Chapter 16
Concluding Remarks

Stephen Martin
Centre for Defence Economics,
University of York, UK

The aim of this chapter is to identify any common themes that emerge from the case studies and the associated lessons that can be drawn for public policy towards offsets. Given that the analysis has focused on a variety of countries, often with very different defence, economic, industrial and political backgrounds, it might be anticipated that few, if any, such points would materialise. Indeed, given the various forms of offset (such as co-production, licensed production, direct and indirect offset) and the different policy objectives, the task of identifying any common themes might have proved an onerous one. On the contrary, though, there appear to be a number of findings which, whilst not readily apparent in all of the case studies, come through sufficiently strongly to warrant discussion.

Perhaps the first point to make — and one which applies to virtually all countries — is that the absence of a reliable and consistent body of data makes any evaluation of offset programmes incredibly difficult. Indeed, in some cases the only publicly available data was the financial size of the offset together with a very brief description of the type of work which was considered to be eligible towards the vendor obligation. This data deficiency is all the more surprising given the substantial financial sums that are often involved and the fact that the offset package has sometimes proved the decisive factor in a purchaser's choice of vendor. Indeed, the US is the only country where regular and rigorous attempts have been made to track the impact of offsets in terms of jobs, technology and international competitiveness. Here, of course, the focus is on the domestic impact of offsets associated with US exports, rather than that associated with US imports (which is the more relevant scenario for most countries).

Typically, the impact of a direct/indirect offset is measured in financial terms (e.g. $500 million over a five-year period) and, in these circumstances, the success or failure of the offset depends on whether the vendor meets its obligation within the specified time period. However, the usefulness of this approach towards the evaluation of any offset programme depends on whether the work which is eligible towards an obligation actually occurred as a result of the offset, or whether it merely reflected existing business relations. If it is the latter case, then the impact of any offset, no matter how large financially, is likely to be rather trivial.

Also relevant for the evaluation of any offset is information on the programme's cost. That is, how much more does the offset cost compared with an off-the-shelf purchase? Many, but not all, states seem wedded to the idea that offsets are free goods and are reluctant to publicly admit that an offset costs more than an off-the-shelf purchase. Once this is recognised, though, further issues arise concerning the cost effectiveness of the offset programme and whether there are any other policy instruments which could obtain similar benefits for a smaller outlay.

Aside from the lacuna of data, the case studies reveal a number of interesting themes. First, offsets have involved a learning experience for both the vendor and purchaser and, as with any new initiative, both parties probably made mistakes in the early days. Vendors might have underestimated both the cost and the degree of difficulty with meeting their offset commitments. Initially, offset agreements were often on a 'best endeavours' basis but, as a number of countries learnt, financial penalties for the non-fulfilment of offsets proved a better incentive than the much vaguer 'best endeavours'. Firms in a number of purchasing countries initially, and quite erroneously, believed that an offset obligation guaranteed them orders irrespective of their cost and quality performance and, when such sales did not materialise, it led to widespread disenchantment with offsets. Also, firms with an obligation would, understandably, seek offset credit for as many purchases as it could lay claim to, irrespective of whether they met the necessary criteria. Consequently, administering offset programmes, particularly large ones, proved an onerous task. Inevitably disputes will arise over whether work is new work, generated by the offset, or whether it reflects established business patterns. Similarly, there will be debate as to whether the work meets the necessary technological standards and, where there is no obvious market price, there might be difficulty attaching a mutually agreeable value to, say, technology transfers. These teething troubles are inevitable although experience suggests that they decline as both parties become more familiar with each other. The only way around many of these problems is to agree a package of offset work in advance rather than wait for the vendor to place work with domestic industry. However, this is simply not practical for, say, a $1 billion worth of indirect offset!

Second, there seems to have been a move away from rather general offset programmes with broad eligibility criteria, and towards more focused measures. This might reflect the recognition that offsets cost more than an off-the-shelf purchase and that purchasers wish to concentrate their scarce resources in specific areas rather than provide a general subsidy to all of industry.

Third, the time horizon of those seeking offset seems to have lengthened, particularly in countries with a developing defence industry. One of the criticisms of offset is that once a vendor has fulfilled its obligation it will transfer its business to another state where it has an outstanding commitment. To overcome this, many countries allow a firm to bank offset credit in anticipation of a future obligation and this provides an incentive for the firm to continue placing work with domestic manufacturers. Of course, many countries are seeking the production work that this can bring and so the banking arrangement is the appropriate response to this form of short-termism. However, developing defence industries often want more than just production work, with technological and marketing skills being particularly attractive. To induce foreign manufacturers to share these assets, a number of countries now seek to draw foreign firms into the domestic economy through either equity investments in existing domestic firms or the establishment of joint ventures. Both approaches provide the foreign firm with an incentive to continue to place work in the domestic economy and to share other skills as this increases the profitability of its overseas investment.

The interpretation of this move away from broadly defined short-term offset work and towards a more focused long-term investment strategy is, by no means, clear cut. It could be that it reflects what is perceived to be the failure of the former approach and that, as alleged, foreign suppliers cease placing work in the domestic economy once their offset obligation is complete. An alternative interpretation would emphasise the success of the offset strategy in laying the foundations on which future joint ventures could be built. By encouraging foreign firms to place work with domestic manufacturers, both parties become familiar with doing business with each other. The foreign firm is made aware of the capabilities of domestic manufacturers who, in turn, become aware of the cost and quality requirements for sales to the foreign firm. In this scenario, offsets force domestic manufacturers to become more efficient and, once this has occurred, make the foreign manufacturer more willing to invest in the local firm. The move away from offsets and towards joint ventures does not reflect the failure of the former; rather, the reverse. Of course, this form of offset is likely to be more attractive to those countries with a developing defence industrial base than to states that have less of a need for new technologies.

Finally, none of the country studies provide any evidence to suggest that offsets are likely to disappear in the foreseeable future. Certainly, the US has unilaterally sought to limit the size of offset that American firms can offer and Congress has passed a bill that limits the steps that US firms can adopt to fulfil any offset obligation. As part of a Code of Conduct for defence trade, the US has also sought multi-lateral agreement with its NATO partners to limit and eventually eliminate all offsets, which it views as a barrier to defence trade. However, since an initial draft in 1992, the Code of Conduct has made little progress towards being a more substantive document and thus the prospect for a mutual elimination of all offsets, within this forum at least, remains remote. Elsewhere, as long as purchasers continue to require offsets, and there is no reason why they should cease to do so, competitive pressures will force vendors to meet such demands.

Index

Each country's main entry (usually a complete chapter) is in bold. For the reader's convenience, particular areas of interest may also be included as a subheading.