

## OFFSET AS AN ECONOMIC OPERATION AND A TRADE PRACTICE

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### Abstract

Offset agreements are widespread in sales of defense products. There is a steady tendency to increase their share as a percentage of world trade. Developed countries with well-established Defence Technological and Industrial Bases, use offset transactions to target activities to business organizations and countries with emerging economies use offset to gain military and commercial benefits. The following paper examines the offset as an economic operation which represents a wide range of industrial and trade practices.

**Keywords:** offset, defence, transaction, trade.

### 1. INTRODUCTION

A big number of researchers share the opinion, that "offset" is a collective concept for a wide range of industrial and commercial practices. The offset agreements are often met by the sales of defense products, for example of aircrafts, radars and other electronic systems, where a stable tendency to the increasing of their share as a ratio of the world export and of the frequency and size of the offset agreements (Brauer, Dunne 2004). The developed countries with approved industries are using the defense offset transactions for directing the activities or technologies towards the defensive business organizations. The countries with newly industrialized economies are using simultaneously military and commercial offset transactions, which include also the transfer of technologies (Nichev, 2017a, pp.129-135; Nichev, Terziev, 2016, pp. 141-146). In her analysis O. Zvinchukova gives the following definition of offset: „transaction, in the frames of which the exporter undertakes the obligation to compensate part of the expenditures incurred by the importer, in one or another way, connected with the acquisition of armament or military equipment" (Zvinchukova, 2011, pp. 49-55).

Terziev and Nichev summarized the motives of the both parties of the offset transaction in this way: for the country-buyer it's important that after the purchase the money remain in the country so that they could stimulate the economy, because the politicians render an account to the society, while the country-seller uses the bigger part of or all the funds from the transaction for the erection of the infrastructure for the

production of arms in the country-buyer. Without this transaction the needed infrastructure wouldn't exist and in case of an ordinary purchase deal there would be no incomes for the state-buyer (Terziev, Nichev, 2016d, pp. 57-62).

According to the definition of the Federal Ministry of Economic and Employment in Austria the counter (offset) deals are back-to-back commercial agreements between two partners with different state affiliation (most frequently a state authority and an international company). As an economic equalization (compensation) of the payment of the purchase price according to the main deal, the buyer requires a compensation (offset) transaction, which is implemented by the supplier in the form of separate projects, connected with the economy of the country-buyer (Nichev, 2017a, pp. 121-128).

The Czech legislation regulated the offsets as business activities, which can be used in the future as a criterion by public tender of the offering countries (the applicants). They are connected with purchases from a foreign counterparty for the amount of more than 300 million Czech Koruna or with foreign counterparties of the local main counterparties with transactions amounting more than 100 million Czech Koruna. With the term "offset benefits" the Management for the Evaluation of the offset benefits by supplies of the Greek Armed Forces defines all kinds of compensation transactions, performed by the supplier as a counter-deal during the provision of a public contract for the Greek Armed Forces, in accordance with the policy of the Greek Ministry of Defense about the offset benefits.

In Lithuania the word "offset" means activity of foreign suppliers or further economic entities, acting on their behalf, during which the contract for supply of weapon, ammunitions, explosives and other goods of military purpose from abroad is being compensated by granting of benefits for the economy of the Republic of Lithuania. This activity can be implemented in the form of order for goods, produced by Lithuanian economic entities, providing of technologies, investments on the territory of the country, organizing of an independent production process etc.

The Offset Law in the Republic of Poland regulates the concluding of the contract, the rights and the obligations of the parties in a special kind of compensation agreements, called "offset agreements". They are concluded in connection with contracts for the supply to the Republic of Poland of weapon and/or military equipment for the purposes of the defense and the protection of the country. The equipment, subject of the contract for supply, is manufactured outside Poland (Kondeva, 2004).

According to the offset management principles, in the Republic of Slovenia the term "offset" is being applicable on the export of goods of Slovenian origin as compensation on the purchase of goods (products, materials and equipment), technologies or supplying of services of foreign origin.

A Directive for the implementation of offset transactions in Turkey regulates the offset agreements as specific deals, which are implemented in order to increase the production opportunities and compatibility of the Turkish industry and the service sector in the international commerce. The offset transactions are part of a concluded state contract /main agreement/ for the supply of goods and services, necessary for the protection and security of Turkey.

The Ministry for Defense of the Republic of Bulgaria gives the following definition "the offset represents an industrial or commercial compensation, required by the Bulgarian government from a foreign company, which has won a public procurement for the supply of material resources and/or services for the Armed Forces or the protection of the country" (Terziev, Nichev, 2016c, pp. 366-391).

The offset is being planned and implemented by means of Offset programs. An Offset program is a written Plan for the implementation of obligations for the fulfillment of definite deals and/or activities, offered by the applicant for Supplier, regarded as direct or indirect counter-compensations for the performance of a concluded public procurement contract. The Offset program is obligation of the Supplier and it's written down as a clause in the Contract for Supply and is implemented through orders to the Bulgarian industry and/or other transactions or activities on the Supplier side. The size of the Offset program is determined as a relative share of the nominal value of the contract for supply of materials and/or services for the Armed Forces and the protection of the country and can't amount less than 20% (as the ratio between the nominal value of the offset and the contract for supply) (Terziev, Nichev, 2016d, pp. 57-62).

## **2. SORTS OF OFFSET TRANSACTIONS**

The majority of the researchers share the opinion that the offset transaction can be basically divided into two kinds of offset – direct or indirect.

According to the legislation of the United States as "direct offset" are regarded those transactions, under which defense goods or service are supplied, while "the indirect offset" includes military goods and services,

which are not connected with the military products or services, imported within the contract (Offsets in Defense Trade. Eighteenth Study. (2013).

In Austria the offset transaction can be divided into three groups: „direct offset transaction”, immediately connected with the main transaction (supply); “semi-direct” – connected with other activities of the supplier; „indirect” – there is no connection with the main transaction.

According to the Polish Law, “direct offset obligation” means assuming of obligations in favor of a definite contractor, whose activity is of a particular importance for the economy and the national security of the country. It’s foreseen in the contract for supply of weapon and/or military equipment. “Indirect offset obligation” are such obligations, which are not included in the definition of a the direct offset obligation (Kondeva, 2004).

In the Czech Republic a “direct offset” is such an offset, which is immediately connected with the subject of the public contract, i.e. includes projects, focused over the direct participation of Czech business formations into the accomplishment of the contract. The national aim of an offset program is that at least 20 % of the contract price is a direct offset. “Indirect offset” are all offset forms, different from those, belonging to the direct offset. The indirect offset includes also these activities, which have no direct connection with the production of the initially purchased equipment. Among them are: export of products and services, transfers of technologies and know-how; support for researches and development; new investments; establishing of collective companies; collaboration for the opening of new jobs; assistance of the small and medium-sized business.

The legislation and the practice in Hungary admit the following main forms of the offset activities: investments; direct offset; additional export (Terziev, Nichev, 2016c, pp. 366-373).

The investments, which form a part of the capital of limited liability companies or Joint Stock Companies, registered in Hungary, are considered to be a form of offset activity. Such conditions are available, which ought to be taken into consideration: in case of a capital increase a registration in the competent court is required; in cases of participation of the company capital in some form of offset activity, no offset investment withdrawal is allowed during the implementation of the offset obligation. Short-term investments, which aim only the liquidation of the company, where it’s being invested, also those investments, which restrict the competition, are inadmissible. This kind of investments, are not considered to be a form of offset activity. In the investment amount no state grants or financing from the state budget of Hungary are included. The contractor of the offset agreement must give an account of the received state budget grants to Offset Coordination Office.

Another form of offset activity in Hungary is the „direct offset”. In this case materials, spare parts and semi-finished products, manufactured in Hungary, needed for the production of the product, subject of the contract for supply according to the offset agreement, are delivered by Hungarian business Associations.

The third form of offset activity in Hungary is the „additional export”, which must be in conformity with the following conditions: it has to do with goods and services, specified in a particular Addendum to the General rules, elaborated by the Ministry for economy and transport concerning the offset trade and the related activities; the goods and/or the services, subject of the additional export, must be purchased by local business associations. In order to be a part of the implementation of an offset agreement, the contract price of the additional export must be in amount of over 50 000 EUR.

In the legislation of Slovenia there’re determined: „direct offset” – export of goods or services, which are directly related to the subject of the contract or with another sphere of similar use and „indirect offset” – all other forms of export of products and services, with are not directly related to the subject of the contract or another sphere of similar use. Education, donations, tourist programs, support of specific exporters and others are considered as indirect offset.

In Greece the offset transactions are also divided into two major groups: transactions, linked exceptionally with the supply of defense equipment and transactions, linked with defense equipment and services, which don’t belong to the first group.

The Lithuanian legislation doesn’t give a definition of the concepts, but explicitly provides that the direct offset is preferred, while the indirect is not allowed.

From the analysis of the accessible literature the conclusion is that the offset transactions can be divided basically into two types:

1. Direct offset: These transactions are implemented by the exporter in the interest of the development of the defense-industrial technological base by means of implementation of offset projects or offset programs,

immediately connected with the supply of defense products and their subsequent exploitation by the armed forces of the state-importer. The subject of these transactions is armament and military equipment and they usually assume the form of production under license, transfer of technologies, investments, credit assistance, training, joint ventures, subcontracting and others.

2. Indirect offset: These are transactions, which are not connected directly with the supply of defense products. The subject of these transactions is the delivery of goods and services, which are not connected with military products within the frames of a trade agreement and usually assume the form of production under license, transfer of technologies, investments, credit assistance, training, purchases and others (Terziev, Nichev, 2016a, pp. 101-106; Terziev, Nichev, 2016b, pp. 385-391).

Production under license: The production is based on commercial agreements between the country-exporter and a company from the country-importer. The ground for the production under license is the affording of production technologies, of know-how etc. between the companies and it usually comprises the production of separate parts or components of the defense products and in rare cases the production of complete systems of weapon and military equipment. This form of offset transactions refers not only to the direct offset, but also to the indirect offset. Production under license occupies 2,78% of the total volume of the implemented offset transactions during the period 1993-2012, 54,08% of them are the share of the direct offset, while 44,56% are the share of the indirect offset and 1,36% belong to indefinite type of transactions.

Joint production: The joint production consists in the production of defense products through the provision of the necessary technology for the particular production based on the government agreements between the both countries. The agreements allow the foreign government or the producer to obtain the necessary technical information regarding the complete or the partial production of defense products. The joint production is implemented only as a direct offset. It includes a licensed by the government production, but excludes a licensed production, based on direct commercial agreements between the producer and the exporting country. The joint production accounted for 5.96% of the value of the implemented offset transactions in the United States during the period 1993-2012.

Subcontracting: The Subcontractor undertakes the production of spare parts, assemblies, detail and components for armament and military equipment outside the territory of the country-supplier. The subcontracting is not bound by the provision of licenses for technical information and is usually implemented through concluding of direct commercial agreements between the subcontractor and the producer from the exporting country. During the period 1993-2012 21.20% of the total volume of the implemented offset transactions, were accomplished by means of hiring a subcontractor by American companies.

Purchases: The purchases always belong to the indirect offset transactions and represent a purchase and the resulting supply of finished defense products to the recipient of the offset. For the period 1993-2012 the purchases occupy the biggest percentage and account for 36.54% of the total amount of all offset transactions (Nichev, Terziev, 2016, pp. 141-146).

Investments: According to the government of the United States these are investments, emerged in result of an offset agreement, which are not connected with the sale of defense products. Most often this sort of investments is in the form of capital holdings, expansion of subsidiaries or establishing of joint venture in a foreign country. The implemented investments cover 2.98% of the amount of the implemented by the United States offset transactions for the period 1993-2012.

Credit assistance: The credit assistance comprises direct loans, brokering loans, loan guarantees and assistance for achieving of favorable payment conditions, credit postponement and lower interests. The transactions, connected with the credit assistance, cover 3.28% of the amount of the implemented by the United States offset transactions for the period 1993-2012. The credit assistance can be an indirect as well as a direct offset transaction. For the same period the percentage of the credit assistance in the total volume of indirect offset transactions is 5.02% and respectively 0.85% of the total volume for the direct offset transactions.

Transfer of technologies: Here belongs the submission of technologies, which result from the offset agreement and can be in the form of implementation of research activity abroad, rendering of technical assistance to companies, qualification improvement of the personnel, provision of technical data, joint usage of licenses and patents and other activities, which are subject of the commercial agreements between the producer from the exporting country and the recipient of the technology. During the examined period the transfer of technologies account for 18.70% of the effective price of all offset transactions in the United States. For the period 1993 – 2006 the transfer of technologies account for 22.44% of the value of the direct transactions and 15.51% of the value of the indirect transactions (Terziev, Nichev, 2016e, pp. 135-140).

Training: the transactions for training are linked with the training of the personnel for the production or exploitation of the contracted in the offset transaction defense products. They may be orientated on such spheres, as the information technologies, teaching of foreign languages, improvement of the technical literacy, management of the life cycle of the defense products, etc. The transactions, connected with training, account for 2.23% of the value of the implemented offset transactions in the United States for the period 1993-2012. For the same period the percentage of the training in the total volume of the indirect offset transactions amounts 2.36% and respectively 2.15% of the total volume of the direct offset transactions.

### 3. CONCLUSION

Increased competition in trade in defense products globally reduces the use of military goods through traditional trade patterns. Therefore, the use of offset transactions is more and more common every year. The economic nature of which is that the buyer is able to connect the purchase of a specific product to the receipt of a wide range of benefits, both in the military and civilian spheres.

Defense-industrial cooperation between the state is becoming an increasingly economic process, the direction of which is primarily determined by economic expediency and in which almost all economic mechanisms to promote global trade in defense products are applied.

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