

# Offsets and Economic Development: Having your Cake and Eating it?

Geoff Harris (reprinted from November 2002)

One of the most controversial government policies in South Africa has been the R30 billion arms purchase agreements signed with a number of European arms producers in late 1999, which relied heavily on offsets which are common in international arms contracts.

These offsets, which provide some return benefits to SA, took three forms. The most obvious is direct offsets, where local firms are contracted to produce components for the vessels and aircraft. Indirect offsets occur where European producers agree to purchase other (non-military) goods from SA producers. The third type is new foreign direct investment in SA by the European arms producers or associated companies.

Together, these offsets were estimated by the Department of Trade and Industry to result in R104 billion in net economic benefits to SA and 65,000 additional jobs, and these figures were crucial in cabinet's decision to approve the arms purchases.

An international conference held in Cape Town in September examined links between offsets and SAs development. Sponsored by the US-based Economists Allied for Arms Reduction (ECAAR), the National Research Foundation (SA), the Centre for Conflict Resolution and the School of Economics, University of Cape Town, the University of Port Elizabeth, Middlesex University and the University of the West of England, it brought together a number of internationally renowned researchers in the field.

Professor Jurgen Brauer, from the US, pointed out that there are many actors and interest groups involved in an arms deal. He argued that the role of the economist is to represent the interests of society as a whole, rather than any one group. In economic terms, this means estimating the value of the various projected benefits from offset arrangements and then deducting the costs of the arms purchases in order to estimate the net effect on society - the net social benefit.

In terms of costs, the purchase price of the arms is normally well known, although it has increased to around R60 billion as a result of inflation and exchange rate movements. However, long experience with offsets indicates that arms producers raise their prices by 20-30% to compensate for the additional costs they incur as a result of offsets.

So an important question is why didn't the SA government simply buy "off the shelf" and pay a lower price? The answer is that it believed that the estimated benefits of the offsets outweighed the higher costs. New foreign investment and jobs have been mentioned, to which may be added technological transfer. That is, by being involved in the production of components, and through new foreign investment, SA would keep abreast of technological advances elsewhere. In addition, some people would argue that it is important to maintain a SA defense industry for strategic reasons.

According to the free trade principles espoused by the World Trade Organization, offsets are a bad idea. They result, Professor Ann Markusen argued, in both microeconomic and macroeconomic distortions. Professor Paul Dunne believes that most offset deals have involved big overestimates of the benefits in fact received by the arms purchasing country. While they remain common in arms purchase agreements, it is worth noting that a number of countries have decided not to be involved with them. That is, they prefer to buy “off the shelf” and forego the potential benefits of offsets. The reason they give is that the potential benefits have not been forthcoming.

Is SA reaping the hoped-for benefits from its arms purchase agreement? The jury is still out on this but there are some worrying signs that some European arms manufacturers are, in effect, renegeing on their commitments and claiming offset credits for benefits that would have happened in any case. Paul Dunne argues, for example, that the joining of British Aerospace and Thomson-CSF with SAs Denel would almost certainly have occurred without the arms deal, given the clear benefits these firms received from such a linkage.

Research led by Professor Richard Haines of the University of Port Elizabeth has found that the flagship non-arms project – the Coega Industrial Development Zone – will require as much as R5 billion of additional government infrastructure development to make it viable. The initial plan of a US\$1 billion stainless steel plant as an offset for the purchase of the three German submarines has been cancelled, given excess capacity in the world steel industry. Every time this sort of thing happens, the net social benefit of the arms deal is reduced.

The conference reached three conclusions of relevance for countries such as SA. First, a domestic arms industry will inevitably require heavy government subsidies and this has to be weighed up against its strategic value. Second, arms purchases must be justifiable in defense terms and never in economic terms. Third, if offset arrangements are entered into, it is most important that they closely complement national industrial strategy. Finally, it will be a long time before the final verdict on these offsets will be made known. Foreign arms producers have up to eleven years to fulfill their offset obligations.

*Geoff Harris is a development economist at the University of KwaZulu Natal in Durban, South Africa. He also directs the university's Conflict Resolution and Peace Studies Programme. He is a Trustee of EPS.*