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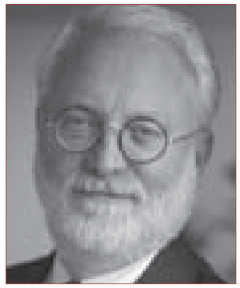

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Struggling with *Domestic Preferences* in a Globalized Economy

Globalization is no longer the domain of the world's multinationals. For the past 20 years, U.S. companies, large and small, have succumbed to the economic necessity of sourcing not just goods, but services as well, from overseas providers. And even if companies do not deal directly with foreign suppliers, the distributors and other sources from which they do purchase are likely furnishing foreign-sourced goods and services, at least in part. Moreover, given that the origin of the Buy American Act of 1933 (BAA) was the Great Depression, it is not surprising that the current extended recession has given rise to renewed focus—and indeed proliferation—of domestic preference programs in connection with providing services and goods to the federal government or under programs funded with federal grants. But the variation in the different domestic preference regimes and the global market economy realities make compliance with these domestic preference programs ever more challenging, especially at a time when increased use of the civil False Claims Act as an enforcement tool makes noncompliance ever more costly.

Accordingly, it is important that any company providing services and products on federally funded projects recognize not only which domestic preference regime may be applicable to its projects, but also some of the traps for the unwary. The applicable domestic preference regime is usually a function of the source of funds and the agency involved. The BAA originally applied to all "goods" procured by a federal agency, but it must now be considered in conjunction with the Trade Agreements Act of 1979 (TAA), as amended. The TAA in part serves to exempt certain contracts above a threshold amount (which changes every two years) from the BAA restriction (at least for goods from certain "designated countries"), but TAA also extends BAA's domestic preference to services, and prohibits the procurement of goods or services from non-designated countries for those covered contracts. Statutes governing many federal grant programs, both domestic, like those administered by the Federal Transit Administration (FTA), and international, like those administered by U.S. Agency for International Development (USAID), have their own statutory domestic preference requirements. Most recently, the American Recovery and Reinvestment Act of 2009 (ARRA) included a domestic preference provision that applied both to federal procurements using ARRA funds, as well as to grants for state and local projects.

This proliferation of domestic preference regimes runs directly counter, in at least two respects, to the federal procurement policy encouraging purchase of commercial goods and services that was established with passage of the Federal Acquisition Streamlining Act of 1994. First, as commercial providers continue to rely on a global supply chain, it becomes increasingly difficult to segregate (and in some cases even to know) the origin of items that they may be furnishing to a federally funded project. Second, and compounding the compliance difficulty, is the fact that the various domestic preference regimes employ different tests and criteria for determining the country of origin. The BAA, for example, has long required "manufacture" (an undefined term) in the United States where at least 50 percent of the cost of the components and material are from components and material that have been domestically manufactured. The TAA does not focus on the origin of components directly, but instead employs the Customs test that looks to where such components and material have been substantially transformed into a new and different product. The ARRA Buy American provision was a hybrid. It is similar to the BAA without the component test, but some agencies have interpreted manufacture as essentially requiring substantial transformation. Each grant program has its own rules for determining country of origin.

> **"This proliferation of domestic preference regimes runs directly counter, ... to the federal procurement policy encouraging purchase of commercial goods and services"**

While these tests can lead to quite different results, there are areas of application that present common difficulties across the different domestic preference regimes. For example, the USAID rules are one of the few that address expressly how to evaluate origin of a system that includes a number of different hardware components, an analysis that can present difficulties. Under other domestic preference regimes, contracting officers may define the end product as a system (versus its components), but that raises the question of where substantial transformation occurs. In cases where installation is done under a supply contract, that location may be the project site, but if furnishing a system is part of a construction project, the special rules covering "construction material" may require applying the relevant rule of origin to each item in the form it is delivered to the site.

Software also presents a challenge. Where the federal procurement contract is for the development of software, GAO has recognized that such a contract is clearly a service and not subject to the BAA. Some have argued that buying shrink-wrap software should somehow be different, even though all that the purchaser actually obtains is the license to use the intellectual property, and even though concepts like "manufacture" and "substantial transformation" are not easily applied to software development. Further complicating the analysis is that while Customs has never articulated a rule of origin for software, it has traditionally used the origin of software—at least where it is installed in a hardware product—as a factor to consider, sometimes the determinative factor, in applying substantial transformation to information technology products. Service contractors can face even greater difficulty in providing spares and other follow-up goods necessary to satisfy the service contract, where the spares or ancillary goods have to be evaluated independently, if not purchased as part of the original system or end product.

> **"None of these domestic preference regimes acknowledge the global supply chains"**

None of these domestic preference regimes acknowledge the global supply chains of the commercial suppliers that the federal government says it wants. Indeed, the furor both domestically and abroad over the ARRA Buy American provision was precisely because, unlike in 1933, contractors and grantees in 2011 cannot simply reinsert domestic

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sources for key components of their equipment. Nor are they always able to identify origin of items purchased through distributors and other resellers. One agency that has undertaken an effort to revisit its regulations in light of globalization is USAID, which in February 2011 issued an advance notice of proposed rulemaking (ANPR) inviting suggestions on how to modify its "source, origin, and nationality" rules to meet the challenges of a global market while nonetheless remaining consistent with its statutory obligations. The ensuing August 2011 proposed rule includes numerous significant changes from the ANPR, including the deletion of the concept of "origin" from the rules (a concept USAID describes as "increasingly obsolete and difficult to apply in today's globalized economy"), and a provision for broad waivers by commodity or service type or category, obviating the need for repeat or serial waivers for the same type or category, recognizing that many goods or services are simply unavailable domestically.

> **"...the restriction could exclude from participation those same commercial suppliers the federal government purports to want."**

All commentators on the proposed rule applauded USAID's attempt to simplify its source and nationality restrictions, and bring them in line with the realities of business today. In particular, eliminating the concept of "origin," i.e., having to identify where a commodity is mined, grown, or produced, eases the compliance issues for contractors and grantees which purchase items through distributors and resellers. Focusing instead on "source," the country from which a commodity is shipped, is more realistic in light of global and changing supply chains. However, it is clear that even USAID's more accommodating approach leaves room for improvement. For example, USAID has added the requirement that for a commodity to have a country as its source, the commodity must also be available for purchase in that country. "Available for purchase" in turn is defined as meaning that there have been documented, multiple sales of the commodity or service by the supplier in the past calendar year. The result is that established suppliers offering new goods or services, or new suppliers of goods or services, may not be eligible to compete. Further, this rule also ignores that, in an era of electronic commerce, many companies no longer maintain static inventories in a particular location. Once again, the restriction could exclude from participation those same commercial suppliers the federal government purports to want.

Buy national restrictions continue to enjoy political popularity. President Obama's proposed American Jobs Act includes the same Buy American language that was enacted in ARRA. However, it is unclear that such restrictions actually protect U.S. companies and workers. To the contrary, the restrictions appear to create major hurdles for U.S. companies, large and small. Such rigidity likely discourages many U.S. companies from competing for federal dollars, whether in direct federal procurements or in state and local projects funded by federal grants, and the disincentives will only increase as globalization becomes more entrenched. Agency and contractor resources spent on complying with and policing buy national rules would be better spent on re-evaluating the entire framework—and even existence—of such regimes.

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