SCHOOL  
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## **ABSTRACT**

The word “offset” in the broad sense represents reciprocal trade advantages that result from economic agreements. However, as a result of increasing competition among suppliers due to the reduced global defense market, declining military budgets, and other aspects, buyers are able to influence the conditions under which major defense programs are obtained. Not only unions, defense industries, trade associations, and public, but also EU is involved. The Czech Republic as a member of these organizations has to follow their rules as well, and their views and policies regarding offsets might be different. The objective of this project is to examine what issues, if any, the Czech Republic faces concerning offsets implementation in international trade. This study will discuss briefly the history of the Czech Republic's participation in offsets, and its current policy, if any, towards using offset practices. The Czech Republic's goals in offset practices, and government support for them, would be another area of research. The Czech Republic is an EU member and therefore is obliged to follow policies implemented by these institutions. Whether there is any connection between the Czech government policy and EU policies will also be examined. Specifically, the project will focus on what should be done in future offsets implementation, and what to be aware of.

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## **LIST OF ABBREVIATIONS, ACRONYMS, AND SYMBOLS**

BAE	British Aerospace
BIS	Bureau of Industry and Security
CDAI	Czech Defense and Aviation Industry
CPI	Corruption Perception Index
CR	Czech Republic
DIA	Defense Industry Association
DOD	Department of Defense
EC	European Commission
EIA	Electronic Industries Association
EPG	European Participating Group
EU	European Union
ECCAE	European Code of Conduct on Arms Export
FMS	Foreign Military Sales
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GPA	Agreement on Government Procurement
IC	Industrial Cooperation
ICP	Industrial Cooperation Program
IMF	International Monetary Fund
IP	Industrial Participation
MA	Ministry of Agriculture
MFN	Most Favored Nation
ME	Ministry of Environment
MEYS	Ministry of Education, Youth and Sports
MF	Ministry of Finance
MFA	Ministry of Foreign Affairs
MI	Ministry of Interior
MIT	Ministry of Industry and Trade
MLSA	Ministry of Labor and Social Affairs
MOD	Ministry of Defense
MRD	Ministry of Regional Development
NATO	North Atlantic Treaty Organization
NGO	Non Governmental Organization
No.	Number
NSA	National Security Authority
NSS	National Security Strategy
OA	Offset Agreement
OECD	Organization for Economic Cooperation and Development
OGCR	Office of the Government of the Czech Republic
OPEC	Office for Protection of Economic Competition
OT	Offset Transaction
OTV	Offset Transaction Value

PPA	Public Procurement Act
R&D	Research and Development
RDC	Research and Development Council
SAO	Supreme Audit Office
TBR	Trade Barriers Regulation
TRIP	Agreement on Intellectual Property Rights
UK	United Kingdom
UN	United Nations
US	United States
WTO	World Trade Organization

## **ACKNOWLEDGMENTS**

The author wishes to acknowledge a number of different people and institutions who provided either direct or indirect contributions to this thesis. The coaching, guidance, encouragement and mentoring provided by John T. Dillard and Dr. Jomana Amara during the research and writing of this thesis have proven invaluable. Without their keen efforts, this work would not have been achieved.

The access provided by other individuals made a substantive difference that was invaluable in the preparation of this thesis. Mr. Peter Fuzak of the Communication Strategies Department, Mr. Antonin Josefik and LTC Petr Hakl -- long-time Armaments Division officials at the Ministry of Defense (MoD) involved with strategic purchasing, offsets, and writing offset reports -- provided insights and access to early MoD reports. Others, from the Division of Assets Administration at the MoD, provided access to the legal aspects of military sales and purchases. Numerous observers of offsets were kind enough to provide permission to use their unpublished work in offsets in this thesis.

Others who helped affect the outcome of this thesis include librarians at a number of different libraries. Foremost, the librarians at the Dudley Knox Library at the Naval Postgraduate School (NPS), in particular Ms. Ann Jacobson, provided outstanding support. Additionally, the librarians at the National Library of the Czech Republic permitted access and helpful guidance.

The author would like to acknowledge Mrs. Barbara Young, an English teacher at the Naval Postgraduate School, for providing constant help and support to this thesis.

Also, the author wishes to acknowledge the support from professional colleagues and classmates for providing insights to offsets, support and commentary.

Finally and most importantly, the author wishes to express heartfelt appreciation to his dearest wife Monika and their one boy for the many sacrifices that they made during the research and writing of this thesis.

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## **I. INTRODUCTION**

### **A. PURPOSE**

The purpose of this project is to examine what issues, if any, the Czech Republic faces concerning offsets implementation in global defense market. Defining offsets in international trade and its purpose right at the outset of this study will enhance its understanding. A brief history of the Czech Republic (CR) participation in offsets, and its current policy, if any, towards using offset practices will be traced as the next step. The Czech Republic is an EU member and therefore is obliged to follow policies implemented by these institutions. Whether there is any connection between the Czech government policy and EU policies will also be examined. Specifically, the project will focus on what should be done in future offsets implementation, and what interested parties must be aware of.

### **B. BACKGROUND**

The word “offset” in the broad sense represents reciprocal economic advantages that result from trade agreements. Currently, however, as a result of increasing competition among suppliers due to the reduced global defense market, and declining military budgets, buyers are able to influence the conditions under which major defense programs are obtained. Therefore, the word offset is used predominantly in a sense of the variety of industrial, commercial and political arrangements under which foreign suppliers implement specific policy aimed at partially or fully compensating the buyer's procurement cost. Nowadays, most buyers, including the Czech Republic, demand these concessions in full for the direct cost of procuring major defense programs.

Offsets vary with the type of trade. Attempts to improve economic infrastructure, health service, and social aspects of a particular country are usually seen behind the implementation of various offsets. Fulfillment of offset agreements is usually achieved through various projects implemented in the buying country, very often together with third parties, and often in the form of technological transfer, and license. These projects also offer the possibility of global expansion for small businesses.

As mentioned above, it is obvious that offsets are linked with global economic trade. At least on the contractual side, offsets serve as a national benefit; however, as is obvious from what is happening with the purchase of supersonic aircraft for the Czech Armed Forces, the governments of various supplying companies also put forth intensive effort for their own self-interest. This is mainly because offset programs are usually implemented in business areas related to national security, and this remains a state domain.

Short term offsets, however, need not only provide benefits for the buying country. In cases where an agreement is made only for a certain period of time (for example, until the delivery of the last equipment), the supplying country may make only a short-term investment or order a huge amount of goods only once. That of course may, for example, reduce unemployment rates for a short period of time, but when the investors leave the country the previous problems re-occur in the same or even worse measure. So in this case a systematic approach to lowering unemployment without any relation to offset programs would be more fruitful. Offsets offered by defense industries of small countries can raise doubts as well, in a sense, whether they really enable access to global markets in branches not related to their business. Moreover, there is a threat posed by incompletely transparent agreements with third parties, in that they can add to the final results of offset investment, which would be realized even without offsets. Therefore, sometimes reciprocal purchasing of military technology is preferred over offsets (for example, F-18 aircraft assembled under license by Patria Industries in Finland for the Finish Air Force).

In addition to the buying government and seller, there are a wide variety of stakeholders involved to some degree with offsets and their implementation. Not only unions, defense industries, trade associations, and the public, but also EU is involved. The Czech Republic, as a member of these organizations, has to follow their rules as well, and their views and policies regarding offsets might be different.

Some strongly support offsets implementation as indispensable to doing business in the current global market. Others view offsets as an inevitable obstacle. Given these

views, offsets are quite controversial. Some areas of controversy might be: transactional cost to implement offset, negative effects on unemployment, and security issues.

The objective of this project is to examine what issues, if any, the Czech Republic faces concerning offsets implementation in international trade. This study will discuss briefly the history of the Czech Republic's participation in offsets, and its current policy, if any, towards using offset practices. What Czech goals are in offset practices, and whether the government's actions support them, would be another area of research. The Czech Republic is a member of EU, and therefore is obliged to follow policies implemented by this institution. Whether there is any connection between the Czech government policy and EU policies will also be examined. The project will then focus upon considerations in future offsets implementation.

### **C. PROJECT OBJECTIVES**

The objective of this research is to determine what issues the Czech Republic faces concerning offsets implementation in defense market. This study will look at the development of offsets in the Czech Republic, its participation in such trade practices, and current policies towards using offsets.

Foreign policy goals and support for EU policies will be discussed in order to find connection between the Czech Republic and EU concerning offset practices.

Additionally, this research examines what to be aware of, and if there is anything to be done in future offsets implementation.

### **D. RESEARCH QUESTIONS**

#### **1. Principal Research Question**

What issues does the Czech Republic face concerning offsets implementation in international trade in the context of military purchases?

#### **2. Secondary Research Questions**

What is the history of the Czech Republic's participation in offsets?

Does the Czech government policy support offsets?

Are there considerations for future offsets.

## **E. SCOPE**

This research is designed to provide a basic understanding of offsets in international trade in the context of military purchases, and to evaluate the impact of using such practices. Additionally, this research will address a brief history of the Czech Republic's participation in offsets, its current policies, if any, toward using such practices, and connection between the Czech government policy and EU policies.

In identifying the elements of Czech government and EU offset policies this research will trace a number of other points associated with offsets, such as advantages and disadvantages of offsets, realization of offsets cost, study of different types of offset arrangements, and identifying countries that participate in offsets. This study will use the Czech Republic's, as well as some other countries', examples and experiences.

This study will not attempt to evaluate or determine the real impact of using offset practices, but will rather provide general conclusions on their effects, possible recommendations, and issues to be aware of.

## **F. METHODOLOGY**

The methodology for research used in this thesis includes literature reviews and a review of documents produced by the Czech Government and international organizations related to offsets. These documents will be analyzed to examine what issues, if any, the Czech Republic faces concerning offsets in the context of military purchases, and to identify current Czech/EU policies towards offsets in international trade. Documents from offices within the executive branch of the Czech Government, studies or regulations issued by the MoD and Ministry of Industry and Trade (MIT), MoD policy and regulations relating to acquisition and foreign sales, and documents from the World Trade Organization (WTO), and European Union (EU) were also consulted.

Many interviews, as appropriate, were conducted during the research for this thesis, including with MoD personnel.

## **G. ORGANIZATION OF STUDY**

Chapter II provides a background for better understanding of offsets in the context of military purchases in international trade. A definition of offsets for this thesis is



provided, characteristics of offsets are identified, different types of direct and indirect offset agreements explained, and various terms and definitions applied to offsets are reviewed. The international trade principles are outlined, and the purpose for using offsets explained.

Chapter III discusses the Czech Republic's history in offset-related activities since 1993, after a so-called “velvet divorce” of Czechoslovakia's two national components, the Czech Republic and Slovakia. The volume of transactions and countries involved in offsets is included in this chapter to gain a broader view of offsets implementation. This chapter will also provide an overall summary of offset policy development.

Chapter IV examines the issues the Czech Republic faces concerning offsets and international trade, if any. The Czech Republic joined EU in 2004; therefore this chapter also discusses any possible connection among EU and the Czech Republic's policies. The author of this study suggests the use of these significant dates as a mechanism to help understanding of the development of offsets policy and practice within the Czech Government.

Chapter V provides a summary and conclusions regarding the issues the Czech Republic faces concerning offsets in the context of military purchases and international trade. This chapter draws conclusion from the analysis and provides recommendations regarding changes in Czech Government policy and practices towards offsets. This chapter also concludes with areas for further research.

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## **II. OFFSETS IN THE CONTEXT OF MILITARY PURCHASES**

### **A. INTRODUCTION**

Chapter II provides a background for better understanding of offsets in the context of military purchases in international trade. A definition of offsets for this thesis is provided, characteristics of offsets are identified, different types of direct and indirect offset agreements explained, and various terms and definitions applied to offsets are reviewed. The international trade principles are outlined, and the purpose for using of offsets explained.

### **B. OFFSETS**

The term offsets is used in defense sales to mean the compensation given to foreign buyers to offset the economic impact on them from having purchased items made in foreign countries, rather than domestically-produced items. It is designed to reduce the massive expenditure needed for military purchases, ensure that some of the money paid out by the government (in some cases by the Armed Forces) is offset by an influx of foreign investment (e.g., Gripen International undertook to perform in the Czech Republic offset programs valued at 130 percent of the contract value of CZK 19.650 billion; approximately USD 0.9 billion)<sup>1</sup>. Countertrade is an immense, pervasive business practice, involving huge numbers of people, and stretching far beyond the military market.

The literature on offsets in the context of military purchases, as well as offsets generally, is overwhelmed with various terms: direct and indirect offsets, countertrade, bilateral government trade, compensatory arrangements, clearing arrangements, simple and multiple barter, coproduction, licensed production, overseas investment, buy-backs, and technology transfer.<sup>2</sup> Some of the most important term definitions are outlined in this chapter.

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<sup>1</sup> Ministry of Defense, "Agreements on the Gripen Lease for the Czech Armed Forces," <http://www.army.cz/scripts/detail.php?id=3567> (accessed July 2, 2006).

<sup>2</sup> Stephanie Neuman, "Coproduction, Barter, and Countertrade: Offsets in the International Arms Market," (Orbis, 1985), 29.

## 1. The Meaning of Offsets, Definitions and Terminology

Offsets have served important foreign policy and national security objectives, such as increasing the industrial capabilities of allied countries, standardizing military equipment, and modernizing allied forces. The use of offsets is now commonplace. Countries require offsets for a variety of reasons: to ease the burden of large defense purchases on their economy, to increase or preserve domestic employment, to obtain desired technology, and to promote targeted industrial sectors. They may include agreements by the seller to purchase from local suppliers with some connection to the buyer, agreements to invest in production or other facilities in geographical proximity to the buyers, or agreements by the seller to meet certain performance targets (e.g., export requirements) or undertake other related activities (e.g., countertrade) on behalf of the buyer. One can even point to certain transactions that might be regarded as "reverse offsets," with the vendor reducing price or providing additional services in exchange for commitments by the buyer that would not normally be part of a "straight" sale (for example, agreement by aircraft vendors to reduce prices in exchange for buyer agreements to exclusively purchase their product over some future period).

The US is the biggest offset provider.<sup>3</sup> Some nations, like Germany and the UK are both offset providers and receivers. But most of the other countries, like the Czech Republic, are the offset receivers. The academic literature and government documents provide a variety of definitions. This study will look at some of these definitions.

### *a. The Czech Government's Definitions and Interpretation of Terms*

Countries use different terms to describe their offset programs. In Finland defense offsets are often called *counterpurchases* or *industrial participation* (IP), and in Sweden offsets are referred to as *industrial cooperation* (IC) or *industrial participation* (IP).<sup>4</sup> The intention there was to emphasize the cooperative aspect of offsets and long-

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<sup>3</sup> According to the US Bureau Industry and Security – Offsets in Defense Trade [www.bis.doc.gov](http://www.bis.doc.gov) (accessed July 15, 2006).

<sup>4</sup> Elisabeth Sköns, "Evaluating Defense Offsets: The Experience in Finland and Sweden," chapter 10 in J. Brauer and J.P. Dunne (eds.) *Arms Trade and Economic Development: Theory, Policy, and Cases in Arms Trade Offsets* (London and New York: Routledge, 2004), 149.

term business relations and activities as opposed to short-term transactions. The Czech Republic uses the term “Industrial Cooperation Program”.<sup>5</sup> The Industrial Cooperation Program (ICP) is a tool of economic compensations of expenditures of the state incurred in connection with purchases of equipment, material and services, in particular for defense and security purposes, and financed from the state budget of the Czech Republic. The ICP applies to the acquisition of equipment, material, and services from a foreign contractor and whose aggregate value exceeds CZK 500 million (approximately USD 23 million), or where a foreign subcontractor's contract signed with a domestic prime contractor exceeds the value of CZK 250 million (approximately USD 11.4 million).

The *Value of the Program* is generally understood as the amount of the contract price, and becomes a so-called *Offset Commitment Value* at the moment the contract has been signed. The Czech Government authorizes an interdepartmental commission to define offset requirements in the course of preparations of tenders for state contracts. This *offset commission* is appointed by the Minister of Industry and Trade for the purpose of coordinating activities and steps related to preparations, negotiations, enforcement, evaluation, implementation, and auditing of the program. The commission consists of four representatives of the MIT, two representatives each of the MoD and Ministry of Interior (MI), and one representative each for the Ministry of Foreign Affairs (MFA), Ministry of Finance (MF), Ministry of Environment (ME), Ministry of Regional Development (MRD), Ministry of Labor and Social Affairs (MLSA), Ministry of Education, Youth and Sports (MEYS), Ministry of Agriculture (MA), and Office of the Government of the Czech Republic (OGCR). However, additional experts from other ministries or institutions, or bidders for public contracts can be invited as well.

The negotiated agreement between the two parties that stipulates that the exporter will complete a certain amount of offset work within a specific time period is called an *offset agreement* (OA; e.g., Agreement on Industrial Cooperation Program,<sup>6</sup> through which Gripen International undertakes to perform in the Czech Republic), while

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<sup>5</sup> See “Annex 1 of Action Document No. 3/2005” of the Ministry of Trade and Industry.

<sup>6</sup> These agreements provide for elimination of tariffs and quantitative restrictions on imports of industrial goods, reciprocal concessions, and a prohibition against the introduction of new duties

the actual delivery of the offset work by the exporter (e.g., placement of a specific contract) is called an *offset transaction (OT)*. There are basically four different types of offset transaction:

Transfer of technologies and know-how, support of research and development (R&D)

Direct foreign investment

Export promotion

Other projects

The economic benefits of the Czech partner, which result from the implementation of the transaction, are called the *Offset Transaction Value (OTV)*. There are many ways of quantifying the OTV (e.g., as direct foreign investment OT is concerned, as revenues generated by the Czech partner as a direct consequence of the OT, minus material and services purchased abroad).

The term *Direct Offset* means offset projects related directly to the subject matter of the public contract, and should account for at least 20 percent of the purchase price (e.g., exactly 20 percent of the Swedish investment in the Gripen Program was directed immediately into the Czech Defense and Aviation Industry CDAI).<sup>7</sup> All other ICP (i.e., those consisting of the involvement of domestic companies in projects related to activities of the bidder, or bidder's subcontractors) are called *indirect offsets*.<sup>8</sup>

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supplemented with exception mechanisms, such as safeguarding or antidumping.

<sup>7</sup> Examples of real implementation of Gripen program's direct offsets:

- Aerospace (Hydraulic cylinder for JAS-39 Gripen, Jihlavan Co., value of CZK 10.3 million)
- Ammunition components (Cellulose Nitrate for BAE Systems, Aliachem Co., value of CZK 68.5 million)
- Naval material (Steel for the Royal Navy ships, Vitkovice Steel Co., value of CZK 108.5 million)

For more information see [www.army.cz](http://www.army.cz) accessed June 24, 2006.

<sup>8</sup> Examples of real implementation of Gripen program's indirect offsets:

- Heavy industry in total of CZK 1847.5 million (Smithy equipment for Saudi Arabia, PSJ Novotech Co., value of CZK 189.5 million)
- Automotive industry in total of CZK 674.8 million (Brake discs for export, BAK Co., value of 534,1 million)

### ***b. Academic Definitions of Offsets***

There are many academic definitions of offsets, such as:

“Offsets, coproduction, barter, and countertrade are compensatory trade agreements – agreements that incorporate some method of reducing the amount of foreign exchange needed to buy a military item or some means of creating revenue to help pay for it.”<sup>9</sup> Indeed, the foreign exchange can play a significant role (e.g., the Gripen Program uses a fixed price contract, and will not be subject to any future exchange rate fluctuation. Taking into consideration the extremely good Czech economy in recent years, the strengthening of the Czech currency and other related factors this could be a major hit).<sup>10</sup>

“... an offset occurs when the supplier places work to an agreed value with firms in buying country, over and above what it would have bought in the absence of the offset.”<sup>11</sup>

“Offsets are simply goods and services which form elements of complex voluntary transactions negotiated between governments as purchasers and foreign suppliers... they are those goods and services on which a government chooses to place the label „offsets ... .”<sup>12</sup>

“... an offset is a contract imposing performance conditions on the seller of a good or service so that the purchasing government can recoup, or offset, some of its

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- Electronics/electrical industry in total of CZK 1504.2 million (Electric tools for export, AEG Electric Tools Co., value of 423.1 million)

For more information see [www.army.cz](http://www.army.cz) accessed June 24, 2006.

<sup>9</sup> Stephanie Neuman, “Offsets in the International Arms Market,” (Orbis, 1985), 183.

<sup>10</sup> On Monday, June 14, 2004, a set of agreements were entered into and signed at the Czech Ministry of Defense by the Czech Republic and the Kingdom of Sweden on the lease of JAS-39 Gripen supersonic fighter aircraft to be operated by the Armed Forces of the Czech Republic. The exchange rate at that time was EUR 1 to CZK 31.145. Today, the exchange rate is EUR 1 to CZK 28.4. (Exchange rates taken from the Czech National Bank websites at [www.cnb.cz](http://www.cnb.cz), accessed June 24, 2006).

<sup>11</sup> Stephen Martin and Keith Hartley, “UK Firms Experience and Perceptions of Defense Offsets: Survey Results”, *Defense and Peace Economics*, 1995, p. 5.

<sup>12</sup> Jurgen Brauer and J. Paul Dunne, *Arms Trade and Economic Development: Theory, Policy, and Cases in Arms Trade Offsets* (London and New York: Routledge, 2004), 4.

investment. In some way, reciprocity beyond that associated with normal market exchange of goods and services is involved.”<sup>13</sup>

There are as many different definitions as authors. These various definitions have a lot in common. The author of this thesis decided to use the following working definition of offsets: “An offset program is a tool of economic compensation of expenditures of the state incurred during purchases of equipment, material and services, in particular for defense and security purposes.”

## 2. Characteristics of Offsets

Although the offset policies vary among states there are some common characteristics. These characteristics are provided below.

Table 1. Characteristics of Offsets

1.	Importing countries usually mandate offset requirements by law, often to more than 100 percent <sup>14</sup> of the contract value.
2.	Offset requirements kick in for minimum contract value, <sup>15</sup> sometimes as low as USD 5 million.
3.	Multipliers <sup>16</sup> are frequently attached to offset deals.
4.	Practically most defense trade contracts now contain clauses that subject defense exporters to a variety of penalties for non-fulfillment of offset commitments (e.g., exclusion from consideration for future contracts in the Czech Republic).
5.	It must be a new cooperation project with quantifiable and provable economic effects

<sup>13</sup> Jurgen Brauer and J. Paul Dunne, *Arms Trade and Economic Development: Theory, Policy, and Cases in Arms Trade Offsets* (London and New York: Routledge, 2004), 3.

<sup>14</sup> In the Czech Republic the compensation to constitute at least 100 percent of the contract value (Decree of the Government of the CR No. 9 of January 5, 2005 on Principles on Implementation of ICP).

<sup>15</sup> The Czech Republic sets the limit at CZK 500 million (approximately USD 23 million) for direct deliveries, or CZK 250 million (approximately USD 11.4 million) for sub-deliveries.

<sup>16</sup> “Multipliers are incentives used by purchasing countries to stimulate particular types of offset transactions. Prime contractors receive added credit toward their obligation above the actual value of the transaction when multipliers are used. In a small number of cases, a negative multiplier is used to discourage certain types of offsets. In Europe, 83 percent of transactions (by number) have no multiplier involved for the prime contractor when fulfilling the offset commitment.” This is taken from DISAM Journal June 22, 2005, p. 34.



	for the purchasing country.
6.	Economic results of the implementation of a specific offset transaction may be credited to just one program.

Furthermore, there are many expectations. Some of them are depicted in Table 2.

Table 2. Offsets Expectations

1.	Offsets will reduce defense acquisition costs.
2.	Offsets will initiate positive changes in employment levels, especially in the purchasing country.
3.	Offset will result in a strengthening of the acquiring country's economy by transfers of capital in the form of direct foreign investments, with an emphasis on improving the competitive ability of advanced industrial sectors and services.
4.	Offsets result in advanced technologies (e.g., environmental) and know-how transfers.
5.	Offsets will help in the development of small and medium-sized businesses.

Unfortunately, components absent in these offset characteristics are auditing, feedback, and offset contract monitoring. Not many countries have ever carried out formal and independent offset contract audits to determine to what degree, if any, the hopes with which offset contracts are invested come to success. Later, this paper discusses issues connected with these facts.

### **3. Government Involvement in Offsets**

There are many reasons why governments get involved in offsets. The author decided to examine the most fundamental reasons:

**Jobs and Export** - In economies where government has a major influence on the behavior of certain sectors (because of public ownership or regulation), governments are frequently tempted to impose formal/informal offset requirements on procurement from abroad that are linked to politically popular goals like jobs or export creation.

Defense Base - In all countries, defense purchases are undertaken by the government with a major goal; national security. Transactions involving domestic and foreign defense firms (and non-defense goods and services with defense applications) are scrutinized and shaped by all governments to reflect their perceived national security interests. In today's international system, national security often has an explicit economic component, such as protecting or stimulating the defense-industrial base. However, in many parts of the world, national security is seen as synonymous over time with industrial strength and national technological capability.

Industrial Policy - Governments often intervene to improve the terms of bargaining between national industry and foreign investors. Clear restrictions and a government-run approval process for foreign investment and access to local markets can be used to reduce or minimize competition among domestic customers in negotiations with foreign sellers, or otherwise increase the bargaining power of the domestic players. The restrictions are designed to improve the terms on which foreign goods and services are purchased.

Public Funding of Research and Development (R&D) - Governments sometimes fund a major portion of the R&D going into defense. While private firms are probably best equipped to secure the deals that capture the maximum return on private investments in new technology, the same may not hold true when it comes to securing the maximum national return on public investments in new technology.

Trade Issues - Offsets might be regarded as a form of subsidy to exports. There are restrictions<sup>17</sup> on subsidies and pricing behavior in international trade that discipline the use of such subsidies, and governments therefore are interested in offsets as a trade issue in sectors where they may be used to promote exports by national companies. The defense sector is unique in this regard, in that the national defense exception exempts defense goods and services from some of the effects of these disciplines. Indeed, one might even argue that what might be labeled as "dumping" is routine practice in international sales of defense articles.

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<sup>17</sup> World Trade Organization, "SCM : Overview of Prohibited Subsidies," [http://www.wto.org/english/thewto\\_e/whatis\\_e/eol/e/wto04/wto4\\_28.htm](http://www.wto.org/english/thewto_e/whatis_e/eol/e/wto04/wto4_28.htm) (accessed June 18, 2006).

## C. TRADE

Everyone involved in trade has to know as much as possible about the principals and conditions of trade. Trade and trade policies have always played key roles in the development of the Czech economy and society as a whole. The importance of trade is reflected in the openness of the economy, its profile and the high share of imports and exports of merchandise and services in Gross Domestic Product (GDP).<sup>18</sup> Due to its (trade) importance, this section examines briefly the fundamental principles of trade.

### 1. Free Trade Principles

According to the World Trade Organization, there are five fundamental principles of trade. They are that trading should be: a) without discrimination, b.) free, c.) predictable, d.) more competitive, and e.) more beneficial for developing countries.<sup>19</sup>

#### a. *Without Discrimination*

It sounds almost like a cliché. People very often talk about all kinds of discrimination. However, it is important to bear in mind that countries should not discriminate among their trading partners. All must be treated equally. The importance of non-discrimination is immense and therefore also a part of the General Agreement on Tariffs and Trade (GATT), General Agreement on Trade in Services (GATS), and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). Those agreements rule the trade in goods and the Czech Republic considers these in its trading Activities.

The real world is not always perfect, nor is trade. There are some examples of discrimination, meaning allowed discrimination. For example, the Czech Armed Forces sets up agreements only with Czech companies.<sup>20</sup> So obviously the Czech Republic does not treat others (foreigners) as its own nationals.

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<sup>18</sup> The Czech Republic s G D P (constant prices) in the second quarter of 2006 was approximately CZK 708.8 billion, of which CZK 636.9 billion represents export of goods and services, and CZK 641.8 billion stands for import (<http://www.czso.cz/csu/csu.nsf/dataprommf?readform> accessed September 18, 2006).

<sup>19</sup> World Trade Organization, "Principles of the Trading System," [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact2\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact2_e.htm) (accessed June 18, 2006).

<sup>20</sup> Perfect example would be the medium off-road trucks that are the most prevalent category of ground equipment within the Armed Forces of the Czech Republic. The Ministry of Defense of the Czech Republic made the decision to procure new TATRA medium off-road trucks, of Czech manufacture, in July

***b. Freer Trade***

Free trade allows all nations to live freer and more prosperous lives. Trade with other nations benefits consumers with lower prices and more choice, while producers gain export markets, new technology and lower-cost inputs. Export-related jobs usually pay more and are growing faster than non-export jobs. Free trade among nations increases global prosperity by allowing people to specialize in what they produce relatively more efficiently. More than two centuries ago, Adam Smith argued that it would be foolish for a family to insist on making its own shoes, tailoring its own clothes, and growing all its own food when it could buy them more cheaply from the shoemaker, tailor, and farmer. “What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.”<sup>21</sup> Countries should negotiate lower trade barriers such as custom duties and import bans to encourage trade. Although industrial countries tariff rates on industrial goods have fallen steadily, there is still a lot to be done.

***c. Predictability***

Investment in various countries (especially the developing countries) is more encouraged when countries are stable and predictable. Consequently, new jobs are created and people can enjoy the benefits of competition, mainly choice and lower price.

Of the former communist countries in Central and Eastern Europe, the Czech Republic has one of the most developed and industrialized economies. The Czech Republic has a well-educated population and a well-developed infrastructure. The country's strategic location in Europe, low-cost structure, and skilled work force has

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2005. Since the truck specifications are in accordance with Czech and European laws that define strategic military material (The author of this thesis does not share the same opinion), the supplier was chosen without public tender. Acquisition of the trucks was approved by the Czech government on September 21, 2005 ([www.army.cz](http://www.army.cz) accessed June 18, 2006). The new trucks will replace old Praga V3S trucks, also of Czech make, and other Soviet trucks, whose ages are over 30 years.

<sup>21</sup> Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937), p. 424.

attracted strong inflows of foreign direct investment. This investment is rapidly modernizing its industrial base and increasing productivity. As a small, open economy in the heart of Europe, economic growth is strongly influenced by demand for Czech exports and flows of foreign direct investment.

The "Velvet Revolution" in 1989 offered a chance for profound and sustained economic reform. Signs of economic resurgence began to appear in the wake of the shock therapy that the International Monetary Fund (IMF) labeled the "big bang" of January 1991. Since then, astute economic management has led to the elimination of 95% of all price controls, large inflows of foreign investment, increasing domestic consumption and industrial production, and a stable exchange rate. Exports to former communist economic bloc markets have shifted to Western Europe. Thanks to foreign investment, the country enjoys a positive balance-of-payments position. Despite a general trend over the last 10 years toward rising budget deficits, the Czech Government's domestic and foreign indebtedness remains relatively low.

Table 3. Czech Republic's State Debt Parameters at the end of June 2006<sup>22</sup>

Debt Parameter (Nominal value)	Dec 31, 2004	June 30, 2005	Sept 30, 2005	Dec 31, 2005	March 31, 2006	June 30, 2006
Total State Debt (CZK billion)	592.9	643.6	662.6	691.2	698.2	728.9

The government has offered investment incentives in order to enhance the Czech Republic's natural advantages, thereby attracting foreign partners and stimulating the economy. The Czech Republic has made significant progress toward creating a stable and attractive climate for investment, although continuing reports of corruption are troubling to investors. The author of this thesis will address corruption issues in the following chapter.

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<sup>22</sup> Ministry of Finance of the Czech Republic, "Czech Republic's State Debt Parameters at the End of June 2006," June 18, 2006, [www.mfcr.cz](http://www.mfcr.cz).

***d. Competition***

Promoting open, fair, and undistorted competition should be in everyone's best interest. Unfair practices such as export subsidies and dumping products at below cost to gain market share ought to be discouraged.

***e. Encouraging Development and Economic Reform***

Trade should be more beneficial for less developed countries, providing them with more time to adjust, greater flexibility, and extra privileges.<sup>23</sup>

**2. Trade Description**

Trade involves the exchange of goods and services between nations. Goods can be defined as finished products, as intermediate goods used in producing other goods, or as agricultural products and foodstuffs. International trade enables a nation to specialize in those goods it can produce most cheaply and efficiently. Trade also enables a country to consume more than it would be able to produce if it depended only on its own resources. Finally, trade enlarges the potential market for the goods of a particular economy. Trade has always been the major force behind the economic relations among nations.

Peoples' views of international trade are complex and cannot be explained as a simple preference for free trade or protectionism. A strong majority of the population views trade, in principle, as something positive and having significant benefits for the country's economy. However, the majority also has major reservations about how trade has been put into practice. There is a strong concern that, though trade has benefited business and the wealthy, it has not benefited workers and has widened the gap between rich and poor. People also show concern that trade has been harmful to the environment<sup>24</sup>, to international labor standards, and to poor countries (against free trade principles).

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<sup>23</sup> The Czech Republic is a fully developed country (The World Bank's official graduation of the Czech Republic from "developing" to "developed" country was on February 28, 2006), and yet is using those privileges.

<sup>24</sup> For more discussion of these issues, see Duncan Brack, "Balancing trade and the environment", *International Affairs* 71:3, July 1995; and Dan Esty, *Greening the GATT: Trade, Environment and the Future* (Washington, DC: Institute for International Economics, 1994).

**a. *Benefits of Trade***

A strong belief in the theoretical benefits of trade predicted by economists reinforces this general support for freer trade. People respond favorably to the idea that increased trade means increased or improved product selection. Free trade leads to better products becoming available in trading countries. Most of the population recognizes the positive effect on prices for consumer products. It must be noted, however, that when the value of lower consumer prices is paired off against job creation or job security, a majority favors the latter. Another reason people have supported trade is their general sense that trade promotes good relations between countries. Freer trade makes the world more stable by putting people from different countries in contact with each other.

**b. *Legal Framework for the International Trade in the CR***

The Czech Republic as a member of various organizations such as the World Trade Organization, European Union, and Organization for Economic Co-operation and Development therefore has to follow rules and regulations of these organizations.

The Czech Republic incorporated into its legislation all relevant provisions of the WTO Agreements, including those dealing with protection of domestic industries against increased imports, subsidized imports or dumping.<sup>25</sup>

Import licensing procedures are regulated under the Act No. 62/2000 that is fully consistent with the appropriate provisions of the Agreement on Import Licensing Procedures. Following the Act 62/2000, the Government has adopted a decree that defines a list of products that can only be imported or exported against a license.

In the areas of investment and competition, the Czech Republic's support for negotiations is motivated by its specific experience as a country that has completely restructured its system of ownership rights and deregulated its former centrally planned economy. Foreign direct investments, on which WTO negotiations should focus, have played a key role in the process of economic transformation, and their importance for

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<sup>25</sup> Act No. 152/1997 Coll., On Protection against the Import of a Dumping Product; Act No. 62/2000 Coll., On Some Measures in the Export or Import of Products and the Licensing Procedures; and Act No. 63/2000 Coll., On Protection against Subsidized Imports.

further development of the economy is continuously growing. This explains why the Czech Republic is committed to creating a stable contractual framework that will provide a transparent, predictable and legally certain environment for foreign investors and concurrently will not undermine the regulatory powers of governments to pursue their legitimate economic objectives.

In the area of competition, negotiations should aim at a framework agreement based on the principles of non-discrimination (national treatment and most-favored nation approach) and transparency, while fully respecting the development objectives. It should focus on prevention of anti-competitive practices having international dimension and hampering market access, and should promote co-operation among national competition authorities.

*c. Trade Barriers*

There are many examples of trade barriers that companies may face in the context of their international businesses. Restrictions on sales (in particular export markets), difficulties in acquiring patent rights in foreign countries, and discriminatory taxes when selling goods abroad are among some of the trade barriers. Restrictive or unfair foreign regulations may have negative effects on exporting goods, providing services or protecting intellectual property, especially in European countries that are not EU members.

To overcome trade barriers and help businesses to develop their activities overseas, the Trade Barriers Regulation (TBR) was adopted by the European Union.<sup>26</sup> The TBR was specifically designed to address the issues in third world countries, and to tackle unfair foreign trade practices that cause harm within the EU internal market. The main reason for adopting the TBR was the fact that EU companies alone could do little to tackle foreign government measures that negatively impacted their businesses. Therefore, the EU developed the TBR as an instrument to provide direct access to the European

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<sup>26</sup> Council Regulation (European Commission) No 3286/94, December 22, 1994, describing Community procedures in the field of the common commercial policy in order to ensure the exercise of the Community's rights under international trade rules, in particular those established under the auspices of the WTO.



Commission (EC), which can then investigate the issue and pursue the elimination or removal of the disputed “obstacles to trade.”<sup>27</sup>

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<sup>27</sup> According to TBR, an obstacle to trade is “any trade practice adopted or maintained by a third country in respect of which international trade rules establish a right of action.” International trade rules are those primarily established under the auspices of WTO, such as the multilateral agreements on trade in goods (GATT, Technical Barriers to Trade, etc.), trade in services (GATS) and intellectual property rights (TRIP).

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### **III. HISTORY OF THE DEVELOPMENT OF OFFSETS IN THE CZECH REPUBLIC**

National defense is believed to be very important for all countries. Research and development, as well as the procurement of modern defense systems are inevitable. However, not all countries have an industry that is capable of manufacturing these systems. Therefore, most nations purchase advanced systems abroad.

New opportunities for the Czech Republic and specifically its national defense industry were brought after the fall of the Berlin Wall. Despite a difficult period of transition in Czech industry, industry observers felt the Czech military industry was ready to expand. After seeing its military sales figures and employment levels steadily decrease for much of the last decade, Czech officials hoped to recapture the nation's tradition of military manufacturing. Although NATO officials have recommended the Czech Republic focus more on recruiting and training its military personnel, Czech Republic officials were anxious to acquire advanced weaponry.

The Czech Republic saw this stage of development as a time to maximize the financial benefits of its future purchases by instituting its own offset policy. Recognizing its leading role as one of the most advanced economies in Central Europe and its important status in the international market for defense items, the Czech Republic formalized an offsets policy in 2000. The policy aims to increase levels of foreign investment in the Czech Republic, especially in civil sectors of society such as high technology and science. In 1998, the drafters of the legislation indicated that they also view offsets as a way to acquire new technology, increase employment opportunities for Czech Republic citizens, enhance sustainable economic development, and effectively further “the economic interests of the Czech Republic.”<sup>28</sup> The Czech government was able to draw from the offset experiences of other European nations while formalizing its own rules for offsets. The Ministry of Industry and Trade consulted with government officials from European allies, such as Great Britain, France, Finland, and Denmark, and

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<sup>28</sup> Czech Ministry of Industry and Trade Order No. 26, on implementation of offset programs, December 1, 1998.

held several conferences on the utility of offsets for the Czech Republic with representatives from both private industry and the government.

The decision to codify its policy on offsets coincided with the Czech Republic's announcement of its plan to devote \$2 billion for the purchase of new fighter aircraft to replace its fleet of Russian MiGs. Because Czech officials view the technical parameters of the fighter jets being offered as so similar, offset packages outweighed technical factors and price when making a final decision.

Realizing this new opportunity for sales, the Czech Republic has been inundated with offers from major international contractors. The companies trying to conclude deals with the Czech government included Boeing with its F/A-18, Lockheed Martin with its F-16, British Aerospace-Saab with the JAS-39 Gripen and Dassault Aviation with its Mirage 2005. In addition to presenting their product, each firm constructed offset packages (each at least 100 percent) and started to create a niche for itself in the Czech economy.

Boeing bought 34 percent of Aero Vodochody, a Czech firm, as a pre-offset and won a contract to supply Boeing 737 to Czech Airlines. It was valued at \$33 million and resulted in a deal between Boeing and Czech Airlines. Boeing's subsidiary, Ayers, also bought LET Kunovice, a major producer of commuter planes. Ayers plans to move part of the production line for its own planes to LET. Lockheed Martin's pre-offset activities included a technology transfer program with Skoda Elcar, a Czech manufacturer of transportation equipment. Saab and British Aerospace have also started to make pre-offset arrangements with the Czech government.<sup>29</sup>

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<sup>29</sup> Countertrade & Offset, Vol. XVII, No. 10, May 24, 1999.

## A. THE CZECH ENVIRONMENT

### 1. Overview

The Czech Republic is commonly considered to be a political and economic success story among the former communist nations. It has a stable currency, low unemployment (7.3% in June 2006),<sup>30</sup> low national debt (CZK 728.9 billion in July 2006),<sup>31</sup> and large foreign currency reserves (USD 30.197 billion in July 2006).<sup>32</sup> Gross Domestic Product (GDP) grew by 7.4 percent in the first quarter of 2006,<sup>33</sup> and is estimated to stay in the range of six to seven percent in 2006 and 2007. The inflation rate in July 2006 was 2.4%.<sup>34</sup>

The Czech Republic became the first former Warsaw Pact member to join the OECD in 1995, the first to be given an A rating by Standard and Poor's. Czechs were among the founding fathers of the UN, IMF, World Bank and GATT but the "iron curtain" did not allow the country to be present at the birth of NATO. However, in 1999 the Czech Republic finally became a NATO member. In 2004, the Czech Republic became a member of the EU as well. The country also offers an excellent central European location and a highly skilled work force. The country's overall macroeconomic, political, and social stability create an attractive investment climate for foreign investment and trade.

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<sup>30</sup> Eurostat, "Euro Area Unemployment Down to 7.8%," [http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP\\_PRD\\_CAT\\_PREREL/PGE\\_CAT\\_PREREL\\_YEAR\\_2006/PGE\\_CAT\\_PREREL\\_YEAR\\_2006\\_MONTH\\_08/3-01082006-EN-AP.PDF](http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2006/PGE_CAT_PREREL_YEAR_2006_MONTH_08/3-01082006-EN-AP.PDF) (accessed August 1, 2006).

<sup>31</sup> Ministry of Finance of the Czech Republic, "Debt Portfolio Management Quarterly Review," [http://www.mfcr.cz/cps/rde/xbcr/mfcr/quarterly\\_review\\_062006\\_pdf.pdf](http://www.mfcr.cz/cps/rde/xbcr/mfcr/quarterly_review_062006_pdf.pdf) (accessed June 30, 2006).

<sup>32</sup> Czech National Bank, "Data Template on International Reserves and Foreign Currency," [http://www.cnb.cz/en/statistics/bop\\_stat/international\\_reserves/drs\\_struktura\\_en.htm](http://www.cnb.cz/en/statistics/bop_stat/international_reserves/drs_struktura_en.htm) (accessed July 31, 2006).

<sup>33</sup> Eurostat, "Euro Area and EU 25 GDP up by 0.9%," [http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP\\_PRD\\_CAT\\_PREREL/PGE\\_CAT\\_PREREL\\_YEAR\\_2006/PGE\\_CAT\\_PREREL\\_YEAR\\_2006\\_MONTH\\_08/2-14082006-EN-AP1.PDF](http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2006/PGE_CAT_PREREL_YEAR_2006_MONTH_08/2-14082006-EN-AP1.PDF) (accessed August 14, 2006).

<sup>34</sup> Eurostat, "Euro Area Annual Inflation Down to 2.4%," [http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP\\_PRD\\_CAT\\_PREREL/PGE\\_CAT\\_PREREL\\_YEAR\\_2006/PGE\\_CAT\\_PREREL\\_YEAR\\_2006\\_MONTH\\_08/2-17082006-EN-BP.PDF](http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2006/PGE_CAT_PREREL_YEAR_2006_MONTH_08/2-17082006-EN-BP.PDF) (accessed August 14, 2006).

## 2. Defense Industry

The Czech MoD's budget in 1993 was CZK 23.777 billion (1993 currency), representing 2.61% of GDP, or 6.7% share of MoD's expenditure in terms of overall expenditure of the State Budget. However, the year 2006 MoD's budget is CZK 55.694 billion (2006 currency), which is only 1.8% of GDP, and 5.8% MoD's share in terms of overall expenditure of the State Budget of the Czech Republic (49% personnel expenditure, 12% equipment expenditure, 10% infrastructure expenditure, and 29% of other expenditure).<sup>35</sup> The decrease in the percentage of GDP allocated for defense is significant.

Similar to defense industries throughout the world, the Czech industry found that it must diversify and seek dual-use technologies to expand its market potential. The Czech Republic has a long industrial history of producing high quality aircraft and heavy equipment, as well as sophisticated technologies for radars. The Czech Republic's massive privatization program included restructuring and consolidating firms. The descendants of the former state owned defense sector include two primary consortia, or holding companies: Aero Holding, and Omnipol.

Aero Holding manages several independent companies within the aviation sector; however, 99.96% of Aero is state-owned through the Czech Consolidation Agency.<sup>36</sup> The Czech aviation industry is regulated by the Ministry of Industry and Trade.

Omnipol deals with the purchase of goods for the purpose of further sale; trading brokerage; economic and management consulting; development, manufacturing, repairs, modification, transport, purchase, sale, lease, storage, degradation and destruction of weapons and ammunition; destruction, degradation, purchase and sale of explosives.<sup>37</sup>

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17, 2006).

<sup>35</sup> Ministry of Defense, "Basic Data of the State Budget in Chapter of the Ministry of Defense in 1993-2005," <http://www.army.cz/scripts/detail.php?id=5760> (accessed July 16, 2006).

<sup>36</sup> Aero Vodochody, "Company Structure," <http://www.aero.cz/main.php?pageid=21> (accessed August 20, 2006).

<sup>37</sup> Omnipol, "Company Profile," <http://www.omnipol.cz/index.html> (accessed August 20, 2006).

Companies trading in the defense industry are required to have licenses. Responsibility for issuing licenses is explained by the author of this thesis in Chapter IV.

Nowadays, most Czech commercial companies have English-speaking staff members, and the same is true at the MoD. The number of sufficient and experienced personnel with foreign experiences is growing significantly.

## **B. CZECH REPUBLIC POLICY AND EXPERIENCE**

In this chapter, the author will present first the principles of industrial cooperation, as it is outlined by the Czech government decree, and then will discuss the first year of the Industrial Cooperation Program, which is related to the lease of the supersonic aircraft JAS Gripen.

### **1. Regulations of Offset Programs**

Offset policy has been implemented into the procurement programs in the Czech Republic since the year 1998. That year, the government issued its first decree that stated conditions for application of offsets requirements.<sup>38</sup> Experience soon demonstrated that the decree needed revision. Especially, works on the supersonic aircraft procurement contract required a considerable amount of flexibility in reaching the agreement from both the procurement staff and the contractor.

The Ministry of Industry and Trade therefore, used that experience to prepare a new decree, which was approved by the government in 2005.<sup>39</sup> Following the decree, the Minister of Industry and Trade issued his order that detailed the governmental decree.<sup>40</sup>

In short, the implementation of offsets, or Industrial Cooperation Programs, has never been regulated by a special law in the Czech Republic. It is regulated by the government decree and is binding on all government organizations and bodies

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<sup>38</sup> The Government of the Czech Republic Decree No. 421, June 17, 1998, on Realization of Offset programs.

<sup>39</sup> The Government of the Czech Republic Decree No. 9, January 5, 2005, on Industry Cooperation Programs Realization.

<sup>40</sup> Ministry of Industry and Trade of the Czech Republic Order No. 3, February 2, 2005, on Industry Cooperation Programs Realization.

performing procurement with state budget funds. The Ministry of Industry and Trade of the Czech Republic is the keeper of the industrial cooperation policy.

## **2. Offset Programs Objective**

To understand reasons for adopting the industrial cooperation policy, it is necessary to look at the recent history of the Czech Republic. Not even two decades ago the former Czechoslovakia, of which the Czech Republic was an integral part, belonged to industrially developed countries. During the last fifteen years the Czech Republic sustained complete political and economical changes. Large heavy industrial companies disappeared and mostly small and medium-sized enterprises took their place. Transformation of the economy also caused a turn away from the traditional markets. That meant also the loss of traditional customers. This situation was particularly significant in the defense industry. Radical changes in the economy resulted also in a radical change in the wealth of citizens. Different regions were developing unevenly. There are traditionally industrial regions of the Czech Republic where the unemployment rate grew up dramatically to 20 %. Therefore, all Government purchases from foreign suppliers are politically a very sensitive issue.

In the above-mentioned decree, the government formulated objectives of the Industrial Cooperation Programs that complement the overall governmental policy of employment, regional development and industrial development.

Compensation for the loss of manufacturing opportunities and jobs incurred by the Czech economy, owing to the fact that a contract for purchasing of equipment, materials and services for defense and security purposes was awarded by an open public tender to a foreign subject, is therefore considered one of the key objectives of industrial cooperation. All other objectives support other governmental policies, like increase in the competitiveness of the domestic industry together with the export capabilities, transfer of know-how and progressive technologies, stimulation of foreign investments and support of the establishment of joint ventures and long-term relationships. All these objectives support employment and regional development.



The author believes it is fair to say that the Czech government uses other means as well to stimulate foreign investment, like the so-called tax vacancy, financial support to the newly opened company, etc. It goes without saying that the Czech Republic is not the only government using such economic tools.

### **3. Principles of Offset Programs**

There are four main principles for offset transactions in the Czech Republic:<sup>41</sup>

To apply compensation transactions to direct deliveries exceeding CZK 500 million (+/- EUR 16.6 million), or sub deliveries exceeding CZK 250 million (+/- EUR 8.3 million) of equipment, materials and services for defense and security purposes from abroad

The compensation to constitute at least 100% of contract value with at least 20% in direct offsets

Offsets have to be implemented within 10 years of contract date

Condition for participation in a public tender

Specific preference for direct offsets is one of the main features of the Industrial Cooperation Programs. The direct offsets are those transactions, directly related to the subject of the public contract, to which the offset obligation is related. Direct Offset Transactions shall account for at least 20 percent of the purchase price of the subject matter of the public contract in question, which is charged by the foreign contractor or subcontractor.

The author emphasizes here that the requirement for the implementation of an offset program in the framework of a public contract is generally formulated as an indispensable condition for taking part in a public tender or, if just one contractor is addressed, an indispensable condition of the performance of the public contract.

Officially, the Czech Republic does not use offsets as a selection criteria for selecting a winner in the public tender. That means that no specific companies have

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<sup>41</sup> Ministry of Industry and Trade of the Czech Republic Order No. 3, February 2, 2005, on Industry Cooperation Programs Realization.

advantage. Nor are coefficients used to show a preference to the specific type of transactions. Therefore it is safe to say that the Czech Republic does not use offsets to give advantage to some companies over the remaining ones.

#### **4. Relationships in the Process of Industrial Cooperation Programs**

The relationship of the Governmental bodies and the supplier in the process of ICP is introduced in Figure 1. There are several key players in the ICP. At the stage of contract negotiation, the key players are the Ministry of Defense on one side and the winner of the competition on the other. These two players therefore maintain the legal relationship as long as the offset agreement is in effect; this means they sign the agreement on the ICP. The MoD represents the Czech Republic and has the final word on approval of the final value of particular offset transactions.

Another key relationship is between the contractor and the Czech industry. Professional associations, such as the Defense Industry Association (DIA), can represent the industry. The government neither declares where the offsets should be directed nor selects the Czech partner of the offset transaction. It is a responsibility of the Contractor to research capabilities of the Czech industry and to find the suitable partner. Once the contractor and the selected Czech partner come to an agreement, they together develop the offset transaction proposal and the contractor submits the proposal to the Ministry of Industry and Trade. The MIT presents the proposal to the Offset Commission.

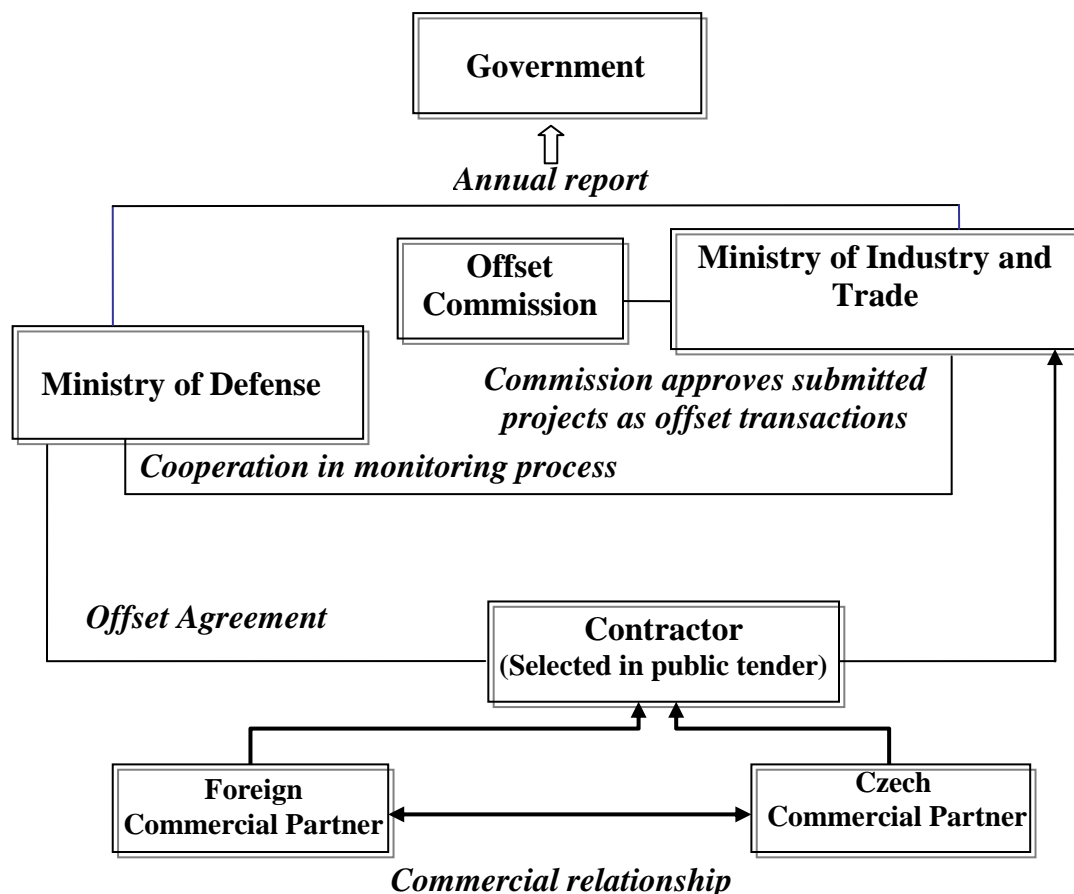


Figure 1. Relationship in the Process of Industrial Cooperation Programs<sup>42</sup>

*a. Specific Role of the Offset Commission*

This Offset Commission is an intergovernmental body, whose members have the delegated authority to approve the submitted transaction. The Commission itself consists of representatives of the Ministry of Industry and Trade, Ministry of Finance, Ministry for Regional Development, Ministry of Foreign Affairs, and Ministries of Defense and Interior as representatives of the state in the offset agreement. The Ministry of Industry and Trade provides the chairman of the Commission and administrative support. The administrative support functions are to take minutes, to prepare the decision on the presented transactions and to keep a record of each of the ICP. The MIT therefore is the only body that has a total overview on all programs and all transactions. By

<sup>42</sup> LTC Petr Hakl, e-mail message to the author, May 11, 2006.

preparing the Commission's decision, it prevents the contractors from registering the same offset transaction to more than one ICP. The Commission meets regularly, at least four times a year. During the meeting, The Ministry of Industry and Trade, after the decision is taken, registers the approved transaction to the specific program.

***b. Actual Value of the Offset Transaction***

Once the Offset Commission approves the transaction and MIT registers it against the particular program, the contractor, foreign commercial partner and the Czech partner work together on meeting the offset transaction objectives. To be able to prove the actual value of the transaction, the Czech partner has to establish a separate branch in its accounting records. The contractor submits an annual report to the MoD. The MoD forwards the report to the MIT and to the Offset Commission for comments. Final decision on the actual value of the offset transaction and the whole ICP, however, is issued by the MoD. The decision is based on the comments of the Offset Committee and on the audit results on the transactions. MoD representatives and/or the private subject with the delegated authority from the MoD reviews the book keeping records of the Czech partner, related to the offset transaction. The contractor therefore is required to forward a list of invoices, and relevant parts of the records of the Czech partner that are related to the transaction, as an attachment of the annual report to the MoD. When the ICP obligations are met, the MoD and the MIT inform the government.

***c. Specific Requirements***

In the effort of foreign commercial partners to look for transaction opportunities, the Czech side does not set up any specific requirement (industrial, branch or regional) for the individual offset programs nor transactions. The MoD and the contractor set the legal relationship. The contractor looks for the business opportunities either for himself or for another foreign partner. The foreign partner and the Czech partner establish the commercial relationship. The MIT provides the keeping of the ICP record. The Offset Commission approves the transactions and provides the statement to the Annual report. The MOD approves the actual value of transactions performed over the monitored year, and through that the overall performance of the Industrial Cooperation Program Agreement.

## **5. Agreement on the Industrial Cooperation Program**

The ICP is a relationship agreed on for a maximum of 10 years. Conditions of the relationship are, as the author mentioned before, listed in the Industrial Cooperation Agreement. The MIT directive set out the important issues that should be covered specifically by the agreement. Those are the subject matter of the deal, scope and structure of the program, rules to be used to measure the program value, timetable of the program, method of monitoring the program and rules governing any changes of and amendments to the program, sanctions for non-performance, and provisions concerning proprietary and confidential information.

The carefully formulated agreement is the key to the good relationship between the MoD and the contractor. Specific areas for negotiation are especially those dealing with the performance timetable, connected with the milestones and related penalizations. Also, procedures and required documents for approval of the final value of the transaction and the whole program are must.

The Industrial Cooperation Agreement should be signed at the same time as the related delivery contract.

## **6. Offset Transactions**

Besides the obvious categories of the offset transactions, which are the direct and indirect offsets, the offset transactions are recognized by their type, as follows:

Transfer of Technologies and Know-how, Support of R&D

Direct Foreign Investment

Export Promotion

Others

The transfer of technologies are represented by Offset Transactions intensifying the transfer of technologies and know-how for the benefit of the Czech Republic, promoting participation of Czech entities in the international research and development programs, strengthening Czech scientific and research capabilities and last, but not least, improving skills and knowledge of human resources.

Direct investments are represented by direct investment activities of a foreign partner in the Czech Republic.

Export promotion is represented by arranging and mediating new export contracts for domestic entities. It may be, for example, introducing a Czech product, which has not yet been exported, to foreign markets, acquiring new foreign customers for products that have already been exported, or a significant increase in existing export levels.

Others are represented by Offset Transactions that have been discussed and accepted by the Offset Commission and in respect whereof an agreement has been achieved between the party submitting the proposal and the Offset Commission.

## **7. Value of the Transaction – Measuring Mechanisms**

The author expresses the importance of the fact that the value of the offset transaction is actually looked at retrospectively. It means that the value is calculated from the account records of the Czech partner of the transaction.

Considering the four types of transactions that were shown on the previous page, an assumption can be made that there are three methods on how to calculate the actual value of the transaction.

### **a. “A ” M echanism**

First, the “A ” M echanism serves for measuring the value of the Direct Foreign Investment Type of the transaction.

Formula:  $Z=X-Y$

Where:  $Y= (P+Q+R)$

Z - The actual value of the transaction for the monitored calendar year,

X - The income from the sale of the products and services,

Y - Value calculated by adding all occurred costs of the Czech partner for procurement of materiel (P), occurred costs of the Czech partner for services, related to the transaction (Q) and costs for energies related to the offset transaction (R). This mechanism is used to measure the Direct Foreign Investments type of transactions.

In case the Czech partner runs other business, "X", "P", "Q" and "R" values will be related to the offset transaction.

When the Czech company agrees on being a partner of the transaction, it has to set up a separate branch in its accounting records.

***b. "B" Mechanism***

Second, the "B" Mechanism is used for measuring a value of the support to export type of transactions.

Formula:  $N=L-M$

Where: L - Summary of all export revenues of the Czech partner that are related to the transaction,

M - Summary of all purchases from abroad of the Czech partner related to the transaction. For declaring the origin of the goods the appropriate certificate is used, and

N – Value of the transaction.

***c. Other Types of Transaction***

Remaining types of transaction are measured according to the agreed way. The agreement must be done between the foreign partner and the Offset Commission. The Offset Commission will always approve the type of the transaction, including the proposed value and the mechanism for measuring. The MoD, following the decision of the Offset Commission, uses the appropriate mechanism for approving the reached value of the transaction.<sup>43</sup>

**C. THE GRIPEN PROGRAM IN THE CZECH REPUBLIC**

Gripen Program is the biggest example of Czech Republic MoD activity under the ICPs. The author believes this program represents one of the positive examples of the offset policy implementation in the Czech Republic. For an overall picture and better

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<sup>43</sup> MIT, Provision No. 3/2005, on realization of the programs for industrial cooperation (accessed September 19, 2006).

understanding the author provides the following development steps of the Supersonic Aircraft Project:

1993 - MiG-29 supersonic fighters were decommissioned from the inventory of the Czech Armed Forces.

1995 - The Chamber of Deputies of the Czech Republic Parliament resolved that plans to modernize the MiG-21 aircraft were ineffective.

1997 - The Government decided in favor of supersonic aircraft acquisition and endorsed the procurement of 72 L-159 subsonic aircraft.

1999 - Concept on the Development of the MoD Department, including procurement of supersonic aircraft, was approved by the Government. In the same year, MiG-23 and Su-25 aircraft were decommissioned from the inventory of the Czech Armed Forces.

2000 - Public bidding process began in order to select a supersonic aircraft supplier.

2001 - Report on bids evaluation was submitted. The Government decided to initiate contractual negotiation with BAE/SAAB. Furthermore, the L-159 aircraft were introduced.

2002 - Draft agreement on the procurement of 24 Gripen tactical supersonic aircraft was submitted, and approved by the Government. With that, the Chamber of Deputies of the Parliament of the Czech Republic rejected the draft bill on the aircraft's procurement financing.

July 9, 2003 - The Government of the Czech Republic Decree No. 686 endorsed the draft provision for completing the Concept on the Development of the Czech Air Force and the Czech Armed Forces in the area of airspace protection by means of a supersonic aircraft. MoD was commissioned to: 1. Send a request for submitting a Feasibility Study to the Governments of the Kingdom of Belgium, French Republic, Canada, the Kingdom of Netherlands, Republic of Turkey, United States of America, Federal Republic of Germany and the Kingdom of Sweden; 2. Assess the Feasibility



Studies received, including that of the Government of the United Kingdom of Great Britain and Northern Ireland, develop a proposal on further procedures and submit these to the government for decision.

July 25, 2003 - Multilateral working session was held where the tender specifications and further requirements by the MoD were conveyed to the bidders.

September 11, 2003 - Expert workshop attended by representatives of addressed countries was held AFB Caslav to specify the terms of the procurement process. The workshop was not attended by UK representatives. The British party, having analyzed the requirements that were submitted to all addressed countries on July 25, 2003, decided not to continue in the process of searching for an interim solution to securing the Czech Republic's airspace. The aim of this meeting was to specify technical, financial and time aspects concerning the bids processing. The workshop participants were apprised of the operational conditions and parameters of the airbase where the aircraft are planned to be operated in future.

October 20, 2003 - The Government of the Czech Republic Decree No. 1051 determined that the aircraft procurement is a strategic order.

October 31, 2003 - The three-month period for development of feasibility studies was terminated and the bidders' proposals were submitted. Seven countries presented their bids - Belgium, Canada, France, Germany, The Netherlands, Sweden and the USA. Turkey withdrew on October 15, 2003. Bids Review and Evaluation Commission was appointed based on the Decree No. 1050, dated October 20, 2003. This nine-member joint commission included representatives of the MoD, MFA, MIT, and MF.

November 30, 2003 - The interdepartmental commission completed the Feasibility Studies assessment, and based on the set criteria established a bids order that was then presented to all government members by the Minister of Defense. The Commission recommended that the bid submitted by the Kingdom of Sweden on the JAS-39 Gripen complex system be accepted as the most favorable. The bid on F-16 MLU aircraft by the Kingdom of Belgium placed second, while bids submitted by Canada, the Netherlands and the USA followed.

December 17, 2003 - The Government of the Czech Republic decided the Swedish bid was the best one for the Armed Forces of the Czech Republic, and commissioned MoD, MF, MIT, and MFA to negotiate procurement of fourteen aircraft exclusively with the Kingdom of Sweden. The negotiations were initiated.

May 28, 2004 - The documentation on the prepared supersonic aircraft lease was presented to the Government.

June 2, 2004 - The Government held deliberations on a draft Memorandum of Understanding, Lease Agreement and Industrial Co-operation Agreement.

June 9, 2004 - The Government of the Czech Republic based on successful negotiation between the Czech and Swedish parties, decided by the Government Decree No. 596 on the lease of Gripen aircraft, and entrusted the Ministry of Defense with finalizing negotiations with the Swedish party and signing contractual obligations.

June 14, 2004 - Agreements between the Czech Republic and the Kingdom of Sweden concerning the lease of JAS-39 Gripen aircraft for the needs of the Czech Armed Forces were signed at the Ministry of Defense.

2005 - Service life of the MiG-21 supersonic aircraft was over.<sup>44</sup>

### **1. Primary Facts about the Gripen Program**

The Agreement on the Industrial cooperation program has been signed<sup>45</sup> for a period from June 14, 2004 through December 31, 2014. This period represents more than 10 years. The offset obligation represents 130% of the Gripen aircraft lease, of which 20% represents the direct offsets. Speaking in absolute figures, the offset obligation is CZK 25.5 billion.<sup>46</sup>

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<sup>44</sup> Peter Fuzak, e-mail message to the author, June 2, 2006.

<sup>45</sup> On Monday, June 14, 2004, a set of agreements were entered into and signed at the Czech Ministry of Defense by the Czech Republic and the Kingdom of Sweden on the lease of JAS-39 Gripen supersonic fighter aircraft to be operated by the Armed Forces of the Czech Republic, <http://www.army.cz/scripts/detail.php?id=3567> (accessed June 24, 2006).

<sup>46</sup> Petr Hakl, telephone interview with the author, July 31, 2006.

The Industrial Cooperation Program was approved, as was the main delivery contract, by the Czech government.<sup>47</sup>

***a. Gripen Program Performance Agreement - Projected***

The projected performance over the years in terms of value and percentage of the Industrial Cooperation is introduced in Figure 2.

BAE Systems actually started fulfillment of the program in the year 2002, when the public bidding started for the first time. However, it was stopped and started again in 2003. After selection of a bidder, it took almost 4 months to develop an industrial cooperation agreement. As the author mentioned previously, under the conditions of the former governmental decree, the agreement required a lot of effort and flexibility from both sides to develop a comprehensive agreement with sound and satisfactory conditions for both sides. The final agreement between both sides is that the new governmental decree applies in full strength to the Industrial Cooperation Agreement.

As shown below, BAE Systems agreed to implement the Industrial Cooperation Program of the total cumulative value CZK 25.5 billion. The performance is carefully estimated with milestones at the years of 2006 and 2009, with the final “milestone” at the end of the program. Milestones are the time points in the program when the performance is judged very carefully. At those points the performance must be reached for the forecasted volume.

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<sup>47</sup> The Government of the Czech Republic Decree No. 596/2004  
[http://wtd.vlada.cz/vyhledavani/vyhledavani\\_usnes.htm](http://wtd.vlada.cz/vyhledavani/vyhledavani_usnes.htm) (accessed July 16, 2006)

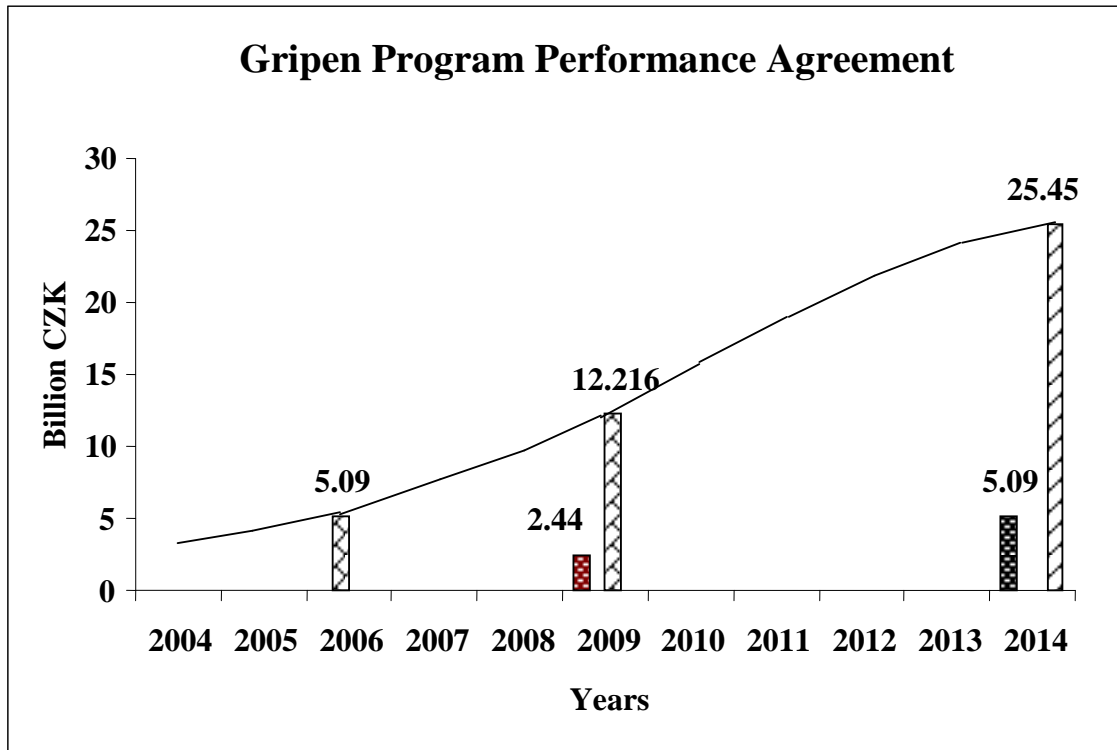


Figure 2. Gripen Program Projected Performance Agreement (current year money)<sup>48</sup>

By the end of the year 2006, the volume of the ICP should reach CZK 5.09 billion. This represents 20% of the total value of the program. By the end of 2009, the overall value of performed transactions shall reach slightly more than CZK 12 billion, with CZK 2.44 billion of that amount in the direct offset area. Those amounts represent 48% and 9.6% respectively. Should the BAE System perform below these agreed values, the penalty will be applied by the MOD. Generally, the penalty will represent a percentage of the difference between the actual performance and the planned value. The penalty bears a feature of the performance bond; it means that once the BAE System reaches the planned performance -- the projected curve again -- the money would be released back by the MoD. Should the BAE Systems remain in delay with the program performance, the penalty will be used as a part of the final penalization.

<sup>48</sup> LTC Petr Hakl, e-mail message to the author, May 11, 2006.

In the time between the milestones, the performance may drop below the projected curve without problems. The drop will be noted and the performance will be closely observed in the upcoming years.

This chart, as well as the related table, is incorporated into the Industrial Cooperation Program Agreement.

***b. Actual Gripen Program Performance***

Actual performance is depicted in Figure 3. As shown, BAE System had an excellent start in the program and instead of the value of CZK 2.79 billion actually generated CZK 4.21 billion. Some of these values have been generated by the pre-offset transactions. Nevertheless, as the author mentioned previously, it had taken two years before the program was approved and the contract signed. Speaking in percents, the required generated value was 11 percent. The approved value generated by the end of 2004 was 16.5 percent.

Unfortunately, the actual publicly releasable data is for the first year of the Gripen Program only. The annual report for the year 2005 is being finalized by the BAE systems as the author of this thesis conducts research. The actual value and the cumulative value of the program for the year 2005 and for the whole period of the program shall be approved by the MoD.

For easier research of capabilities of the Czech industry, looking for the transaction opportunities and also in order to liaise with the MoD, BAE SYSTEMS provides the Czech offset delivery team and is contractually responsible to Gripen International for the timely delivery of the offset requirement. This practice proved to be successful. The BAE employees are able to conduct research “on the ground”, identify opportunities in terms of subject and possible value of the transaction and send the data to the center. The data is evaluated there and a possible partner is being sought. If the partner agrees, the offset delivery team will organize preparation of the transaction from the point of administrative requirement. Up to now, the concept works fine. There are five new offset transactions submitted to the Ministry of Industry and Trade and awaiting Offset Commission approval.

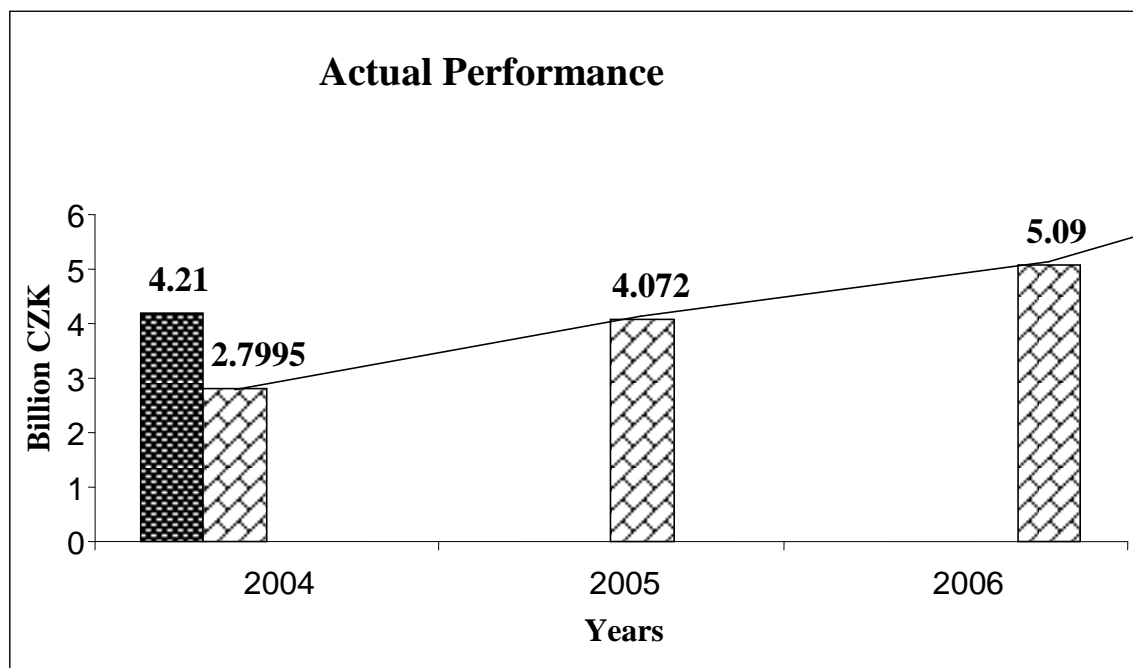


Figure 3. Actual Gripen Program Performance (current year money)<sup>49</sup>

Figure 4 gives an impression of how the ICP is being filled by single transactions.

The geographical spread of transactions shows how the offset delivery team did cope with this issue. The offset delivery team obviously tried to spread all transactions evenly, so they would not face any future complaints. However, the author believes that this is not supposed to be the main issue. Once the Government agrees with the Industrial Cooperation, the areas with huge unemployment rate and with the need of investment should be considered. All principles of offset as well as principles of free trade should be taken into consideration.

<sup>49</sup> LTC Petr Hakl, e-mail message to the author, May 19, 2006.

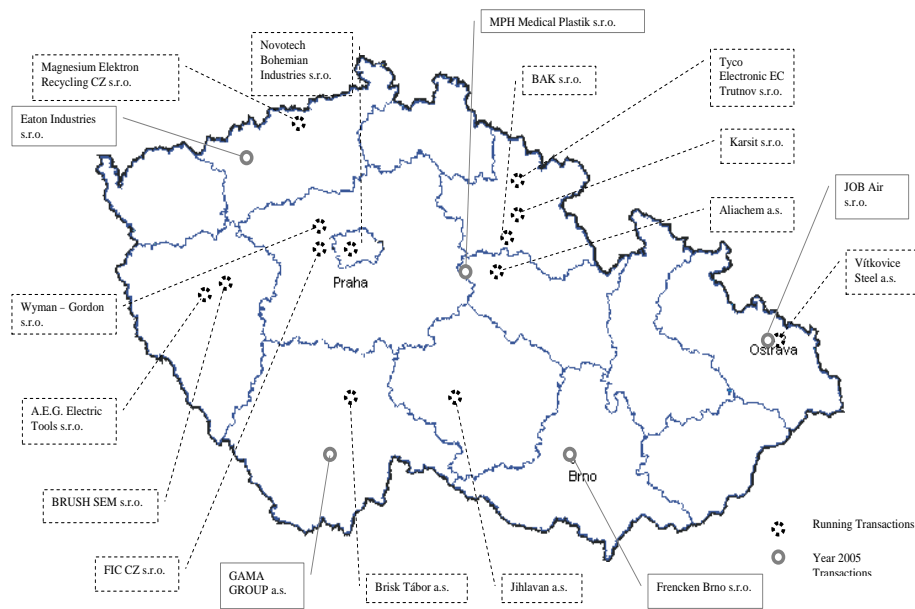


Figure 4. Distribution of Offset Transactions

### c. *Transactions Distribution*

The approximate distribution of running transactions for the Gripen Program by the type of industry is as follow:

#### Direct Offsets

- Aerospace CZK 10.3 million
- Ammunition Components CZK 68.5 million
- Naval Material CZK 108.5 million

#### Indirect Offsets

- Heavy Industry CZK 1847.5 million
- Automotive Industry CZK 674.8 million
- Electronics/Electrical CZK 1504.2 million

To clarify, the Government agreed to extend the understanding of direct offsets to the transactions placed with the whole defense industry of the Czech Republic for purposes of the Gripen program. The offsets were placed with the traditionally strong

areas of the Czech economy, except for the transactions directed to the area of electronics. The government has obviously preferred regions of the Czech Republic, or areas of the industry. The preferred regions are those with higher unemployment rates. The areas of industry are those where the technological progress can be the highest and where the Czech Republic feels her industrial capabilities are lagging.

The Czech Republic understands offsets as generating new economic benefit for the Czech Republic by means of income produced by foreign investments, by means of new export, and contracts of transfer of technology. The government does not use offsets (with rare exception) as a means to provide advantage to the selected regions, nor areas of industry. The MoD, as a contractual partner, has final authority to endorse the actually produced value of each offset transaction and the overall performance of the program.

The key to the successful, and for both sides beneficial, relationship is the comprehensive agreement on the ICP. The Gripen program is a good proof of the quality of the new government policy and a positive example of the industrial cooperation execution.

Although most of these offset transactions will generate a value in the future, the Czech MoD approved the second annual Offset Performance Report, which claims that about two years into the ten year program, the total offset reached CZK 6.6 billion (26% of the total obligation).<sup>50</sup> Nevertheless, about 3/4 of the overall value of the program has yet to be generated. Up to now, it seems that the program will be going well in the near future. The latest claim also forwarded new transaction proposals to the MIT.

#### **D. THE F-16 PROGRAM IN POLAND**

To provide some comparison with another country's experience, the author introduces the F-16 program carried out in Poland.

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<sup>50</sup> Gripen International, "Second Gripen Offset Claim Approved in Czech Republic," <http://www.gripen.hu/pressreleases/060524/secondgripenoffsetclaimapprovedinczechrepublic.4.10948cf10b64c88e22800022.html> (accessed July 20, 2006).



Poland faced similar problems with modernizing its military, according to NATO standards, as the Czech Republic. Replacing the aging Soviet-made MIG fighters was a huge challenge for Poland, and offset offers were expected to be an important part of foreign suppliers proposals.

In December 2002, Poland announced Lockheed Martin's F-16 C/D Block 52 model powered by F-100-299 engines from the United Technologies unit of Pratt & Whitney, the winner of a three-way tender to support 48 combat jets. Along with the F-16, the French Dassault Aviation's Mirage 2000-5 Mk2 and the Swedish Jas-39 Gripen participated in the contest. Lockheed's proposal included over 100 offset projects valued at USD 9.8 billion (According to Polish officials it was a value of USD only 6 billion). Dassault, in comparison, proposed projects valued at USD 7.8 billion and Gripen USD 3.9 billion. Military experts rated the F-16 and Mirage about the same as fighting aircraft, with the cheaper Gripen third. Since the Lockheed offset proposals outweighed the others, Poland decided to go ahead with the F-16.<sup>51</sup>

The author wants to emphasize also the fact that Lockheed Martin was backed by a U.S. Government loan of USD 3.8 billion which foresaw interest payment only through 2010.

On April 18, 2003 four significant agreements were signed by the Polish Government, the U.S. Armed Forces, and Lockheed Martin. The documents are as follows:

The USD 3.5 billion contract for the delivery of forty eight F-16 aircraft to the Polish Air Force in 2006 – 2008

The Financial Agreement accommodating the contract

The Agreement for the U.S. Government's soft loan to the Polish Government financing the purchase

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<sup>51</sup> "Poland picks Lockheed F-16 in \$3.5B deal," F-16.net, [http://www.f-16.net/news\\_article698.html](http://www.f-16.net/news_article698.html) (accessed July 18, 2006).

Finally, the biggest offset agreement between Poland and foreign suppliers – the Master Offset Agreement, called the “Contract of the Century” -- was signed by the Polish Minister of Economy, Labor and Social Policy and the Lockheed Martin Aeronautics Company.

According to the Press and Information Office of the Polish Ministry of Economy, Labor, and Social Policy the nominal value (without multiplier) of the Lockheed Martin's offset commitments is USD 7.751 billion.<sup>52</sup> The agreement contains 44 offset programs out of which 16 are direct investment into the defense industry and 28 are indirect investments.

The offset obligation, in the case of the Czech Gripen Program, represents 130% of the Gripen aircraft lease, of which 20% represents the direct offsets. While in the case of the Polish F-16 aircraft purchase, the offset obligation represents more than 200%, of which 36% represents the direct offset. The Czech Minister of Defense has the final word in particular contract, and also signs an agreement. In Poland, the decision is made and an agreement signed by the Minister of Economy, Labor and Social Policy. The first aircrafts were assigned to the Czech Air Force in less than a year after the agreement was signed. In the case of Polish F-16, the first delivery was planned after three years from the agreement signature. Both the Czech Republic and Poland claim that offset commitments are not the most important in the process of selecting the winner of contract, however, the opposite is the truth.

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<sup>52</sup> Polish Ministry of Economy, Labor, and Social Policy, “The Comparison of Lockheed Martin's Offset Commitments,” [http://www.mgip.gov.pl/nr/rdonlyres/d388b4f0-f028-4d79-a15f-b5efd29bdc8f/0/zestawienie\\_zbiorcze.doc](http://www.mgip.gov.pl/nr/rdonlyres/d388b4f0-f028-4d79-a15f-b5efd29bdc8f/0/zestawienie_zbiorcze.doc), (accessed August 13, 2006).

## **IV. ISSUES CONCERNING OFFSET IMPLEMENTATION IN THE CZECH REPUBLIC**

### **A. INTRODUCTION**

The Czech Republic does not have a long experience with offset practices. However, the Czech Government claims many benefits for defense trade offsets, although the total value of offset transactions will not be clear until the end of the particular offset program (The biggest offset transaction in the Czech Republic so far, the Gripen Program will end in 2015).

Employment creation, technology transfers, and foreign exchange are among some of the benefits. The first policy on offset realization was approved by the Government in 1998, as the author introduced in Chapter III.

The international defense market is complex, very often lacking in transparency, characterized by corruption, bribery, dishonest deals, and nepotism ( see Appendix A for more details). Defense offsets have been criticized in this light mainly by U.S. policymakers, but at the same time appreciated by others, such as the Czech Government. The author does not intend to answer the question why it is so, nor whether ambitions match with achievements. Rather, the author wants to emphasize some issues the Czech Republic should focus on in order to increase competitiveness in an international, as well as domestic, market.

### **B. PUBLIC PROCUREMENT POLICY**

#### **1. Imperfection of the Public Procurement Act**

##### ***a. Introduction***

Public procurement is one of the cornerstones of the European, as well as world, market, and is an important sector of the economy. In the past years, the EU bodies, NGOs, and professional associations and chambers have criticized provisions of the Public Procurement Act (PPA). The EU criticized both selected provisions of the PPA and the inefficiency of its enforcement. In recent years, the Act has been amended numerous times. The last amendment, intended to harmonize the Czech legislation with

the EU norm in this particular area, has been approved by both chambers of the Parliament and was signed by the President and came into force in full on May 1, 2004.<sup>53</sup> However, even this last amendment has met, as a result of its inadequate anti-corruption measures, with fierce criticism. This act is not fully approximated to the EU legislation. Non Governmental Organizations (NGOs), such as Transparency International Czech Republic, and representatives of the business community have criticized the newly amended act for its failure to allow public access to information on the content of contracts and their appendices.

***b. Deficiency of the Public Procurement Act***

The author of this research believes that the adoption of the Act on Public Procurement still needs to be finalized, to ensure equal access for European Community companies through abolition of the national preference clause, alignment on remedies, improve transparency, alignment on time limits and thresholds. The Ministry of Regional Development has overall responsibility for public procurement legislation. The lack of qualified staff working at the ministry in this area should be urgently addressed. The Office for the Protection of Economic Competition should thoroughly exercise the surveillance of adherence to the Act on Public Procurement when awarding public contracts. The level of administrative capacity seems sufficient. Staff in both organizations, as well as in other relevant institutions (ministries, regional bodies, etc.) will need re-training once the adoption of the new, aligned public procurement act is finalized.

As it currently reads the amended Public Procurement Act (PPA) stipulates solely the minimum price of the future contract. It limits the term public procurement to subcontractor, service, and construction contracts, as well as restricting the interim provisions guiding the private contractors to those contracts where the public stake amounts to a minimum of 50 per cent of the contract. The Public Procurement Act allows for more exceptions from the law, and more exceptions from the force of the Act. Although PPA gives the government a free hand in selecting the type of the selection

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<sup>53</sup> Act No. 40/2004 Coll. on Public Procurement.

process – fully open procurement process or an invitation for bid -- it further complicates the proposal for a review process by a supervisory body by introducing high administrative fees simultaneously with a non-returnable advance deposit.

The PPA fails to introduce proper provisions guiding bid bonds by subcontractors and bidders whose bid process are not known; it fails to introduce a deadline for the ruling of a supervisory body on a preliminary measure or any other remedy to discontinue the challenged act of a contractor. Besides the above-mentioned failures, it further fails to provide for a mechanism to review the evaluation of the bids by the selection commission by a supervisory body. The PPA also introduces incorrect remedies and sanctions and its selected provisions may be impossible to apply and may make the PPA unenforceable. The author sees a negative impact of the amended Act on the prevention of corruption. An example would be the fact that the PPA excludes from its scope the sale of redundant military material from the warehouses of the Czech Armed Forces as well as arms acquisitions for the use of the military. The previous PPA<sup>54</sup> excluded from its scope the sale of redundant military material as well as procurement of “strategic property and services approved by the Government of the Czech Republic and related to the accession and membership of the CR in NATO.”

However, in §4, the new PPA No. 40/2004 further limits its effectiveness by excluding from its scope contracts “should they concern secret facts or matters”, “should it be necessary in order to protect fundamental national security interests”, or “should such contracts concern production, procurement, or maintenance of arms, weapon systems, ammunition, or supply of other military material to defend or protect national security”.<sup>55</sup> Under this new PPA, such contracts do not require government approval and do not fall under the supervision of the anti-monopoly authority, the Office for Protection of Economic Competition (OPEC). The older version of the PPA had withdrawn OPEC from supervising the sale of excess weaponry from the military warehouses and the new one now stipulates that the anti-monopoly office shall not supervise procurement of weapons for the military either. Public spending in acquisition

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<sup>54</sup> Public Procurement Act No. 199/1994 Coll.

<sup>55</sup> See reference No. 30.

and sale of weapons is thus excluded from already limited public control, and the same is true for supervision by more or less independent subjects. The legislators, however, not only failed to justify the exclusion but also forgot to replace the abolished supervision mechanisms by substitute control provisions. Therefore, they negated one of the most important principles in the arms trading.

***c. Secretiveness of Agreements***

Although the MoD has introduced some positive changes to its public procurement practice, especially in the area of internal control mechanisms,<sup>56</sup> such measures fail to replace independent control over the matter. In the case of large public contracts to acquire armament for the Czech military, the authorities, in keeping with the PPA have often used provisions that allow for limiting the procurement process to an invitation for bid to a group of pre-selected bidders or solely to a single bidder. Such a process, combined with the widely used provision of the Commercial Code, which guides events of business secret<sup>57</sup> and “protection under the Act on Protection of Secret Facts”,<sup>58</sup> have understandably led to suspicions of corruption and non-transparency of the public procurement process.

**2. Intricacy of Contracts and Offsets**

***a. Offsets Importance for the Government***

Intricacy of contracts and their appendices concerning offsets is another issue in arms trade, and is one of the risk factors. The offsets allow government representatives to justify contracts given out to bidders whose quality and price are far from perfect by saying that their offsets will bring investments in a form of side or additional investment programs. In some cases, such investments may be in the hands of business entities in which the decision makers hold substantial stakes. Moreover, enforcement of the provisions regarding offsets is often disputable. Regardless of the

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<sup>56</sup> Partially structuring the public procurement process and introducing internal MoD control mechanisms, and providing wider access to information regarding both planned and implemented public contracts on the web pages of the MoD. For more information see [www.army.cz/scripts/detail.php?id=170](http://www.army.cz/scripts/detail.php?id=170) (accessed July 22, 2006).

<sup>57</sup> §17, Act No. 513/1991 Coll., Commercial Code, as amended.

<sup>58</sup> §3, Act No. 148/1998 Coll., on Protection of Secret Facts.

risks, the Czech Government, in its decisions regarding the largest strategic public procurements, viewed offsets as an important part of the bids.<sup>59</sup>

***b. Unclear Evaluation Criteria***

Unclear evaluation criteria that may even change in the course of the procurement process are among other risks. Such criteria may be used to influence the key decision makers and to cover up for potential corrupt behavior. The evaluation criteria were not transparent, and suspicions of changes in the course of the procurement process have been present in the selection process for the supersonic aircraft for the Czech military (worth CZK 19.65 billion) and threaten to influence the upcoming contract for wheeled transporters (worth CZK 20.8 billion).<sup>60</sup>

***c. Unclear Czech National Armament Strategy and the Consequent Changes***

The first National Security Strategy (NSS) of the Czech Republic was adopted by the Czech government in 1999,<sup>61</sup> before the Czech Republic joined NATO. It was the key strategic document of the national security policy and as such it has been revised several times since then. Since 1993,<sup>62</sup> the government annually revises the Czech Military Development Concept.

Regardless of the two documents, the Czech armed forces in the past few years have witnessed substantial changes in decision-making concerning the Czech armed forces concept, scope, goals, and armament requirements. A number of decisions were made concerning expensive armament acquisitions, only to be cancelled several years later, resulting in billions in wasted funds. There have been no political or criminal sanctions for wrongly invested public funds. The lack of a clearly defined concept or the frequent changes thereof, as well as the failure to assign responsibility for specific wrong

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<sup>59</sup> Not To Compare Would Be Better, Euro on December 22, 2003; Any Advice Is Beyond Price, Euro on December 1, 2003; Slowly It Flows But Fast It Burns, Euro on December 1, 2003.

<sup>60</sup> Ministry of Defense, "Minister of Defense Signed the Contract on Armored Transporters," <http://www.army.cz/scripts/detail.php?id=7639> (accessed June 9, 2006). However the consensus throughout the Government was not reached, and the contract was signed in the time of parliamentary elections.

<sup>61</sup> Resolution of the Government of the Czech Republic No. 123, February 17, 1999.

<sup>62</sup> Resolution of the Government of the Czech Republic No. 297, June 9, 1993.

decisions, increases the risk of unlawful influence of commercial entities interested in the results of the decision making process over government officials.

### **C. PUBLIC SUBSIDIES**

Public subsidies to industrial plants or corporations are common in the Czech Republic and all over the world, and due to their potential the author believes they are an issue for the defense trade. Publicly, of course, the Czech government talk about the need to maintain jobs and the defense industrial base. These corporations are among the largest in the Czech Republic, as well as in the world, and they have tremendous political influence.

Public subsidies in the Czech Republic are guided by the Act on Public Subsidies,<sup>63</sup> and supervised by the Office for Protection of Economic Competition (OPEC). This research considers public subsidies in the Czech Republic's defense trade as relatively high, non-transparent, and very often kept secret.

#### **1. Unnecessary Contract Awards**

Awarding of unnecessary defense contracts has been an issue for a long time. For illustration, the author presents some of them. In 1997, the Czech government approved the acquisition of 72 L-159 subsonic aircraft, in an attempt to avert the bankruptcy of Aero Vodochody at the time of the negotiations concerning the entry of Boeing into Aero as a new strategic partner.<sup>64</sup> In 2003, however, the Ministry of Defense reported that the armed forces actually did not need 47 of the aircraft ordered.<sup>65</sup> Aero Vodochody delivered the last L-159 in February 2004, and only four months later the Government approved the sale of those 47 un-needed aircraft. Since that time, both Aero Vodochody and the Czech Armed Forces have been trying to sell the aircraft. Moreover, the Czech Armed Forces pay CZK 4.0 million monthly for storage of these excess aircraft in Aero Vodochody's hangars.<sup>66</sup> The military expended a total of CZK 42.6 billion to acquire

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<sup>63</sup> Act No: 59/2000 Coll., on public support.

<sup>64</sup> [www.globalsecurity.org/military/world/europe/l-159.htm](http://www.globalsecurity.org/military/world/europe/l-159.htm) (accessed June 16, 2006).

<sup>65</sup> <http://www.army.cz/scripts/detail.php?id=6520> (accessed June 16, 2006).

<sup>66</sup> MoD signed the contract with Aero Vodochody on February 28, 2006, <http://aktualne.centrum.cz/domaci/bezpecnost-a-doprava>, (accessed on August 29, 2006).



these aircraft. In relation to the aircraft acquisition, the government had also ordered (ZVI Vsetin Co.) and partially funded a controversial project of the research and development of the PLAMEN aircraft cannon. It had also awarded a contract worth CZK 400 million for the development of a flight simulator for this aircraft without a proper selection procedure.<sup>67</sup>

A similar procedure had been used in the case of the modernization of T-72 tanks. In 1995, selection procedures had commenced to find the suppliers of modernization components, counting on the adjustment of up to 353 of these tanks for military purposes.<sup>68</sup> The army had then ordered the modernization of 250 tanks, but reported in 2003 that it would only use 30 of them and keep another five for spare parts. However, the Defense Minister stated that the army would keep “80 percent of the modernized tanks to support national industry and its exporting efforts, and 20 percent for the necessary training.”<sup>69</sup> The costs of modernizing the definitive number of tanks, according to a contract concluded with the state-owned Military Repair Enterprise 025 in 2001 should have been approximately CZK 6 billion. However, this figure did not include the previous government investments in research and development.<sup>70</sup>

## **2. Lack of Control Over R&D Subsidies**

Standards for the provision of public support for research and development, stipulating the terms and conditions for public tenders, and introducing substantial elements of public control into the system, are formulated in the R&D Support Act.<sup>71</sup> However, in the field of defense acquisition, the act allows the Ministry of Defense to avoid disclosing the terms of public tenders in certain situations. Such a procedure requires the previous consent of the Research and Development Council (RDC).<sup>72</sup> In 2003, the RDC drafted their opinions on R&D programs, namely to public tender

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<sup>67</sup> Military awarded contract for 400 million without tender, Hospodarske noviny, December 18, 2003.

<sup>68</sup> [www.army.cz/mo/tisk/areport/2002/5/7.htm](http://www.army.cz/mo/tisk/areport/2002/5/7.htm) (accessed June 16, 2006).

<sup>69</sup> Armed Forces: Small and Professional, Hospodarske Noviny, July 11, 2003.

<sup>70</sup> [www.army.cz/mo/tisk/areport/2002/5/7.htm](http://www.army.cz/mo/tisk/areport/2002/5/7.htm) (accessed June 16, 2006).

<sup>71</sup> Research & Development Support Act No. 130/2002 Coll.

<sup>72</sup> Act 130/2002 Coll., Article 17, Section 6.

proposals in research & development, including the proposals for defense R&D programs “Professionalization of the Czech Military” and “Reform of Armed Forces in the Czech Republic”, presented by the Ministry of Defense. The Council also presents the government with an annual analysis and evaluation of the state of R&D in the Czech Republic, comparing them to the situation abroad. The analysis states that when investigating the practical use of applied R&D projects, the MoD recorded the most unexploited project results. Also, the majority of projects commissioned by the MoD had not achieved the anticipated results, and the majority of projects had remained unexploited due to the MoD's lack of interest in the project results (27 projects) and due to insufficient funds (22 projects).<sup>73</sup> The report does not make clear whether any conclusions have been drawn from this indicator.

In November 2003, the government adopted a general document concerning the focus of future defense R&D programs in the context of professionalization of the Czech military and reform of the Czech Armed Forces. It also ordered the Ministry of Defense to invite tenders for the various programs, and award contracts in accordance with the Public Procurement Act.<sup>74</sup>

### **3. Indirect Subsidies**

Indirect subsidies are the most widespread, if least visible, forms of assistance provided to private enterprise and other institutions. Indirect subsidies may take such forms as favorable tax policies, loans, import quotas, and price supports. Indirect public subsidies to state co-owned companies active in defense production include the government taking over guarantees for those companies' loans. In 1998, the government decided to undertake a government guarantee for the loans of Aero Vodochody, a. s., manufacturer of the L-159 aircraft. In February 2004, the government realized that Aero Vodochody was not doing well and admitted that the impact on the government budget

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<sup>73</sup> “Analysis of the Development and the State of the Research and Development in the Czech Republic, Comparison with Foreign Countries, and a Proposal of the Preparation Procedure for the new National Research and Development Policy of the Czech Republic for the Period from 2003 to 2008”, Government Resolution No. 516, May 22, 2002.

<sup>74</sup> Resolution No. 1133, November 12, 2003 of the Government of the Czech Republic on the programs of defense R&D and development for the professionalization of the Army of the Czech Republic and on the Reform of the Armed Forces of the Czech Republic.

caused by the payment of the company's obligations due to the state guarantee may reach up to CZK 3.3 billion in 2004, and up to CZK 6 billion in 2005. The government had also decided to initiate negotiations with Boeing concerning its withdrawal from Aero Vodochody and to find a new strategic partner in order to facilitate the company's restructuring. A new act on budgetary rules came into force in 2000,<sup>75</sup> substantially restructuring the possibilities of the uncontrolled taking over of state guarantees, stipulating that each individual case must be approved by the Czech government, and subsequently adopted as an act of the Parliament. Regardless of that, the Supreme Audit Office (SAO) claims that the Czech legal system continues to lack a satisfactory definition of non-standard government guarantees, thereby providing a wide opportunity for their abuse.

#### **4. Transparency of Public Support of Exports**

The author of this thesis already mentioned the public support of the production and export of arms through awarding unnecessary contracts. The Czech Armed Forces keep ordering arms that they either do not need for their own activities, or need a much smaller quantity, explaining that it is important for improvement of exporting possibilities for certain products of domestic companies (e.g., Tatra trucks for the Czech armed forces).<sup>76</sup> Not surprisingly, commercial entities as well as the Czech government representatives support defense export. However, there are no records of funds spent for such promotion (including the expenses of private business representatives traveling together with official delegations) or the number of such activities, let alone the number of businessmen participating in such missions.<sup>77</sup> There is no comprehensive information on the number of cases where Czech representatives lobbied in favor of Czech arms trading companies in meetings with their foreign partners.

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<sup>75</sup> Ministry of Finance of the Czech Republic, Act 218/2000 Coll., on Budgetary Rules.

<sup>76</sup> Český Rozhlas, "Czech army to buy Tatra trucks", <http://www.radio.cz/en/news/68609> (accessed September 19, 2006).

<sup>77</sup> It is happening on almost a regular basis. Not only the Defense Minister visits abroad, but also visits of the Prime Minister and the President of the Czech Republic are accompanied by businessmen.

**a. *Insufficient Parliamentary Control***

Debate over public support of defense export is not at the level its importance deserves. Until now, only a few isolated deputies or senators have protested in the media against the export of Czech arms into countries such as Somalia or Georgia. The deputies have not had the opportunity to discuss the national reports on arms transactions executed and debate the policy for controlling arms trade. Neither of the chambers has yet reviewed annual reports on trading in small arms published so far. Unlike deputies in other European countries, such as Sweden, the Czech politicians may not advise the executive bodies in controversial cases of granting permits for planned arms exports. Until recently, it was not even clear which parliamentary body or committee could control arms export.<sup>78</sup>

**b. *Revolving Door Syndrome***

A serious phenomenon, known as the “Revolving Door” syndrome, has been experienced in the Czech military. This involves situations where former government officials or military officers retire to jobs in private companies in fields of their specialization in the public service, for example, participation of retired military officers in private companies supplying the Czech Armed Forces. Several foreign studies have warned that such cases help create mutually dependent personal networks or lead to conflicts of interest, where responsible behavior of such officials is difficult to enforce.<sup>79</sup>

An example of the revolving door syndrome from the Czech Military would be case of the former chief of the General Staff who retired from the military in 2002. The media reported that less than a year later he founded Generals Ltd., a company specializing in commercial consultancy to companies wishing to get military contracts.<sup>80</sup> His company organized a tour for senior executives of the US company General

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<sup>78</sup> In attempt to increase the parliamentary control over military equipment export, the Chamber of Deputies Committee for Foreign Affairs established its Subcommittee on Foreign Economic Relation and Control over Military Equipment Trade on June 2, 2005. However, the last known meeting was on June 21, 2005, <http://www.mzv.cz/servis/soubor.asp?id=19677> (accessed August 1, 2006).

<sup>79</sup> Catherine Courtney: Corruption in the Official Arms Trade. Policy Research Paper 001, April 2002, Transparency International UK, edited by: Laurence Cockcroft and David Murray.

<sup>80</sup> Tomáš Horejsi, “Former Chief of the General Staff Advise Companies on How to Sell to the Czech Military,” *EURO*, February 2, 2004.

Dynamics to meet top military officers and MoD officials. General Dynamics was interested securing in a contract for 243 armored transporters, worth approximately CZK 25 billion (at that time). In relation to this contract, Generals Ltd. employed two other retired generals. Another well-known example of the involvement of former military officers in arms trading or manufacturing companies is the former air force commander who became, after his retirement from the military,<sup>81</sup> an employee of the most important arms producing company in the Czech Republic, Aero Vodochody.

Currently, the “Revolving Door” syndrome is not addressed by law. The issue was even not included in the act<sup>82</sup> guiding the conditions for obtaining retirement benefits, severance payment and settlement for professional military members. Members of the government further failed to address the issue in the Public Interest Protection Act, the Conflict of Interests Act or any other mechanisms that may protect the country from the above mentioned syndrome.

*c. Transparency in Managing of Arms Excess*

Since the governmental “divorce” in the former Czechoslovakia, the Czech Armed Forces have been reducing extensively their military armaments and technology. This reduction has been prompted by the Treaty on Conventional Armed Forces in Europe, modernization of the Czech Armed Forces, and the Reform of the Czech Armed Forces. However, the MoD is not able to provide comprehensive statistical data concerning the volume of surplus reserves it has disposed of, and of the volume resold to private entities for further exportation abroad. According to the Czech Ministry of Foreign Affairs, between the years 2003 and 2005 the Czech Republic exported/sold weapons at the total cost of approximately EUR 173 million.<sup>83</sup>

The author of this thesis sees another issue in the above-mentioned exports, particularly in selling weapons to countries such as Ethiopia, Azerbaijan,

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<sup>81</sup> Military Getting Influence at the MoD and Private Sector, Hospodarske Noviny, September 25, 2003.

<sup>82</sup> Act No. 221/1999 Coll., on Professional Soldiers, as amended.

<sup>83</sup> Czech Ministry of Foreign Affairs, “Report on Export of Military Equipment and Weapons in 2005,” <http://www.mzv.cz/servis> (accessed June 16, 2006).

Nigeria, etc. The practice is, in the author's belief, against the European Code of Conduct on Arms Export (ECCAE).<sup>84</sup> Based on various national security sources, the excess military materials have constituted the majority of both legal and illegal exports from the Czech Republic.

*d. Licensing Issues*

The Czech Republic's defense exports are subject to a two-tier licensing process. Private companies wishing to sell, offer, advertise, or purchase military material have to first obtain a general license issued by the Ministry of Industry and Trade, based on the consent of the Ministry of Foreign Affairs, the Ministry of Defense, and the Ministry of Interior, and which may be granted only to legal entities registered in the Czech Republic in which Czech citizens hold a majority stake and which possess sufficient technical and financial resources. Furthermore, vetting by the National Security Authority (NSU) is required for senior company executives. The companies that obtain the permit must then apply for a special license for each export. Export licenses are issued by the Ministry of Industry and Trade, following a consultation with the Ministry of Foreign Affairs, which has to assess the application with regard to foreign policy consequences and a proof of the end purpose. In case of the export of important military material, the license application has to be reviewed by the Ministry of Defense as well.

Mainly due to the security measures adopted following the terrorist attacks in September 2001, the current control system has been revised several times in recent years. The Central Crisis Headquarters established an investigation committee within the National Action Plan for Combating Terrorism,<sup>85</sup> in order to ascertain whether Czech companies were involved in supply chains providing military materials to terrorist groups.

Later, in 2003, the government ordered the Ministries of Industry and Trade, Interior, and Defense to submit their evaluations of the functioning of the existing

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<sup>84</sup> European Union, "European Union Code of Conduct on Arms Exports," June 5, 1998, <http://ue.eu.int/uedocs> (accessed August 1, 2006).

<sup>85</sup> The Government of the Czech Republic Decree No. 385, "National Action Plan for Combating Terrorism," adopted on April 10, 2002.

control regime for foreign trade of military material. In July 2003, a series of measures proposed by the final document were adopted.<sup>86</sup> The decision was made to include supervisory board members in companies applying for a foreign trade permit for military materials, within the group of persons subject to security audits. The government also extended the deadlines by which the Ministries have to issue their opinion on the license application. Moreover, it requires the Ministry of Industry and Trade to immediately notify the Ministry of Interior of all license applications received, and allows the Ministry of Interior to refuse an application should the export concerned threaten national security interests. It also requires the Ministry of Industry and Trade to establish an information exchange between the Ministry and the EU bodies concerning denials (denied export licenses).

All of the above measures represent a step in the right direction. Strengthening the internal control mechanisms of the authorities involved, standardizing the decision-making process and extending the scope of information-sharing between the ministries throughout the licensing procedure, which has been somewhat problematic so far, represents the right direction. In spite of all of these measures, certain problems remain.

Czech authorities have considered the establishment of a central registry of all administrative sanctions, recording the offences of companies and individuals against the administrative law, for a long time. The analysis of options for establishing a registry of certain administrative sanctions, provided by the Ministry of Interior, identified the creation of such a register as the key step among anti-corruption measures. However, it is not clear when such a registry will be established, or even if it should be established. At present, there is no source of information concerning arms trade that would provide the relevant record of past offences of the entities involved, thus enabling the bodies involved in the license procedure, export supervision, or procurement procedure to obtain important information to prevent possible unfair conduct or repeated offences of such entities. Within the existing license procedure, similar databases are

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<sup>86</sup> The Government of the Czech Republic Resolution No. 685, July 9, 2003.

maintained by various authorities (Ministry of Industry and Trade Licensing Administration, Ministry of Foreign Affairs, Customs Service of the Ministry of Finance), but they are not shared. This prevents both proper control and systemization of the public authorities' decision-making process.

A recent incident, thoroughly discussed in the media and raising questions concerning the authorities' impartiality and adherence to clearly defined rules in licensing procedures, was the attempt to export Vera passive surveillance systems into the People's Republic of China. Omnipol, the Czech arms export company, obtained a permit to export the systems in the middle of January 2004, despite the fact that the EU has imposed an arms export embargo on China. The Czech government has finally decided on 20 May that the respective Ministry should withdraw the export permit granted for foreign policy reasons.<sup>87</sup>

None of the measures adopted to date, not even the government amendment of the Act on Trading in Military Material,<sup>88</sup> attempt to reduce the risks of illegal exports concerning re-export to other countries by establishing a procedure of performance audit of the end user stated in the export permit application after a certain time period, and the imposition of automatic sanctions on both the exporter and the customer for violations of permit conditions.

*e. Public Control*

As the author already mentioned, the licensing as well as the arms export in recent years have called for attention of media and NGOs. However, due to the lack of information concerning licensing procedures provided by public authorities in recent years, public debate was limited.

Since 2000, the transparency of the arms trade in the Czech Republic has greatly improved due to publication of an annual report on the export and import of small arms.<sup>89</sup> This and other reports in the subsequent years have been drafted by the

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<sup>87</sup> Radio Prague, "Government to Halt Export of Radar System to China," May 20, 2004.

<sup>88</sup> Act No 38/1994 Coll., on Foreign Trade in Military Material.

<sup>89</sup> The Government of the Czech Republic Resolution No. 138, November 20, 2000. The following year, the Resolution No. 189/2001 was adopted considering the 2000 report. This report did not include



interdepartmental working group for small arms, and issued by the Ministry of Foreign Affairs. The reports analyze the approach of the Czech Republic toward international negotiations concerning small arms owned by firearm license holders in the Czech Republic. However, they fail to report data on the number of small arms owned by the Czech Armed Forces. Similar limitations apply to the information on production, permitted exports and permit denials.

The above-mentioned information represented a breakthrough in improving transparency of government authorities towards the public -- their scope was limited to only one category of military equipment (i.e., small arms and light weapons). Therefore, in 2004 the Government decided to publish a national annual report covering exports of all military equipment in a given period, whereby the quantity and quality of provided information would correspond to broadly shared standards within the European Union. The first report of this kind entitled "Control of Exports in the Czech Republic in 2003" was published in December 2004.

### **3. Czech Participation in International Organizations Fighting Corruption**

Unfortunately, corruption is witnessed all over the world, and therefore is involved also in international business relationships. High risk of corruption for that reason, at least in the recent years, has been the centre of attention of both international and intergovernmental organizations. The Czech Republic has joined a number of international initiatives and mechanisms to prevent corruption in this field. In 2000, the Czech Republic acceded to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions;<sup>90</sup> in 2002, the Criminal Law Convention on Corruption of the Council of Europe came into force,<sup>91</sup> followed by the

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data on small arms and light weapons in service with the Czech Armed Forces and armed corps. These data were classified under Act No. 148/1998 to regulate classified information and to amend certain other laws and regulations and Government Directive No. 246/1998.

<sup>90</sup> OECD, "Convention on Combating Bribery of Foreign Public Officials in International Business Transactions," entered into force on February 15, 1999, <http://www.oecd.org> (accessed July 1, 2006).

<sup>91</sup> Council of Europe, "Criminal Law Convention on Corruption," entered into force on July 1, 2002, <http://conventions.coe.int/treaty> (accessed July 1, 2006).

Civil Law Convention on Corruption in 2004. The Czech Republic has also joined the Group of States against Corruption, working under the Council of Europe. In 2006, the Council issued a number of recommendations particularly for the Czech Republic, which were aimed at reducing corruption, such as restriction of the parliamentary immunity of the Czech deputies against criminal prosecution, money laundering, etc.<sup>92</sup> However, the Czech Republic has not yet joined several important international mechanisms and it has not ratified the UN Convention Against Transnational Organized Crime. One of the reasons for not ratifying is the non-existence in the Czech law of the criminal liability of legal entities, which is required by the text of the Convention. The Czech Republic finally signed<sup>93</sup> the UN Convention against Corruption, adopted by the UN General Assembly, in October 2003.

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<sup>92</sup> Council of Europe, Group of States against Corruption, "Evaluation Report on the Czech Republic," May 12, 2006.

<sup>93</sup> The UN Convention Against Corruption was signed by the Czech Republic on April 22, 2005, [http://www.unodc.org/unodc/crime\\_signatures\\_corruption.html](http://www.unodc.org/unodc/crime_signatures_corruption.html) (accessed June 22, 2006).

## **V. CONCLUSION AND SUGGESTIONS FOR FURTHER RESEARCH**

This chapter provides a summary and conclusions regarding the issues the Czech Republic faces concerning offsets in the context of military purchases and international trade. This chapter draws conclusion from the analysis and provides recommendations regarding changes in Czech Government policy and practices towards offsets. The summary concludes with areas for further research.

### **A. SUMMARY AND CONCLUSION**

Offsets represent reciprocal economic advantages that result from trade agreements. Nowadays, due to increasing competition among suppliers, the reduced global defense market, declining military budgets, and other aspects, buyers are able to influence the conditions under which major defense programs are obtained. Therefore, offsets are used predominantly in a sense of variety of industrial, commercial and political arrangements under which foreign suppliers implement specific actions aimed at partially or fully compensating the buyer's procurement cost. The Czech Republic seeks these compensations in full for the direct cost of procuring major defense programs. These offset practices, however, do not fit the free trade principles and create barriers to free trade.

Better economic infrastructure, health service, and social aspects of a particular country are usually seen behind implementation of different offsets. Fulfillment of offset agreement is usually achieved through various projects realized in the buying country, and very often together with third parties, and often in the form of technological transfer, license, and mutual interest. These projects also offer the possibility of global expansion for small businesses.

Besides the buying government and seller, there is a wide variety of stakeholders involved in some degrees with offsets and their implementation. Unions, defense industries, trade associations, and the public are among some of them.

Some countries, such as the Czech Republic, strongly support offsets implementation as indispensable to making a business. Others view offsets as an inevitable obstacle. Given these views, offsets are quite controversial. Some areas of controversies might be transactional cost to implement offset, negative effects on unemployment, and security issues.

### **1. Summary of the Economic Environment of the Czech Republic**

The Czech Republic is one of the most stable and prosperous of the post-Communist countries of Central and Eastern Europe. The Czech Republic's economic growth performance has continuously been improving and now compares favorably with other countries in the region. It has a stable currency, low unemployment (7.3% in June 2006), and low national debt (CZK 728.9 billion in July 2006, nominal value). Gross Domestic Product grew by 7.4 percent in first quarter of 2006, and is estimated to stay in the range of six to seven percent in 2006 and 2007. The inflation rate in July 2006 was 2.4%. Low inflation and interest rates have been a strong point of the economy for recent years and also policy is well prepared to meet the monetary challenges of Euro entry which is scheduled for 2010. However, the next government will face considerable challenges in achieving fiscal sustainability. Currently, three months after the parliamentary election in the Czech Republic, it is still not clear whether the country will have a stable Government, and who it is going to be. Challenges also remain in improving administrative processes, overcoming shortcomings in specific areas of business legislation and dealing with corruption.

The Czech Republic became the first former Warsaw Pact member to join the OECD in 1995, and the first to be given an A rating by Standard and Poor's. Czechs were among the founding fathers of the UN, IMF, World Bank and GATT but the "iron curtain" did not allow the country to be present at the birth of NATO. However, in 1999 the Czech Republic finally became a NATO member. In 2004, the Czech Republic became a member of the EU as well. The country also offers an excellent central European location and a highly skilled work force. The country's overall macroeconomic, political, and social stability create an attractive investment climate for foreign investment and trade.

## **2. Offset Policy**

Offset policy has been implemented into the procurement programs of the Czech Republic since the year 1998, when the Czech Government issued its first decree (Decree No. 421/1998) that stated conditions for application of offset requirements. Gaining experience, especially from work on the supersonic aircraft procurement contract, required a considerable amount of flexibility in reaching the agreement from both the procurement staff and the contractor. The Ministry of Industry and Trade therefore, using that experience, prepared a new decree (Decree No. 9/2005), and following the decree, the MIT issued its order (Order No.3/2005) that detailed the governmental decree.

In short, the implementation of offsets, or industrial cooperation programs, has never been regulated by a special law in the Czech Republic. It is regulated by government decree and is binding on all government organizations and bodies performing procurement through state budget. The Ministry of Industry and Trade of the Czech Republic is the keeper of the industrial cooperation policy.

## **3. Offset Regulations**

There are four main principles for offset transactions in the Czech Republic provided in Table 6.

Table 4. Principles for Offset Transactions

1.	To apply compensation transactions to direct deliveries exceeding CZK 500 million (+/- EUR 16.6 million), or sub deliveries exceeding CZK 250 million (+/- EUR 8.3 million) of equipment, materials and services for defense and security purposes from abroad
2.	The compensation to constitute at least 100% of contract value with at least 20% of the direct offsets
3.	Maximum length of the program to be 10 years
4.	Condition for participation in a public tender

Direct Offset Transactions shall account for at least 20 percent of the purchase price of the subject matter of the public contract in question, which is charged to the foreign contractor or subcontractor.

The requirement for the implementation of an offset program in the framework of a public contract is generally formulated as an indispensable condition for taking part in a public tender or, if just one contractor is addressed, an indispensable condition of the performance of the public contract.

#### **4. Principal Participants in the Process of Industrial Cooperation Programs**

There are several key players in the ICP. At the stage of contract negotiation, the key players are the MoD on one side and the winner of the competition on the other. These two players therefore maintain the legal relationship as long as the offset agreement is in effect. The MoD represents the Czech Republic and has the final word in approval of the final value of particular offset transactions.

Another key relationship is between the contractor and the Czech industry. Professional associations, such as the Defense Industry Association (DIA), can represent the industry. The government does not declare where the offsets should be directed, nor does it select the Czech partner of the offset transaction. It is a responsibility of the Contractor to research capabilities of the Czech industry and to find the suitable partner. Once the contractor with the selected Czech partner come to the agreement, they together develop the offset transaction proposal and the contractor submits the proposal to the Ministry of Industry and Trade. The MIT presents the proposal to the Offset Commission.

This Offset Commission is an intergovernmental body, whose members have the delegated authority to approve the submitted transaction. The Commission itself consists of representatives of the Ministry of Industry and Trade, Ministry of Finance, Ministry for Regional Development, Ministry of Foreign Affairs, and Ministries of Defense and of Interior as representatives of the state in the offset agreement. The MIT is the only body that has a total overview on all programs and all transactions.

In the effort of foreign commercial partners to look for transaction opportunities, the Czech side does not set up any specific requirement (industrial, branch nor regional) for the individual offset programs nor transactions.

The carefully formulated agreement is the key to the good relationship between the MoD and the contractor. The Industrial Cooperation Agreement should be signed at the same time as the related delivery contract.

## **5. Czech Gripen Program – A Successful Story (So Far)**

The Agreement on the Industrial Cooperation Program has been signed for a period from June 14, 2004 through December 31, 2014. This period represents more than 10 years. The offset obligation represents 130% of the Gripen aircraft lease, of which 20% represents the direct offsets. In absolute figures, the offset obligation is CZK 25.5 billion.

Although most of these offset transactions will generate a value in the future, the Czech MoD has already approved the second annual Offset Performance Report, which claims that after about two years into the ten year program, the total offset reached CZK 6.6 billion (26% of the total obligation). Nevertheless, about 3/4 of the overall value of the program has yet to be generated. Up to now, it seems that the program will be going well in the near future. The latest claim also forwarded new transaction proposals to the MIT.

## **6. Issues Concerning Offsets and International Trade**

The Czech Republic became an EU member in 2004. Nearly all barriers to trade in industrial goods with the EU fell in the course of the accession process, which had a positive impact on reform in the Czech Republic, and new EU regulations and directives continue to shape the business environment. The Czech Republic was also announced to be a fully developed country in 2006. Free trade, as well as stronger regulation and rising labor costs, will mean tougher competition for Czech producers in the future.

However, the Czech Republic's economic transformation is not yet complete. The government still faces serious challenges mainly in completing industrial restructuring

and increasing transparency. In the annual reports on the implementation of the “Program for the Fight against Corruption,” the Czech government has in the past years introduced various measures to prevent and fight corruption. In spite of this, corruption remains a serious problem, as is evidenced by recent corruption scandals. Therefore, further efforts are required in the years to come. To be more specific, the author believes that there is an insistent and immediate need to address conflicts of interest, competitive hiring of persons employed in the whole public sector, reporting suspicions of corruption and satisfactory protection for those who do, and protection of public officials who report instances of corruption in good faith.

As indicated by this thesis, should the Czech government truly wish to succeed in combating corruption in the field of the defense trade (and indeed, in other fields as well), it needs to implement a number of changes to limit the corruption behavior. Some of the most needed and most important measures were introduced in Chapter IV, and their summary follows below.

An amendment to the Public Procurement Act should be implemented to limit the number of exemptions from the force of the Act, including the defense and arms trade. Restricting the contracting authority's free choice of the type of the selection process, simplifying the process of proposing reviews of the contracting authority's actions, introducing a system allowing for a review by a supervisory body of bid evaluations performed by evaluation committees, and introducing active remedies and sanctions for the violation of provisions of the PPA, should all be a part of the new amendment.

Transparency, as well as simplification of the selection process, must be improved. The evaluation criteria and contracts as such should remain the same throughout the entire selection process. The selection process should always be open and simple to the maximum extent, and bid evaluations should not take into consideration offset proposals.

To ensure public access to information on public subsidies of R&D and arms sales, the central registry of subsidies should be extended to include information on all types of government subsidies.



When allocating the Government's subsidies, the transparent conditions must be provided. The Government should favor neither indirect support nor classified support over public or parliamentary control. When the Government provides its subsidies via awarding unnecessary contracts, the key officials involved shall bear full personal, political, or even criminal responsibility.

Last, but not least, introduction of preliminary and follow-up parliamentary defense trade control, as well as publishing of regular detailed reports on arms trade for the use of the general public, should follow.

## **7. Conclusions**

The introduction of the Czech Republic's experience with defense offsets, although limited in scope and depth, can be useful to other countries. The biggest offset program in the Czech Republic used as an example for the purpose of this thesis, the Gripen Industrial Cooperation Program, proved to be effective in the time this thesis was written.

It is relatively easy to monitor formal fulfillment of offset program in terms of contracts signed; however, it is difficult to establish whether these offset transactions are the result of the offset arrangements. It is also difficult to evaluate the contribution of offsets to the achievement of long-term goals within defense and economic development policy due to the multitude of other determinants that can affect these goals.

The effects of offsets on jobs are a crucially important question because the industry contributes so much to total Czech employment: 34% of GDP is an industry share, 26% of the total number of employees in the Czech Republic work in industry, mostly high-skill, high-wage jobs. The nation would benefit from more of them, and a priority policy question is how to generate them. One view holds that offsets generate or at least sustain jobs in the Czech Republic. However, the author of this thesis didn't find any proof for supporting this view. More time is needed to evaluate the offset effects on employment in the Czech Republic.

For the public sector, an aging, retirement-eligible workforce means that the necessary talent for the future will not be available unless actions are taken to recruit

quality employees with requisite skills. For the private sector, the ability to attract new talent is directly related to the current business environment. Until potential employees look upon the defense industry as a growth sector of the economy, it will continue to have difficulty competing with other sectors for the next generation talent it needs. However, no sufficient evidence that the offsets improve human capital was found.

Technology transfer is the most common type of direct offset in defense transactions. Up to 30 per cent of all offsets provided relate to technology transfer of varying degree. Most of the buyers want the technology to manufacture the complete system, if possible, or at least its sub-assemblies. Although commonly touted as the most beneficial offset, its effectiveness remains suspect for many nations. Examples of various manufacturers taking the advantage of the Gripen program in the Czech republic show no evidence to support the technology transfer. However, not all offset transactions have been applied yet, and the Gripen program is still at the beginning. The biggest drawback of technology transfer as an offset is that it is very difficult to measure its real impact and effectiveness. The Czech Republic, as well as any recipient nation, has to have a dedicated set-up to verify and assess the overall benefits. Technology transfer for the sake of getting an offset is of no avail.

The duration of the Industrial Cooperation Program must be also considered when assessing the long-term impact of an offset program. Direct offsets are usually established for the time period of the contract and so are considered to have a relatively short-term economic effect. When the offset program is completed, there is a need to find another work for labor, and other use for machinery, equipment, capital, etc. Therefore, it is even more difficult to estimate the value of a particular contract. The more an offset activity is fitted to an existing strategy, the better results in the future.

Offsets themselves add complexity to an already complex international trade. The more complex the program, the more space it has for a hidden agenda. Maximum effort has to be made to ensure transparency throughout the whole process of Industrial Cooperation Programs.

## **B. SUGGESTIONS FOR FUTHER RESEARCH**

The research conducted for this thesis investigated the issues the Czech Republic face concerning offset implementation in the context of military purchases. Further research in the area of the Czech Republic involvement in offsets is warranted, particularly identifying alternatives to offsets within the Czech Government that would follow and respect principles of free trade.

Identifying the real total value of the Gripen Industrial Cooperation to the Czech Republic and its Armed Forces would also prove valuable. That would require a group of knowledgeable people with access to all relevant information, and would also require that this group stay with the program for its duration. That would be an extremely difficult mission, especially due to the complexity of the offset program.

Determining costs associated only with the implementation of offset programs would be another interesting topic for further research. That would embrace the significance of various costs incurred during the offset program implementation by both sides. This research would also identify methods of payment and its distribution, as well as to how these costs are paid and identify who pays these costs.

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## **APPENDIX A**

### **A. CORRUPTIVE ENVIRONMENT**

#### **1. Introduction**

There are many different definitions of corruption. For the purpose of this research the author uses the Czech government's definition of corruption: "the abuse of a person's office and violation of the impartiality principle in decision-making, motivated by a desire of profit. Corruption is a mistake in the decision-making (governing) process. The elements of corruption relationship are the decision-maker; the decision-maker's power to deviate from prescribed rules; making such a deviated decision in exchange for a certain benefit; and the wrongfulness and immorality of such an exchange. The capability of institutions to subdue and combat corruption indicates the quality of such institutions and of the institutional system as such."<sup>94</sup>

The risk factors enhancing the danger of corruption are the following: distribution of government subsidies; trading restrictions; inconsistent and non-transparent decision-making of the public bodies; inefficient sanctioning and monitoring mechanisms; lack of public and parliamentary control; and the conflict of interests.

#### **2. Corruption in the Czech Republic**

Early, in 1998, the Czech government had acknowledged the seriousness of corruption in the Czech Republic and subsequently defined the fight against corruption as one of its priorities.<sup>95</sup> In the following year, it adopted<sup>96</sup> the Government Program of Fighting Corruption, which it has been circulating annually since then. As regards indirect corruption criteria, the Czech Republic ranked 47<sup>th</sup> among world countries with a score of 4.3, according to the Corruption Perception Index (CPI), published by Transparency International in 2005. A survey conducted among senior private business

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<sup>94</sup> Resolution of the Government of the Czech Republic No. 473 of May 19, 2003 concerning the Report on Corruption in the Czech Republic and on Meeting the Schedule of Measures adopted under the National Program for Combating Corruption.

<sup>95</sup> Statement of Government Policy of the Czech Republic, Prague, August 1998, [www.mzv.cz](http://www.mzv.cz) (accessed June 18, 2006).

<sup>96</sup> Resolution of the Government of the Czech Republic No.125, of February 17, 1999.

officials in the developed countries revealed that 38 percent of the respondents believe that the highest bribes in their country are being paid in the defense industry. According to the US Department of Trade, almost 50 percent of bribes in the U.S. are paid in connection with defense industry contracts.<sup>97</sup> In the Czech Republic, no such indirect quantitative review of corruption in the arms trade has yet been performed. Apart from institutional barriers and the extent of the aversion of society to corruption, the total scope and level of corruption obviously depend on the total volume of funds involved in the respective area of trade. The scope of arms trading in the Czech Republic is nowhere near the figures involved in certain developed countries (especially the United States). The tables below provide a general overview of the volume of financial transactions in Czech domestic and foreign defense trade. However, the outline does not intend to suggest that the figures are directly related to the scope of corruption in this industry. They should merely serve as a framework for better understanding of the scope and importance of the defense trade for the national economy.

Table 5. Czech Foreign Trade in Arms and Ammunition (real value, CS0 didn't provide with the base year)<sup>98</sup>

<b>Year</b>	<b>Import (CZK)</b>	<b>Share of Total Import (%)</b>	<b>Export (CZK)</b>	<b>Share of Total Export (%)</b>
2005	1,177,954,000	6.4	2,736,637,000	14.6
2004	1,065,677,000	6.1	2,428,258,000	14.1
2003	1,221,943,000	8.5	2,208,868,000	16.1
2002	559,797,000	4.2	2,425,313,000	19.3
2001	375,271,000	2.7	2,534,947,000	19.9
2000	387,489,000	3.1	2,685,771,000	23.9

The most important part of the “domestic” arms trade is the acquisitions of the Czech military. Exact figures are not being published in this field, and the total expenses for the procurement of arms and ammunition may only be roughly inferred from the Ministry of Defense annual reports, or from reports submitted by the Czech Republic to the UN.

<sup>97</sup> U S Department of Commerce: “The National Export Strategy”, Trade Promotion Coordinating Committee Report, March 2000, page 11.

<sup>98</sup> Czech Statistical Office, <http://dw.czso.cz/pls/stazo/stazo.stazo> (accessed July 17, 2006).

Table 6. Defense Expenditures of the Czech Republic (current year money)<sup>99</sup>

<b>Defense Expenditures (CZK billion)</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>	<b>2001</b>	<b>2000</b>
Ammunition and Arms Procurement	11,103	9,951	9,629	10,232	9,866
Defense Research & Development	0,486	0,530	0,398	0,396	0,282

There is a certain increase in the volume of arms procurement for the military, in connection with the recently launched process of modernization of the Czech military, and in connection with the purchase of 199 wheeled armored transporters (worth CZK 20.8 billion)<sup>100</sup>, and the leasing of 14 Gripen supersonic aircraft (worth CZK 19.65 billion).<sup>101</sup>

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<sup>99</sup> <http://daccessdds.un.org> (accessed July 17, 2006).

<sup>100</sup> The Czech Defense Minister signed the contract on June 9, 2006, [www.army.cz](http://www.army.cz) (accessed June 18, 2006).

<sup>101</sup> Contract signed by the Czech Defense Minister on June 14, 2004, [www.army.cz](http://www.army.cz) (accessed June 18, 2006).

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