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OFFSETS AND INTERNATIONAL GOVERNMENT PROCUREMENT:

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OFFSETS AND INTERNATIONAL GOVERNMENT PROCUREMENT: DO TRANSPARENT AND ACTIVE OFFSETS POLICIES HAVE A POSITIVE IMPACT ON CORRUPTION?

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SUMMARY

A large number of World Trade Organization (WTO) member countries require offsets compensations for their major international contracts, despite the fact that WTO / Government Procurement Agreement (GPA) prohibits or strictly limits offsets to prevent distortion of competition and public sector corruption. In that paradoxical context, a significant number of active offsets countries have implemented transparency policies for their offsets requirements. This paper identifies a positive impact of offsets transparency policies on public sector corruption as measured by Transparency International Corruption Perception Index (CPI). Recommendations for active and transparent offsets policies to support ethical economic development are presented in conclusion.

KEYWORDS LIST

Corruption Perception Index, Government Procurement Agreement (WTO / GPA) International Government Procurement, Offsets, Offsets Transparency Policies, Offsets Requirements, Public Sector Corruption,

Introduction

Government procurement was not originally included in the scope of the multilateral trade discussions that followed WW2 and especially in the "General Agreement on Tariffs and Trade" round that was held in 1947. But as government procurement represented a significant part of the GDP of most countries, it could no longer be ignored in the following multilateral negotiation rounds on international trade. Tokyo Round of Trade Negotiations in 1979 adopted a first Agreement on Government Procurement, implemented in 1981 and amended in 1987 (Arrowsmith, 2003). It is in 1994, through the Uruguay Round, that the current Government Procurement Agreement (GPA) was signed in Marrakesh. This agreement defines a framework of rights and obligations for government procurement with respect to national laws and regulations for WTO member countries including a specific article formally prohibiting offsets practices with some exceptions for developing countries¹. The Agreement allows a special treatment for offsets practices in least-developed countries, on the conditions it fulfils specific economical purposes and it is not used as criteria for awarding contracts. In December 2006, negotiators reached provisional agreement on the revision of the 1994 GPA text, confirming general prohibition of offsets with the exception for developing countries and a general exemption for military, defence and security related procurements.

Offsets definitions and debates

Offsets refer to contractual practices applying to international government procurement markets, in the fields of defence, energy, transport, telecommunications and other general public infrastructure. The 1994 WTO/GPA defines offsets as "*measures used to encourage local development or improve the balance-of-payments accounts by means of domestic content, licensing of technology, investment requirements,*

¹WTO-Agreement on Government Procurement(1994)Article XVI and Provisionally Agreed Revised GPA Text Articles III and IV on exceptions and exemptions.

counter-trade or similar requirements. Offsets are usually categorised into direct offsets and indirect offsets, and in some cases into semi-direct offsets (Martin, 1996). Direct offsets are linked to a specific tender and generally are a part of the infrastructure to be built or implemented locally by the buying country. Through direct offsets, government authorities require suppliers to transfer either a part of the technology of the system sold and/or to subcontract a certain share of the contract to local companies such as local manufacturing, local procurement of sub systems or components, or local training. Indirect offsets consist in implementing or supporting locally value-added operations that are not, per se, linked to a specific public tender. Indirect offsets may be investments in existing local industries, transfer of technology or of licence to create new local industries, or export assistance for existing local products. Offsets contract terms generally makes provision for penalties if the obligation as described above is not adequately fulfilled by foreign private parties.

Offsets practices have been subject to considerable debates in the last 20 years (Nackman, 2011). About 120 countries around the world are estimated to have required some forms of offsets programs linked to their government procurement contracts in the last 25 years. At the political and macro-economic levels, a number of benefits have been consistently attached to offsets practices (Brauer, 2004) : 1) balance of payment benefits as offsets are considered as a way to finance expansive projects for countries without access to substantial financial resources, 2) economic and technological development benefits as local companies might be involved in the engineering, manufacturing and servicing for the contract implementation, providing opportunities for technology and know-how transfers, 3) strategic benefits, especially in the case of defence contracts, as offsets might create financial and technological inter-dependencies between countries². However, a significant number of critics have been addressed to offsets practices: 1) offsets generate important transaction costs for the selling party in order to prepare, administer and monitor the offset contracts, adding important costs to the buying party 2) Offsets distort competition and foster uncompetitive practices between selling parties due to contract complexity and opacity in decision criteria and implementation follow-up 3) Indirect offsets and especially practices of indirect pre-offsets limit competition as they favour coalitions between selling and buying parties that contradict principles of international contractors equal access to International Government Procurement, 4) In general terms, offsets in international governmental procurement are suspected to foster corruption between political and business circles and between buying parties and selling parties (Auriol, 2006).

Those negative effects attributed to offsets explain why inter-governmental agencies such as the World Trade Organization, the European Union³ and other inter-governmental agencies have prohibited or strictly limited offsets practices (Pacini, 2002). However, despite prohibition and restrictions, offsets practices have constantly increased in the last 25 years, in developing countries as well as in developed countries. According to Transparency International, offsets requirements in international government procurement doubled between 1993 and 2005 and after a decline in the years 2007 – 2008 due to the financial crisis, offsets have increased again between 2009 and 2011.

The emergence of governmental regulatory initiatives for offsets contracts

Recognising the fact that offsets have become a resilient component of international government procurement, a significant number of governments have implemented regulations to ensure transparent offsets criteria in their tenders and, for some of them, introduced independent reporting on offsets implementation to monitor cooperation between foreign and local parties and to prevent corruption. This movement towards regulation and monitoring of offsets requirements has been driven, in most cases, by governmental defence contracts due, on one hand, to the fact that offsets are allowed for defence and security contracts as a general exemption from WTO / GPA and on the other hand, to the fact that defence contracts are amongst the most important international government procurement expenses in many countries⁴. Those regulations, known as "*fair offsets practices*" have not been subject to any official inter-governmental regulation schemes and have been left to the initiative of individual governments. A precursor of an active policy maker regarding "*fair offsets practices*" has been the Federation of the

²As an example the F 35 Joint Strike Fighter Program links 9 partners +2 participants countries to this US lead Program (Source : Congressional Research Service 7-5700 September 16, 2009)

³European Union 2004/18 Directive on Government Procurement.

⁴For Intra-European offsets registered in 2009: 48 % were related to defence and security issues, 38 % to transportation infrastructure and equipment and 14 % to energy. Source EU Eurostat

United Arab Emirates (UAE) creating an Offset Program Bureau in 1992 and implementing a dedicated internet site⁵ presenting the country "offsets policy guidelines". In the case of the European Union, which public procurement legal framework for member states is governed by the 2004 Directive, the initiative regarding "fair offsets practices" has been instigated by public and private actors of the defence sector, leading in 2009 to a specific Directive⁶ for defence and security procurement, allowing an exception for offsets in defence procurement contracts. This led to the creation in 2011 of a "Code of Conduct on Offsets" agreed by the 26 EU member states participating in the European Defence Agency. This code of conduct asks participants to clarify, for every defence contract between EU member states, if offsets are a factor considered in the governmental decision and, if positive, the weight attributed to the offsets factor in governmental decision and, last but not least, to comply with a limitation of offsets to a percentage of the value of the procurement contract⁷.

According to a study published by the Federal Public Service of Belgium⁸, policies of "fair offsets practices" have been implemented by 31 countries between 1990 and 2011 out of 43 identified countries having required offsets for their governmental contracts during that period. Those 31 "fair offsets practising countries" have officially communicated on their offsets regulation policies and implemented various processes to monitor and control offsets. An analysis of the most significant fair offsets practices implemented so far can be summarized as follows: (1) publication of a framework for transparency clarifying offsets requirements in public tenders, (2) creation of an independent offsets management team staffed by experienced experts bound by a code of conduct and having no links or dependency to the main governmental procurement organizations or with offsets potential stakeholders, (3) implementation of due diligences to be carried out for all beneficiaries of offset contracts to ensure that no members of the government or official will benefit improperly, (4) implementation of monitoring processes of offsets contract performances including incentives and penalties and publication by Government bodies of progress and achievement of every offsets contract (5) implementation of a dual tendering procedure ensuring that all bids will be submitted with two prices: one with the offsets requirements and one without, allowing for a cost-benefit analysis on the contract with and without offsets requirements.

Offsets and corruption issues

Corruption in International Government Procurement is a long standing concern for public sector. It has been estimated by a World Bank research to USD 200 billion per year representing around 3.5% of the world government procurement spending (Auriol, 2010). To assess relative corruption levels of countries and business sectors corruption, Non-governmental organization (NGO) Transparency International has designed a specific metric: the Corruption Perception Index (CPI). Based on surveys of experts, enterprises, users of public services, and civil servants, this indicator is published each year to assess corruption level of WTO member countries⁹. As government public procurement contracts are mostly large contracts and offsets agreements are representing substantial amounts in value, ethical concerns regarding offsets practices are considered a key issue by experts working on corruption issues. In defence procurement contracts, offsets have been qualified by Transparency International analysts as an "ideal playground for corruption" (Ben Magahy, 2010). When no clear and transparent rules apply regarding offsets in large public procurement contracts, we might suspect that public sector corruption might be higher than when laws, rules, guidelines and reporting are enforced. Hence, we consider that the implementation of air offsets policies is a significant contribution to "the strength and effectiveness of public sector anti-corruption efforts" that the CPI index from Transparency International is measuring and promoting.

For experts in offsets contracts, corruption risks are perceived as higher when: (1) governmental parties have a low control on offsets discussions and agreements during the negotiation phase of international

⁵<http://www.idp.ae/en/Menu/index.aspx?PriMenuID=8&CatID=8&RefID=0&mnu=Cat>

⁶Directive 2009/81/EC on defence and sensitive security procurement

⁷Usually, between 60 % and 100 % of the main contract value, in some cases, until 130 % of the main contract.

⁸Federal Public Service of Belgium (2008) – "Policy on industrial participation in defence contracts", available at http://economie.fgov.be/en/binaries/industrial_compensations_en_tcm327-58443.pdf

⁹Transparency international (2010): "Corruption perception index report 2010.., Surveys and assessments used to compile the index include questions relating to bribery of public officials, kickbacks in public procurement, embezzlement of public funds, and questions that probe the strength and effectiveness of public sector anti-corruption efforts."

government procurement contracts (2) offsets have a high level of complexity with the involvement of a great number of local and foreign companies and subsidiaries (3) governmental parties have not implemented any monitoring processes of local beneficiaries of offsets based on auditing of contractual delivery and publication of offsets productions and results.

Research Methodology

For the purpose of this research, we have named “*active offsets countries*” those countries having implemented permanent fair offsets practices as opposed to “*passive offsets countries*” which have not implemented any formal procedures but do require trade compensations for their main public procurement contracts. Although it is difficult to get an exhaustive view of offsets practices worldwide as it is a non-regulated practice, we consider that the 43 countries identified for having required offsets over the last 20 years¹⁰ by the above mentioned study, are significant in number and representative in terms of geographical dispersion, economic level and contracts variety, although defence contracts appear as dominant in numbers and values in this sample. We have reviewed those 43 offsets countries to assess their offsets policies in terms of transparency and fair practices and we have established a ranking based on criteria presented and discussed below.

Our research hypothesis is that a causality can be identified between fair offsets policies and corruption levels of public sectors as measured by the CPI index published by Transparency International. Using the CPI index for assessing corruption in international governmental procurement appears relevant as this index explicitly tracks public sector corruption. For its computation, it relies on surveys of experts from development banks and multilateral agencies as well as business leaders, both residents and non-residents¹¹ on their perception of the anti-corruption measures implemented in the public sector and on their perception of the corruption climate surrounding public procurement, civil servants and politicians.

Assessment and Ranking of Offsets Countries

To assess and rank the 43 offsets countries on the basis of their offsets policies, we have reviewed each country on the three following items: a) transparency level on offsets contract requirements through law, rules or guidelines b) existence of an offsets managing body, independent from buying party c) implementation of contractual offsets monitoring and public reporting procedures.

a) Official information on offsets requirements varies significantly between active offsets countries. Most transparent countries have enforced offsets requirements by law and have implemented a dedicated offsets web site where international bidders can find offsets requirements contractual terms and conditions as well as standard templates to prepare proposals for answering tenders. Less transparent offsets countries have opted for publication of detailed rules dedicated to offsets requirement but not enforced by law, allowing more freedom for bidders in their offsets approaches. Finally, countries with low transparency provide general guidelines that are not considered binding for international bidders. A high level of offsets standardized contractual requirements has a positive impact on corruption control as interpretations regarding offsets are strictly limited and as it allows monitoring, auditing and reporting.

b) The existence of a dedicated independent agency in charge of managing and monitoring offsets by means of procedures, due diligences and audits appears as another important prerequisite to prevent corruption between tendering and bidding parties. The most transparent active offsets countries have implemented dedicated teams of independent experts in charge of monitoring offsets requirements. Experiences from international bidders demonstrate that collusion between parties is more limited when a dedicated team, independent from the buying party, has been implemented. In the less transparent countries, tendering parties are directly in

¹⁰Federal Public Service of Belgium (2008) – “Policy on industrial participation in Defence contracts”, Available at : http://economie.fgov.be/en/binaries/industrial_compensations_en_tcm327-58443.pdf

¹¹CPI measures the degree to which public sector corruption is perceived in 178 countries around the world (in 2010). It scores countries on a scale from 10 (very clean) to 0 (highly corrupt).

charge of monitoring offsets contracts as it is the case for many defence procurement contracts, paving the road for collusions of interests and corruption between tendering and bidding parties.

c) Finally, the most advanced transparent offsets countries complement their policy by a contractual monitoring of offsets implementation through separate and binding contracts with agreed milestones between parties. Those specific contracts rely on a formal reporting validated by third parties and/or by the independent offset team and include incentives and penalties for the foreign as well as for the local party. This monitoring of offsets implementation appears as a powerful mean to ensure that promises made during bidding and negotiation phases were real, concrete and binding for all parties.

Taking into considerations those criteria, the 43 offsets countries have been assessed and ranked in appendix 1. From this ranking, we have identified 12 “*passive offsets countries*” with very limited or no formal requirements in terms of transparency and implementation processes. The 31 remaining “*active offsets countries*” have all implemented a substantial level of formal requirements in terms of transparency, fair practices and monitoring processes regarding offsets. However, as there are major differences between the levels of transparency policies and procedures implemented by this group, we have divided those 31 countries into three groups: “*high active offsets countries*”, “*medium active offsets countries*” and “*limited active offsets countries*”, as presented in appendix 2.

Research main results

Based on the 2010 data, the average CPI ¹² of the 31 “*active offsets countries*” was 6,2 comparing favourably to the average CPI of the group of the 12 “*passive offsets countries*” which reached 5,0 ¹³ indicating some causality between offsets fair practices and corruption control. As a general comparison, the average CPI of the 124 WTO members as presented in appendix 4 was 4,3 in 2010.

2010	Active Offsets Countries N = 31	Passive Offsets Countries N = 12	WTO Countries N = 124
Average CPI	6,2	5,0	4,3

Table 1: Comparison of average CPIs of groups of Active and Passive Offsets Countries and WTO countries (with a CPI calculation)

When comparing for the average and median CPIs of the four different groups of offsets countries, a clear relationship appears between the average and median CPIs of the identified groups and their levels of offsets fair practices as presented in table 2. The group of 13 countries with high requirements in offsets transparency and management processes has a significantly higher CPI (average of 8,1 and median of 8,7) than the three other groups, which have a CPI comprised between 4,2 and 5,2. Using the median CPI, results indicate an almost linear relationship between offsets fair practices levels and improvement of public sector corruption control as measured by the CPI.

Offsets Countries Groups	Offsets Country Group Average CPI – 2010	Offsets Country Group Median CPI – 2010
Passive Offsets Countries (no requirements) N = 12	5,0	4,0
Active Offsets Countries (Limited requirements) N = 9	4,2	4,4
Active Offsets Countries (Medium requirements) N = 9	5,2	5,5

¹²In 2010, 178 countries were scored by Transparency International with a Corruption Perception Index ranging from 1,1 (Somalia) to 9,3 (Denmark). In 2010, 124 countries were scored by Transparency International. Details on CPI methodology available at : http://www.transparency.org/policy_research/surveys_indices/cpi/2010/in_detail

¹³A difference of 1,2 in CPI (6,2 – 5) between offsets countries means a difference of 18 places in the 43 offsets countries and 32 places in the 124 WTO member countries with a CPI ranking (2010).

Active Offsets Countries (High requirements) 13	N =	8,1	8,7
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Table 2: Comparison of average and median CPIs of groups of Offsets Countries

As the implementation of fair offsets fair practices might require a couple of years to change perceptions of experts surveyed by Transparency International, we have tested the variations of CPIs between 2000 and 2010 comparing three groups: (a) “passive countries” (N = 12), (b) “senior active assets countries” with more than 7 years anteriority in offsets fair practices (N = 14), and “junior active assets countries” with less than 7 years anteriority (N =13)¹⁴. Fair assets practices implementation of 27 countries could be traced back and are presented in [appendix 3](#). Table 3 below presents the variations of CPIs per group between 2000 and 2010.

Offsets Countries Groups	CPI – 2000		CPI – 2010		Variation 2010 - 2000	
	Average	Median	Average	Median	Average	Median
WTO Countries - N = 124 With CPI calculation in 2000, 2010	4,3	3,5	4,3	3,5	0	0
Passive Countries- N = 12 No Offsets transparency policies	5,1	4,3	5	4	-0,1	-0,3
Junior Active Countries - N=13 Offsets transparency policies implemented after 2002	5,0	4,1	5,2	4,6	+0,2	+0,5
Senior Active Countries - N=14 Ofssets transparency policies implemented before 2002	7,1	7,1	7,2	7,5	+0,1	+0,4

Table 3: Comparison of average and median CPIs of country groups between 2000 and 2010

From this longitudinal comparison between 2000 and 2010, we observe that the CPIs (average as well as median) of passive countries have deteriorated (-0,1 and -0,3) contrary to the two other groups which have both improve their average and median CPI (+0,4 and +0,5 median CPI improvement). We can also observe that the junior active countries, which were at the level of the passive countries in 2000, have improved their position in 2010, marked by an improvement of + 0,8 in CPI median. Finally, the senior active countries have reached a high level (CPI above 7) improved between 2000 and 2010. During the same period of time, the average and median CPI of the 124 WTO countries, with a CPI calculation in 2000 and 2010, registered no variation and stayed at a low level with an average CPI of 4,3 and a median of 3,5.

This analysis substantiates the hypothesis that countries having applied active fair offsets policies reached a higher position on corruption control than passive countries. However, those results establishing a causality between positive CPIs and fair offsets policies do not take into consideration other factors which might influence public sector corruption like political regime, historical and cultural backgrounds and relative wealth. For that purpose, 4 groups of countries sharing the same cultural

¹⁴Average anteriority of 4 years of fair Offsets Policies implementation in 2010 for this “junior group” of active offsets countries

backgrounds, political regimes and relative wealth have been compared: Middle East / Arabic countries (N = 4), Asian countries (N=5), Western Nordic European Countries (n = 9) and Eastern Balkan European Countries (n = 9) in order to test if the relationship between perceptions of public sector corruption and Offsets policies could be confirmed for each separate, controlling for factors such as cultural background, political regimes and relative wealth¹⁵.

MIDDLE EAST / ARABIC COUNTRIES	OFFSETS PRACTICES	CPI - 2000	CPI - 2010
Turkey	Limited Requirements	3,8	4,4
Saudi Arabia	Limited Requirements	4,5	4,7
Kuwait	Medium Requirements	5,3	4,5
United Arab Emirates	High Requirements	5,2	6,3
Arabic Active Group (N=4)		4,7	5
Arabic Passive Group (N=1)¹⁶	No Requirements	2,1	2,2

ASIAN COUNTRIES	OFFSETS PRACTICES	CPI - 2000	CPI - 2010
India	Limited Requirements	2,8	3,3
Malaysia	Limited Requirements	4,8	4,4
Korea (South)	Medium Requirements	4,0	5,4
Taiwan	Medium Requirements	5,5	5,8
Singapore	High Requirements	9,1	9,3
Asian Active Group (N=5)		5,2	5,6
Asian Passive Group (N=2)¹⁷	No Requirements	3	3

EASTERN / BALKAN EUROPEAN COUNTRIES	OFFSETS PRACTICES	CPI - 2000	CPI - 2010
Romania	Limited Requirements	2,9	3,7
Greece	Limited Requirements	4,9	3,5
Bulgaria	Limited Requirements	3,5	3,6
Slovak Republic	Medium Requirements	3,5	4,3
Czech Republic	Medium Requirements	4,3	4,6
Hungary	Medium Requirements	5,2	4,7
Lithuania	Medium requirements	4,1	5
Slovenia	Medium Requirements	5,5	6,4
Poland	High Requirements	4,1	5,3
East European Active Group (N=9)		4,2	4,6
East European Passive Group (N=2)¹⁸	No Requirements	4,7	5,3

WESTERN / NORDIC EUROPEAN COUNTRIES	OFFSETS PRACTICES	CPI - 2000	CPI - 2010
Portugal	High Requirements	6,4	6,0

¹⁵Canada, New Zealand, Israel, and South Africa could not be attached to one of these groups.

¹⁶Libya

¹⁷Philippines, Thailand

¹⁸Estonia, Croatia

Belgium	High Requirements	6,1	7,1
Austria	High Requirements	7,7	7,9
Switzerland	High Requirements	8,6	8,7
Netherland	High Requirements	8,9	8,8
Norway	High Requirements	9,1	8,6
Sweden	High Requirements	9,4	9,2
Denmark	High Requirements	9,8	9,3
Finland	high Requirements	10	9,2
West European Active Group (N=10)		8,4	8,3
West European Passive Group N=3 ¹⁹	No Requirements	6,8	5,9

This analysis conducted on homogeneous cultural and regional backgrounds confirms the relationship between high CPIs and levels of requirements in terms of offsets fair practices, for each of the four regions. CPIs are increasing almost linearly with the level of offsets transparency practices, in each group except for the Western / Nordic Group where countries have all reached the same level of "High Requirements". Furthermore, when comparing active countries with passive countries in each regional group, active countries CPIs are highest in all groups and record a better evolution between 2000 and 2010, except for the Eastern/ Balkan Group, the reason being the high CPI reached by the passive country Estonia in 2010 (6,5). A synthesis of the results per regional group is presented in table 4 below.

REGIONAL GROUP	CPI - 2000	CPI - 2010	CPI Variation
Asian Active Group (N=5)	5,2	5,6	+ 0,4
Asian Passive Group (N=2)	3	3	0
Arabic Active Group (N=4)	4,7	5	+ 0,3
Arabic Passive Group (N=1)	2,1	2,2	+0,1
East European Active Group (N=9)	4,2	4,6	+0,4
East European Passive Group (N=2)	4,7	5,3	+0,6
West European Active Group (N=10)	8,4	8,3	-0,1
West European Passive Group (N=3)	6,8	5,9	-0,9

Table 4: Comparisons of average CPIs per regional groups for 2000 and 2010

These results open the discussion on the relevancy of WTO offsets prohibition on the ground that offsets encourage public corruption. When transparent, independent and contractual fair offsets practices are implemented in public tendering, corruption risks are seriously limited.

Discussion

This analysis is based on a limited number of countries (43 countries) as we are relying on data from official sources that do not cover all offsets practising countries and this research would benefit from an exhaustive number of offsets countries. Another issue is the heterogeneity of international government contracts requiring offsets, in terms of sectors but also in terms of values of contracts. Defence offsets and/or important public contract values act as magnets for corruption and research on offsets best practices would benefit from sectorial and focused approaches.

Conclusion

¹⁹United Kingdom, Italy, Spain

Offsets are complex mechanisms that have been officially prohibited or strictly restricted by WTO when the Agreement on Government Procurement has been negotiated in 1994 and revised in 2006. However, offsets are a common practice for a large number of WTO member countries and a substantial number of countries have implemented offsets fair policies to monitor industrial, commercial and technical cooperation between foreign and local partners and to prevent corruption. This research has identified a significant causality between countries having implemented fair offsets policies and their improvement of public corruption control, as measured by Transparency International Corruption perception Index (CPI). Implementation of transparent and fair offsets requirements policies in the area of government procurement should be considered as a significant contribution to the strength and effectiveness of public sector anti-corruption efforts and as a contribution to an ethical economic development.

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