

Offset Policies in Defence Procurement: Lessons for the European Defence Equipment Market

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OFFSETS IN INTERNATIONAL DEFENCE TRADE

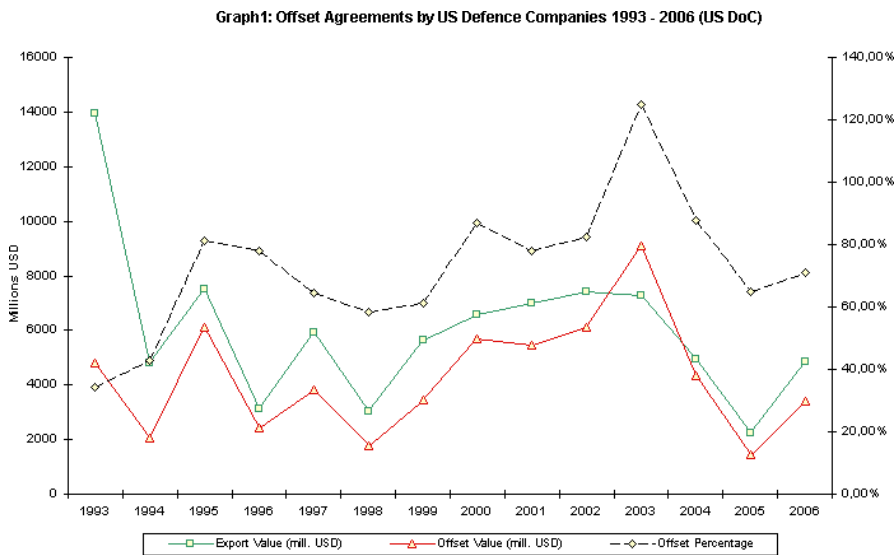
Offsets represent industrial compensation agreements that arms importing governments impose on their foreign suppliers. Once a contract on the import of defence equipment is concluded, it is made conditional on the acceptance of offset obligations by the foreign contractor. Offset obligations are discharged through different kinds of transactions that may include co-production, subcontracting, licensed production, training, technology transfers, or other investment in the importer's economy.

This article will review the importance of offsets in international defence trade with a specific focus on offset practices in the European Union. It will argue that offsets are the result of existing imperfections in the functioning of the European Defence Equipment Market (EDEM). It will conclude that the core issues that need to be tackled are existing imperfections impeding the spontaneous emergence of trans-border industrial relations, rather than imposing an across-the-board prohibition of offsets policies and practices.

Offset deals first became popular in the mid 1970s. In the "Deal of the century", in 1975 a consortium of four European countries

comprising Belgium, Denmark, the Netherlands and Norway decided to procure 348 General Dynamics F-16 combat aircraft worth USD 2.8 billion. The proposed offset package played a decisive role in the selection of the US aircraft over the French Mirage F-1. In exchange for their order, the four countries obtained industrial participation in the production of the F-16 with the following shares: 40% of the value of the consortium's order, 15% of the value of orders by third countries and 10% of the value of the F-16 purchases by the US Air Force.¹

Steadily increasing since the 1970s, the reliance on offset policies² today represents one of the main characteristics of international defence trade. The "Offset Guidelines Quarterly Bulletin" published by Countertrade & Offsets (CTO) provides information about the offset practices of at least 75 countries worldwide. Quantitative data on offsets is generally scarce and the annual reports on "Offsets in Defence Trade" published by the United States Department of Commerce (US DoC)³ represent almost the sole source available.



¹ Struys, Wally, *Offsets and Weapons Procurement: The Belgium Experience*, in Martin, Stephen (ed.) (1996), *The Economics of Offsets: Defense Procurement and Countertrade*, Harwood Academic Publishers, pp. 75-105.

² Some countries use the term Industrial Participation Policies instead of Offset Policies.

³ United States Department of Commerce, *Offsets in Defense Trade*, various editions (last December 2007).

Graph 1 presents the US DoC's data on the value of offset agreements and related export contracts concluded by exporting US defence firms between 1993 and 2006, as well as their ratio, or offset percentage. The latter is considered as the best available indicator of the level of offset requirements, the value of offset agreements value alone being too sensitive to changes in the value of related exports sales.

Over the same period US defence firms alone had entered into offset agreements valued at USD 60 billion, or the equivalent of 71.2% of their related export contracts value. By 2006 the offset percentage had doubled its value from 35% in 1996 to 70%. It peaked in 2003 with offset agreements representing almost 125% of the value of related export contracts. Despite the subsequent decline in the value of the offset percentage in 2004 and 2005, Graph 1 shows that over the period offset demand has generally and substantially increased.

The aforementioned reports also show that Europe is in the lead. Offset agreements with European countries totalled USD 40 billion over the same period, with an offset percentage of almost 100%. Offset percentages related to agreements with European countries are higher than those of non-European countries. The latter however are progressively catching up by increasing their offset demands. A study on offsets ordered by the European Defence Agency (EDA)⁴ estimates the offset percentage required by EU Member States was on average at 135% between 2000 and 2006.

Almost all EU Member States have some formal or informal offset policy. The CTO's compilation of offset guidelines lists 23 countries⁵, and those that are absent are mainly the smallest Member States. Amongst them only Ireland and Estonia seem relatively reluctant in requiring offsets. Offset policies therefore represent an important factor in the EU's defence procurement practices.

⁴ FOI and SCS (2007), Study on the Effects of Offsets on the Development of a European Defence Industry and Market. The study has been financed by the EDA and is available on its Internet site. It covers 24 participating EU's Member States. Denmark, Bulgaria and Romania are not covered. For reasons of simplicity we will designate this study as the EDA's study on offsets.

⁵ Based on editions from 2005 and 2006 no information was provided on Cyprus, Latvia, Luxembourg and Malta.

OFFSET PRACTICES IN THE EUROPEAN UNION

Today, a wide array of offset policies exist across the EU that can be differentiated on the basis of criteria such as offset percentage required, fulfilment period, penalties, rules concerning the acceptability of offset transactions and their counting with regard to the extinction of offset obligations, etc. An important distinction concerns the nature of the offsets required. Three main categories of offsets can be distinguished⁶: direct, indirect defence and indirect civilian.

Direct offsets are related to the defence equipment or service acquired. They aim to attain more than a simple economic return on investment and are motivated by objectives of strategic independence, like acquiring independent maintenance and upgrade capabilities. Indirect offsets are not linked to the imported defence product or service. A distinction should be made between defence and civilian indirect offsets.

European defence industry has three big players: France, Germany and the United Kingdom. The majority of the large European defence system integrators are located in these countries. The first two do not boast official offset policies. They are mainly exporters of defence equipment and have a low level of imports. On an informal base however offsets have been required for some large import contracts. The United Kingdom's Ministry of Defence operates an Industrial Participation Policy directed essentially towards North American suppliers.

Another group of countries can be distinguished, with offset policies generally focused on defence offsets. The EDA study on offsets differentiates two such categories. The first one includes Italy, Sweden and the Netherlands⁷. This group relies mainly on indirect defence offsets as a tool for providing opportunities to their sizeable defence industries. The second one is more diverse and includes Spain, Finland, Portugal, Greece and Poland. Its main characteristic is the high importance attached to direct offsets.

The EDA study also estimates that direct offsets represent 40% of total offsets in Europe, while indirect defence offsets account for

⁶There is no universally admitted terminology on offsets. Definitions of terms may substantially differ from one country to another.

⁷The study also includes the UK in this group and not in the one comprising France and Germany.

35%, and indirect civilian offset come at 25%. Defence offsets therefore are the preferred choice for EU Member States, with civil offsets being concentrated in new and small EU countries that lack substantial experience with offset policies. The majority of these countries have only recently established, or are still in the process of setting up, offset policies⁸. Their national guidelines, while allowing civilian offsets, also frequently emphasise a willingness to obtain defence related compensations.

Caution however should be exercised when drawing conclusions on the basis of these figures. It is rather difficult to draw a clear distinction between defence and civil offsets. Not only national definitions differ, but the evolution of defence systems is increasingly blurring the lines with the growing contribution of potential dual-use sectors like electronics and software.

A ratio nevertheless of three to one in favour of defence offsets appears as a sufficiently significant trend that raises a highly important question - namely why offsets are needed to provide industrial opportunities to importing countries' defence industrial base. Part of the answer lies in the fact that some countries with modern and efficient defence industries use offset policies in order to induce the establishment of sustainable industrial partnerships with the large foreign system integrators. For instance the Swedish Guidelines state the following objectives : "The Supplier shall enter into Industrial Participation agreements intended to contribute towards maintaining and strengthening the expertise, capacity and marketing potential of Swedish defence industries, [...] extending long-term co-operation between Swedish defence industries and the Supplier [...] to secure the participation of the Swedish defence industry in manufacturing and to gain know-how on sub-systems to be delivered within the procurement programme [...]"⁹. Understanding such reasoning has important implications in respect to the functioning of the EDEM.

⁸ The decision to implement an offset policy is not always based on an underlying industrial strategy. Sometimes it is motivated by the desire to imitate policies seen in other countries.

⁹ FMV (1999), Guidelines for establishing and implementing industrial participation in connexion with procurement of weapon systems and defence-related items from foreign suppliers, p. 1.

OFFSETS AND THE EUROPEAN DEFENCE EQUIPMENT MARKET

There is a widespread negative preconception of offsets, which has to some extent been embedded in the official policy of some countries, usually considering themselves as net offset providers: “The official U.S. Government policy on offsets in defence trade states that the Government considers offsets to be “economically inefficient and trade distorting,”¹⁰. It is worth mentioning that US defence procurement practices require a North American source for defence systems acquired, which is in fact equivalent to an offset policy.

Offsets are prohibited by the rules of the World Trade Organization (WTO) and the EU. In a paper published in 1986, Michael Czinkota and Anne Talbot argued that countertrade, of which offsets are a subdivision, contradicts the spirit of some of the most fundamental principles of the GATT/WTO system: transparency, consultation, multilateralism, compensation, and the “aim to reduce trade distortions”¹¹. Offsets are explicitly disallowed by the WTO’s “Agreement on Government Procurement”¹². Relevant dispositions are also present in the Agreement on Trade-Related Investment Measures (TRIM’s). However, WTO regulations are subject to a national security exception which results in the generalized non-respect of these rules in relation to defence procurement.

The situation is quite similar in what concerns the European Community’s principle of free movement of goods and services. Defence procurement in the EU has remained unaffected by European Community law because of the extensive reliance on exceptions provided by Article 296¹³ of the EC Treaty. According to the

¹⁰US DoC (2007), *Offsets in Defense Trade –Twelfth Study*, p. iii.

¹¹ Czinkota, Michael and Anne Talbot (1986), *GATT Regulation of Countertrade: Issues and Prospect*, *The International Trade Journal*, Vol.1, No. 2, pp. 155-172.

¹² Article XVI of the AGP states that “Entities shall not, in the qualification and selection of suppliers, products or services, or in the evaluation of tenders and award of contracts, impose, seek or consider offsets”.

¹³ Article 296 of the EC Treaty:

“(1)The provisions of this Treaty shall not preclude the application of the following rules:

(a)no Member State shall be obliged to supply information the disclosure of which it considers contrary to the essential interests of its security;

(b)any Member State may take such measures as it considers necessary for the protection of the essential interests of its security which are connected with the production of or trade in arms, munitions and war material; such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.”

European Court of Justice and the European Commission however, Article 296 should not be considered as providing a general exception in relation to defence procurement. Derogations need to be narrowly interpreted and justified on a case by case base. The EDA study on offsets has demonstrated that in such a legal context there is almost no possibility to use Article 296 as a justification for the use of offset policies.

The situation however may be more complex than it appears at first glance. It is interesting to refer again to the conclusions of Czinkota and Tablot (1986): "While countertrade may be repugnant to the spirit of the GATT, it may be the only practicable solution to current world trade dislocations ... countertrade is a symptom of world economic difficulty rather than the problem itself."¹⁴ This phrase can easily be applied today with regard to offsets in defence procurement. Rather than considering them as a problem per se, it is much more useful to look at them as a symptom of the deficiencies of the defence equipment market. One problem deserves particular attention: the apparent lack of access of potential foreign suppliers to the supply chains of the large defence prime contractors. This issue is crucial because for a large number of small and medium size countries and enterprises for who access to the defence market is synonymous with access to large system integrators' supply chains. Without such access their market survival is questionable.

A survey by Martin and Hartley (1995) on the experience of British exporting firms with offset requirements provides an intriguing result: "In six of the 11 offset sales the respondents said that the offset obligation had led to the discovery of new, lower cost, sources of supply and in all six cases the intention was to continue to do business with new sources once the offset obligation had been fulfilled."¹⁵ Offset thereby may be a useful tool in allowing new foreign suppliers to access the system integrators' supply chains. This possibility is also confirmed by the EDA study on offsets. Some anecdotal evidence exists in the economic literature on offsets¹⁶. Further important questions stem from this line of thought. Why are offset policies needed to induce industrial relations between large

¹⁴ Czinkota, Michael and Anne Talbot (1986), *op. cit.*, p. 172.

¹⁵ Martin, Stephen and Keith Hartley (1995), *Defence Equipment, Exports and Offsets: The UK Experience*, *Defence Analysis*, Vol. 11, No. 1, p. 29.

¹⁶ See for instance Redlich, Alon and Maison Miscavage (1996), *The Business of Offset: A Practitioner's Perspective. Case Study: Israel*, in Martin, Stephen (ed.) (1996), *op. cit.*, pp. 381-406.

system integrators and suppliers, which are more efficient than the incumbent ones and why such relations do not appear spontaneously?

The first cause is the existence of policy-induced barriers, resulting from regulations based on national preferences that are widespread in the field of defence procurement. Defence markets, especially those of large countries, have developed on a national basis with the underlying principle of national independence. Such is the case of the US market, but the situation is quite similar in the largest EU Member States. Market liberalization, i.e. suppression of protectionist national regulations, will provide enhanced access to foreign markets and will eventually lead to a more unified EDEM. Initiatives taken in the framework of the EDA like the Code of Conduct on Defence Procurement and the Code of Best Practice in the Supply Chain are useful in this respect. The “Defence Package” recently proposed by the European Commission goes even further by providing real legal instruments aimed at liberalizing the EDEM. The new European Directive on Defence Procurement¹⁷ and the Directive on the Transfer of Defence-related Products within the EU¹⁸ will, if adopted, seriously enhance the efficiency of the EDEM.

Dropping regulation-induced barriers to trade and industrial cooperation may not be sufficient. The fact that offsets may induce long term transborder industrial partnerships surviving after the extinction of offset obligations indicates that policy induced barriers are only a part of the problem. Offset policies can at best provide some form of temporary bilateral waiver of protectionist regulations. This is, however, not very common as the governments of arms exporting countries are not always willing to be part of offset agreements concluded by their national companies. Offsets are not an instrument of permanent liberalization. When an offset agreement expires protectionist regulations should kick in again and put an end to the relations established. If this is not the case, then protectionist regulations are only a part of the problem – other barriers exist that impede the spontaneous emergence of transborder industrial relations.

Imperfect information is such a barrier. Uncovering new, more efficient suppliers comes at a price. Direct costs of gathering infor-

¹⁷ COM (2007) 766.

¹⁸ COM (2007) 765.

mation exist along with implicit costs, such as the value of time and opportunity costs. In a field characterised by national fragmentation of markets coupled with comparatively high levels of secrecy, these costs can be significant.

Switching suppliers is also expensive. Negotiations have a cost, establishing new contracts or new financial channels do not come for free. Companies need to invest in developing partnerships with new foreign counterparts, they need to overcome possible cultural and linguistic barriers, etc. Implementing the necessary transfers of technology and ensuring technological compatibility is also costly. Finally, the costs of uncertainty, especially with regard to quality and security of supply, are particularly relevant in the defence industry.

When substantial supplier search and switching costs exist, search for new suppliers will be limited. This is a rational response by companies: search will only occur if the expected gains of prospecting for new partners outweigh the related costs. If search and switching costs are sufficiently high, potential suppliers, more efficient than the incumbent ones may be deprived from market access and pushed out of business.

The presence of supplier search and switching costs reinforces the effects of policy induced barriers and favours incumbent suppliers. Even more, they may limit the effects of liberalisation by creating a form of path dependency that will survive even after the suppression of protectionist regulations. Reshaping the supply chains' architecture may require more than simple deregulation. Suppression of policy created barriers does not inevitably suppress their effects.

The success of offset policies as an instrument for overcoming barriers to the establishment of transborder industrial relations resides in the incentives that they provide for searching for local partners in the importer's economy. These incentives result from the conditioning of the core contract to the acceptance of the offset obligation: refusing to establish relations with local suppliers implies losing the profits obtained through the main contract. The resulting incentives are very high, and probably higher than what can be expected from other alternative instruments available. This is however also the main reason why offsets may have important trade distorting effects: the desire to obtain the main contract may lead to resorting to local suppliers less efficient than the incumbent ones, in-

flating production costs and creating duplications in the European industrial base.

CONCLUSION AND OUTLOOK

Like in medicine, symptoms may sometimes be detrimental. Treating symptoms alone is however not an efficient approach – it may provide some temporary relief but will not cure the patient. But if the underlying causes of the disease are adequately treated the symptoms will vanish. The study on offsets published by the EDA emphasises the importance of implementation of state-of-art Supply Chain Management practices by European defence companies. Indeed some of the largest European defence system integrators are also highly competitive companies acting in civil markets. It is not unreasonable to assume that modern supply chain management practices are already applied.

New instruments should therefore be set up to complement liberalisation and efficient management in order to ensure that the EDEM provides equal opportunity for participation to companies from all Member States without consideration for their size, nationality, history and current involvement. It appears difficult to completely address the issue only at the corporate and national level. Some instruments should also be set up at the Community level in order to reduce the effects of barriers impeding the spontaneous establishment of industrial relations between European defence companies. European industry associations' involvement can be highly valuable. Institutions like the EDA and the OCCAR may also play an important role, especially through their expertise in managing multinational cooperative programs that are not based on the traditional *juste retour* practices. They may act as a catalyst for the establishment of transborder industrial partnerships and contribute to the emergence of an EDEM combining economic efficiency and fair access which will eventually put an end to the reliance on offset policies.

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