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Offsets in Belgium: between Scylla and Charybdis?

Wally Struys

Introduction[1]

The purpose of defense is not to pursue economic goals, but to fulfill defense needs. But undeniably, an economic role exists within the framework of resource allocation to satisfy collective goals in addition to defense. Organizing and equipping armed forces depends not only on their needs, but also on the available resources[2] and on the economic and technological fall-out of a state's defense policy. Defense policy can thus be linked to the pursuit of economic policy goals such as an improvement in employment levels, economic growth of domestic defense and other industries, improvements in the balance of trade, or of the distribution of income. By integrating defense offset requirements and priorities into its defense industrial policy, Belgium pursued such general economic policy goals as part of its defense acquisitions. In particular, Belgium used offsets as a means to maintain its defense industrial base and to improve its technical prowess. This chapter briefly summarizes and evaluates Belgium's experiences with defense-related offset arrangements.

Offsets in Belgium[3]

Belgium distinguishes among three forms of offsets. First, *direct compensations* refer to Belgium's share in co-producing the acquired equipment as well as associated supplies and services. These are produced to meet the needs only of the Belgian armed forces. Direct offsets are directly related to the product delivered. Second, *semi-direct compensations* resulting from an arms acquisition contract, refer to equipment, supplies, and services produced in Belgium either for the arms-originating country or for third countries. Semi-direct offsets are thus also directly related to the acquired arms. And, third, *indirect compensations* are products, supplies, and services intended for countries that awarded a contract in any other field of activity. Hence, indirect offsets embody the purchase of products or services unrelated to arms.

The benefits of offsets

Offsets are thought to have brought many advantages to the Belgian economy. In principle, they allow the country to recuperate an important part of the acquisition

expense through direct utilization of domestic defense-related inputs, reduction in unemployment compensation, growth of social security contributions and fiscal income, and the indirect and induced economic effects in upstream and downstream industries. Defense production also contributes indirectly to the utilization of highly specialized manpower and to the creation of employment in all industrial sectors, especially in high-technology sectors such as aerospace, optics, electronics, telecommunications, and composite materials. Since requisite physical investments are partially financed from abroad, offset risks are low and costs limited. Consequently, offsets have also been responsible for *structural* macroeconomic advantages. For example, without offsets, it is unlikely that Belgium would have been able to sustain aircraft or engine manufacturers, and the acquisition of know-how in advanced modern technology would have remained a dream.

Offsets allowed the Belgian economy to benefit from positive direct, indirect, and induced effects in all its sectors. The political, economic, and even psychological importance of offsets in Belgium is confirmed by the fact that whenever an important defense contract was signed, the media called it the "deal of the century." There are other advantages such as accelerated profit growth for domestic firms, acquisition of a higher level of technological know-how, and new investments in the client country that permit seller and buyer to expand their markets. Recourse to offsets implies that investments by the beneficiary are reduced since the recipient firm only produces part of the purchased arms. This might free capital to seek profit in other sectors. Offset compensations also improve the balance of payments and contribute to a better division of labor. On the whole, the following Belgian actors are happy with current offset policy: the military, because its allows them to buy new equipment; the politicians, because they can create employment in their political hinterland; and the industrialists, because they obtain contracts in a hermetic, captive market.

Disadvantages of offsets

General drawbacks

Offsets do not offer benefits free of costs. They present significant handicaps as well. They are antithetical to free trade, they alter the nature of sales by including terms unrelated to prices and performance, they introduce market rigidities, cause growing state intervention, and create distortions in world economy and trade. The working of natural market mechanisms is suspended: the negotiated price paid by the purchaser is generally higher than the free-market price. Offsets thus reduce general welfare. Where offsets are used to direct work to suppliers who are not under the pressure of competition, it is unlikely that they are cost effective. Offsets used in this way act as a subsidy; gains in employment generally are (more than) compensated by losses in efficiency.

Moreover, offsets cause perverse production effects. For example, they finance a costly infrastructure for short production runs. Technology transfers, for their part, do not offer guarantees for success; they may be new, yet already ageing instead of being emerging or "future" technologies. Offset-related investments have also lead to excess production capacities, resulting in idle capital. Furthermore, the defense industry

becomes even more dependent on the international arms market than it already is, and it suffers from political machinations and constraints. Technological progress presupposes permanent flows of replacement and upgrade investments; however, since the timing of offset contracts is uncertain and subject to long time intervals, offsets make long-run government investment policy difficult. Moreover, sectoral protection results in a lack of economic and commercial aggressiveness, low activity and employment levels, additional costs and higher prices, poorly developed marketing, disappointing R&T activities, and the necessity to start the learning curve all over again with each new contract.

Offsets are economically inefficient. Belgium used them as a means to maintain its defense industrial activities and to improve the sector's technical quality. But since they operated on a contract-by-contract basis, with subcontracting benefits drying up once the foreign supplier had completed its offset obligations, these were short-term solutions of little use in the long-run. Offsets have led to limited cooperation on an *ad hoc* basis, thereby weakening Belgium's defense industry. They gave rise to heavy lobbying activity and, consequently, to overprotection of national enterprises and to overcapacity in the production lines of weapon systems. They masked shortcomings and prevented management from taking appropriate measures. More often than not, the decision to purchase arms from abroad was made at a point when it was no longer possible to share in its R&D.

Disadvantages of indirect compensations

At first sight, indirect compensations seem to be the most interesting since they lead to increased economic activity in the non-military sector. In reality, however, many problems reduce their effectiveness. The purchasing country often gets low quality work and finds it difficult to measure if the work results in genuine additional, or merely re-labeled or redirected, activities that it would have been able to perform even in the absence of offsets. Other problems relate to product commercialization and uncertainty about the duration of offset-related work. Without renewal, indirect compensations tend to die out gradually. In any case, it is difficult to capture the technological value of indirect compensations in the non-military sector, and the effects on the balance of payments are likely marginal. Moreover, Belgium witnessed the spontaneous appearance of "pre-compensations" (offset banking credits) which are purchases by an arms-selling country from the buying country prior to signing an arms deal. This allows the arms seller to use the value of otherwise normal international trade activity to count against the value of offset obligations the buying country imposes.

Overcosts

Small and medium-sized countries like Belgium do not buy weapons off-the-shelf from the lowest-cost foreign supplier. They pursue other economic policy goals and demand economic compensations. Offsets do, however, increase costs. Such "overcosts" can find their origin in the seller's as well as in the buyer's country. Offsets arrangements frequently impose added costs on suppliers, particularly if technology transfer is involved. Where such costs are incurred they lead to increases in the price of defense

goods and services. This directly affects the defense budget. With offsets, the seller overhead burden increases because it has to manage a process of seeking and training international sources. Jobs in the arms-selling country are supplanted by offsets and appear to reduce the manufacturing base of the seller's industry. As a result, they increase the selling price of the purchased equipment. Buying governments are, however, anxious to pay these overcosts, since they typically view offsets as a form of investment which they expect to yield results well worth the extra cost associated with such arrangements. In addition, production costs in small and medium-sized industrialized countries, such as Belgium, tend to be higher than in big arms producing countries, especially due to higher labor costs. On the whole, it is estimated that Belgium pays a 20 to 30 percent penalty for imported weapon systems. These overcosts are financed solely from the Ministry of Defense budget, impinging upon other defense budget categories.

The regional factor

In the 1980s, constitutional changes in Belgium toward a three-way federalization of the country resulted in an important shift in economic and industrial policy decision making, away from national and toward regional authorities. Diverging interests and the absence of political and financial coordination led to completely different industrial strategies in the Brussels, Walloon, and Flemish regions. Each region attempted (and still attempts) to obtain maximum benefit from measures to protect existing, or create new, production capacity. Nowadays, it is a political imperative to distribute defense acquisition contracts according to a regional quota formula. Understandably, the specifics of this formula are constantly contested by regional, rent-seeking pressure groups. In the end, each contract for defense includes an explicit regional partition of offsets, imposing even on the seller an obligation not only to provide *Belgium* with a minimum of activities, but to distribute these to its *regions*.

The future of defense compensations in Belgium

An academic approach

Logically, four solutions to the various problems outlined in this chapter are possible:

maintain the old offset policy;
maintain the offsets under an improved form;
replace compensations with participation in structural industrial cooperation that is not linked to any particular arms import contract; or
reduce not only offsets but also any defense industrial activity in the country.

For obvious reasons, the first proposal must be rejected. Politically, economically, and industrially, maintaining the old offset policy is not justified. The same applies to the fourth solution. Even if offsets are more costly than beneficial, the goal cannot be simply to eradicate all of Belgium's defense production activity, nor to forego whatever genuine

offset advantages there may be. It remains reasonable to maintain some defense production capacity even in a small country, especially when taking the evolving development of the European Security and Defense Policy into account. Instead of regarding offsets as a means to involve national industries, common economic sense suggests to use international cooperation to strengthen the European defense technological and industrial base, taking particular account of the position of smaller nations' industries.

Although ideal, an international cooperative solution will take time. A transitional period with gradually improved offset policies may be the short and medium-term solution but offsets, *en régime*, will have to disappear in favor of other forms of economic returns and the pursuit of long-term objectives, such as increased structural industrial cooperation (i.e., *Arianespace* and *Airbus*). In future, firms must become high-value added centers of excellence and develop niche activities. They will have to emphasize comparative advantage with regard to their expertise, the quality of their products, and other attributes, and no longer rely on arms-import offset obligations of foreign sellers. If not, Belgian arms producers take the risk of being swept away by competition in a genuine Europe-wide defense market. But such a policy cannot of course be implemented overnight, certainly not in a global industry in which Belgium plays a very minor role. A transition period would allow improvements in the old offset instrument and its progressive replacement by economically more acceptable tools.

For their part, Belgium's national and its regional governments must achieve coherence between disparate defense industrial policies in a sector that is supposed to fulfill national needs. Not only the national ministers of defense, of economic affairs, of social affairs, of employment, and of science and technology, but also their regional counterparts must be involved. With the coming implementation of a European Security and Defense Policy and the already happening Europe-wide defense industry regrouping, the set of feasible defense-industrial policy choices becomes progressively smaller for Belgian decision makers. Time to avoid default-decisions is running out. Indeed, not only is the supply side consolidating (BAE Systems, Astrium, Thales, EADS, and MBDA), but so is the demand side (e.g., the Organisation Conjointe de Cooperation en matière d'Armement, or OCCAR, which is the four-nation procurement agency of France, Germany, Italy, and the UK, and the incipient European Armaments Agency, EAA). Evidently, the future of small and medium-sized defense firms in small and medium-sized countries such as Belgium can only be envisaged in the framework of the ongoing Europeanization and globalization of the arms market.

In a word, the second solution is not viable in the long-run either.

The third solution

For small and medium-sized countries, the third solution is the best possible choice. Since offsets ultimately perpetuate inefficiency and maintain the independence of firms that are too numerous and too small, one must depart from the offset concept. Offsets must be progressively abandoned in favor of other economic returns that pursue long-term goals. As I argued, offsets will disappear anyway when a genuine European market will come into being, even as EU member states today still take advantage of article 296, paragraph l(b) of the Rome Treaty which provides that

> 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; and that such measures shall not adversely affect the conditions of competition in the common market regarding products which are not intended for specifically military purposes.

Although not precluding international cooperation, in practice this article prevented the defense sector from following the general movement toward European commercial integration. It was used to justify protectionist measures in the sector. Offsets worsen the situation by inhibiting or else distorting European defense industrial restructuring. At a time when there is a major overcapacity in many European nations, the use of defense offsets subsidizes uncompetitive enterprises. It is nevertheless clear that these restrictions will disappear in the framework of a genuine European Security and Defense Policy (ESDP). Security cooperation among EU members within ESDP imply common maintenance of a European defense technology and industrial base (DTIB). Any final agreement on the use of economic and industrial instruments in this sector can only be cross-national, or even global. On the supply side of the market, many have underlined the importance of the creation of a Europe-wide defense equipment market, with equal opportunities for all industrial actors. In an open market with fair competition, offsets will no longer be required. In this ideal situation, offsets can be waived for trade among European nations.

Belgian offsets will have to give way to other measures. Time is short for Belgium to establish a genuine and coherent defense industrial strategy, compounded by the vexing difficulty of taking regional needs (and political realities) into account. If its defense industry is to survive, it requires the country to ensure a smooth transition from the old offset policy to a future where its defense sector will find a well-deserved place in a pan-European arms market thanks to the existence of centers of excellence where quality of performance and competitiveness reign.

Under ESDP, European armed forces will increasingly participate in common arms acquisition programs, and international cooperation will take place not only in the military operational field, but also in the technical and industrial fields. The Belgian government will have to put in place measures now that would ensure full participation in international cooperation agreements. The alternative—the default solution—is the death of Belgium's defense industry.

The political issue

On the occasion of two minor contracts, the Belgian government decided in December 2000 to put a "final" end to its offset policy and to take into account only operational, technical, and military criteria when acquiring new defense equipment. As could be expected, reactions were ferocious. Industrialists pleaded, not without reason, that were this policy adopted they would be placed in an unfavorable competitive situation if they could benefit no longer from economic compensations. Some politicians were, for purely dogmatic reasons, against offset policy but others, craving the *status quo ex ante*, supported the industrialists. An *ad hoc* working group of high-level advisors created by

the Prime Minister was entrusted with developing new forms of economic "returns" for defense acquisitions. Within the framework of its mission, the advisors agreed to propose to government to no longer seek recourse to offsets, except when the tenders are equivalent.[4] This results in potential new options for defense contracts (Marsia, 2002), allowing government to choose from among three procedures: invitation for tenders, request for a quotation, or negotiated procedures, i.e., contracts either with or without classic offsets provisions but with participation in international cooperative production activities. A final policy has not yet been adopted since lobbying is still underway. But, interestingly, during 2000 and 2001, the Belgian government placed arms orders for over €1.4 billion, without offset requirements.[5]

Conclusion

For several decades, Belgium used offsets as a means to maintain its defense industry and to improve its technical quality. Offsets strengthened Belgian defense firms in the short-run, but inhibited international cooperation and made them vulnerable to international structural changes in the industry. As a result, offsets are at least partly responsible for the current weakness of Belgium's defense industry. Belgium never developed a coherent network of defense firms and subcontractors, its defense industry was not restructured soon enough to cope with international changes, and the defense-technological revolution elsewhere in the world did not result in the expected qualitative improvements in Belgium.

As it turns out, more than 80 percent of the "Belgian" defense industry already belongs to foreign investors. Mergers, regroupings, and take-overs by foreign firms nevertheless did not, in most cases, lead to rationalization and more efficient division of labor. Notwithstanding potentially attractive advantages, on balance offsets have been negative for the country. Over the years—probably due to the absence of a genuine industrial policy in the defense sector—defense acquisitions gave rise to short-term strategy and transformed offset policy to dogmatic behavior.

It should be emphasized that the arguments presented here apply to the Belgian case and, probably, to most of the small and medium-sized *developed* countries. In contrast, central and east European countries as a group exhibit different characteristics: they possessed, for example, a highly developed defense potential that is now undergoing an important transformation. Offsets might assist them to achieve wider economic development but should be limited in time so as not to give way to the disadvantages discussed in this chapter.[6] In fact, as the central and east European countries are adapting and preparing themselves to participate in European industrial cooperation, it will not be necessary for them to insist on offsets at all.

An analogous argument can be made with regard to *developing* countries and countries that have little or no defense exports at the moment. Since they attempt to leverage arms imports to provide benefits for their domestic economies, the main difficulty may be to convince these nations to drop offset requirements, or at least to limit them to a reasonable period of time.

Notes

1. In Greek mythology, Scylla and Charybdis are personifications of rock and whirlwind that made navigation of Italy's Straits of Messina hazardous. In contemporary American English, we would say that Belgium's military industry finds itself between "a rock and a hard place."
2. Each year, Belgium spends between €375 and €495 millions for the acquisition of equipment, land, and construction for its armed forces. Even if this sum is marginal in international comparison, for Belgian defense firms it is an important sum.
3. This section is a summary of Struys (2001).
4. Thus, when price, quality, and technical properties are close among competing offers, offsets will continue to determine the ultimate choice. The government decided to limit the weight of economic compensations in this case to a maximum of 15 percent of the contract value.
5. A400M, Hélios II, Strategic Transport Ship, Advanced European Jet Pilot Training facilities.
6. For example, see chapter 12 in this book by Markowski and Hall (2004) on Poland.

References

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