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South Africa's Arms Acquisition Package An Analysis of the Socio-Economic Costs and Benefits

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Introduction

The South African government Cabinet decision on 18 November 1998 to purchase thirty billion rand in armaments—submarines, corvettes, helicopters and jet fighters—raises important questions for concerned citizens and policy-makers. First, given the country's defense requirements and pressing socio-economic backlogs, is this the most appropriate allocation of resources? Second, how will these arms purchases affect the macroeconomy and the policy-making process? Finally, are the negotiated offsets likely to have the projected impact on job creation and economic growth? This paper examines the available evidence, analyzing South Africa's situation and drawing on international experience.

The Arms Purchase and the Allocation of Public Resources

South Africa's military spending increased rapidly from 1960 to 1990, as the apartheid regime mobilized resources to prop up its minority rule and to destabilize neighboring countries. South Africa's military expenditure peaked in 1989 at a level of 530 rand *per capita*, compared to a level of 40 rand *per capita* in the rest of sub-Saharan Africa. From 1990 to 1995, South Africa's military spending fell in line with global trends, falling to 256 rand *per capita*. Spending in the rest of sub-Saharan Africa nearly mirrored this trend, falling to 25 rand *per capita*. At its peak in the late 1980s, South Africa's military spending consumed over four percent of national income—by 1995, this had fallen to just over two percent, and in the past few years has fallen even lower. Never the less, whether measured in *per capita* terms or relative to national income, South Africa's military spending is high compared to other sub-Saharan African countries. By global standards, however, South Africa's level of military spending is fairly low—the global average *per capita* military spending in 1995 was 548 rand, and military spending consumed nearly three percent of global income.[1]

Since the elections in 1994, South Africa's defense spending has fallen significantly, from 11.6 billion rand in the 1995/1996 fiscal year to 10.7 billion rand in the 1997/1998 fiscal year. The government's *Medium Term Expenditure Framework*, however, projects that this trend will be reversed, and that military expenditures will rise to 12.3 billion rand in the 2000/2001 fiscal year.[2] This figure may rise even further, if the proposed arms acquisition package cannot be financed in line with existing budgets. These increases will erode the progress the democratic government has achieved in reducing military spending in order to reallocate public expenditure towards social transformation.

International studies document the extent to which reallocating defense expenditures to non-military purposes fosters growth and increases employment,

[1] Data is calculated from Table 1 of the publication *World Military Expenditures and Arms Transfers 1996* published by the US Arms Control and Disarmament Agency. All rand figures represent 1995 constant rand converted from constant 1995 US dollars using an exchange rate of 3.6 rand to the dollar.
[2] Department of Finance. *The 1998 Budget Review*. RSA: Pretoria, 1998. Page 5.8.

since the civil sector creates more jobs per rand of investment than does the military sector.[3] Batchelor and Willett discuss the macroeconomic consequences of this choice for South Africa, identifying how in the spirit of meeting basic needs for the majority of the population, defense savings were reallocated to social priorities after 1994. The resulting human capital investment and job creation were intended to promote genuine transformation. "Savings of 1.6 billion rand were released from the defense budget between fiscal years 1993/94 and 1995/96 to the housing, education, health and sanitation programmes of the RDP."[4] This peace dividend was invested in critical social assets, thus contributing to South Africa's social stability and long term economic growth.

The most important question, which has not been adequately addressed, is "Does South Africa actually *need* the particular weapons involved in this arms deal?" Accepting that the country will have certain military and policing duties, are submarines, jet fighters, corvettes and helicopters the most appropriate armaments to fulfill those duties? In order to answer that question we must first determine what the main security issues of the country are. In the case of the navy, for example, some experts believe that strike craft would be more effective than submarines in dealing with South Africa's most pressing naval threat: no, not foreign invasion, fish poaching. In the same vein, many believe that a strengthened police force would be more valuable to the internal safety and security of the country than an army equipped for international warfare.[5] Similarly, it stands to reason that smaller, more mobile vehicles and greater numbers of personnel would do a more efficient job with such duties as border control and internal policing than jet fighters.

South Africa reportedly has the "most powerful army on the continent" and yet we continue to build. According to Professor Jacky Cock, there are indications of a remilitarization of the region, with fourteen SADC states currently at war.[6] Some argue, paraphrasing former British PM Margaret Thatcher, that in order to maintain our peace we must be ready to defend that peace. The fact is, South Africa has not yet achieved peace. Poverty and unemployment continue to feed civil unrest and no amount of fighter jets or submarines are likely to fix that.[7] Acquiring more weapons is simply a way of containing the symptoms; it will not cure the disease.

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3 International Monetary Fund, *World Economic Outlook 1993*. IMF: Washington, D.C.; also, Melman, S. *From Military to Civilian Economy: Issues and Options*, Occasional Paper No. 8; California State University: Los Angeles, Calif. 1981.
4 Batchelor, P. and S. Willett. *Disarmament and Defense Industrial Adjustment in South Africa*. Oxford University Press: New York, 1998.
5 Kgosana, Philip. "South Africa Can't Afford to Spend on Weaponry." Letter to the Sowetan. 25/11/1998.
6 "Amnesia, Anger and Experience" *Ceasefire Anti-war News*. December 1998/January 1999. Page 1.
7 Pothier, Mike. "South Africa's Arms Purchases" *Southern African Council of Bishops' Conference.* Parliamentary Liason Office: Breifing Paper 15. 12/98. Page 4.

The government counters by arguing that defense hardware can perform civil actions, as well, that South Africa will be getting two for the price of one. Studies suggest that this reasoning, while appealing, is actually financially unsound. “Military equipment is far more expensive to operate and maintain than are comparable civilian items.” The United States is the perfect example of a country which certainly has enough naval equipment to maintain coastal security. However, the United States Coast Guard, which has its own equipment, its own personnel and its own training, exists expressly for that reason. The bottom line is that it is actually inefficient to use the military for civilian operations. As Mike Pothier of the Southern African Catholic Bishops’ Conference explains, “It is widely acknowledged that the military should be used to assist the police only as a last resort. Military personnel lack the proper training and background for police work and seeing them as a kind of ‘reserve police force’ is far from ideal. If additional police capacity is needed the answer is to budget for, recruit and train police officers, not to “borrow” soldiers.”[8]

Pothier further elaborates as to why it is irrational “to maintain a capability of any sort primarily or solely for it’s collateral functions. A school building may be used as an emergency shelter, but you do not build more schools than necessary in order to cater for emergencies; you build as many schools as you need for educational purposes. In the same way, you maintain a defense force in order to repel foreign aggression; if that need falls away-or becomes extremely remote—it is no argument to fall back on the collateral functions.”[9]

And if, hypothetically, jet fighters really were necessary for national security, why would we spend our precious few defense dollars on the Swedish Gripen-a plane that crashed during both of it’s public test flights? In fact, South Africa will be the first country outside of Sweden to purchase the Gripen.[10] Recent reports indicate that the government is considering delaying the deal for financial reasons.[11] Hopefully, they will reconsider the deal entirely. At a time when countries such as the USA, which has a stronger economy and a much greater security threat, are embarking on projects reduce defense spending South Africa should not be experimenting with its defense dollars. Similarly, the public should not be expected to pay for costly mistakes for the sake of political horse-trading.

Equally as suspect as the choice of armaments is the way in which the defense contractors seem to have been chosen. Certain companies, namely Bell and Dassault (French manufacturers of Mirage fighter jets) complained of not being able to revise their quotes to or submit second round bids for the reduced order prompting speculation that, in fact, the industrial alliances had been sealed

[8] Pothier. Supra n 32. Page 4.
[9] Pothier. Supra n 32. Page 4.
[10] “In Defense of South Africa’s R30bn Arms Deal” *Engineering News*. 4/12/98.
[11] Laufer, Stephen. “Government Puts Safety Catch On Arms Deal” *Business Day*. 10/6/99.

long before bidding opened.[12] The disconcerting implication is that government seems more concerned with political favoritism than with cost control. Similarly disturbing reports have surfaced about Agusta, the Italian manufacturer that has been contracted to build eleven fighter jets,[13] and their purported involvement in a corrupt defense contract in Belgium. Last November the Mail and Guardian published details of a bribe scandal in which Belgian political parties were awarded kickbacks in return for large defense contracts. Thus far, former NATO secretary general and Belgian finance minister Willy Claes, two fellow ministers and seven aides have had to step down. In an example closer to home, Agusta sold what are commonly acknowledged to be overly equipped helicopters (with features such as a night vision cockpit) to Portnet, South Africa's port authority, and some believe that the deal involved kickbacks to Portnet executives.[14] Although these claims have not yet been proven in a legal forum, they none-the-less highlight the importance of a transparent process and a policy of full disclosure. So far, with respect to the arms package, this has not been the policy of the government and the public has good reason to be both wary and vigilant in their continued inquiries.

South Africa is also shielded from understanding exactly how this deal will be funded, and therefore from having a reasoned public discussion about the issue, because the acquisition is not in any budget projection, including the MTEF budget. In fact, South Africa is committing to making payments without yet knowing or agreeing to where the money will come from. This is of particular concern for the approximately 7.8 billion rand that will not be covered by the military or the defense budget. In as sense, then, this deal will by-pass parliamentary approval by entering into contracts with foreign governments and companies three years before parliament needs to find specific funding.[15]

This situation is both unethical and, by implication, perilous for the sparse social funding still available. If the military is going to ask the public to make a huge financial investment in armaments, they should at least be willing to ensure that the small amount of funding still available for social programs will not be jeopardized for the remaining arms payments. The public is entitled to a strong commitment from government before backing such a tremendous project.

One needs only consider the recent cutbacks on social spending programs to know that such a concern is a viable one. In the area of education, for example, the government has reduced the budget for school text books 85% since 1995.[16] It is reported that the cost of one German submarine would be enough fund such textbooks for all of the children in South Africa.

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[12] Rosenthal, J. "Furore Over South Africa's R30bn Arms Deal." *Business Report*. 19/11/98.
[13] Fine, Alan. "Sure Thing for the Black Company" *Business Day*. 19/11/98.
[14] Ka'Nkosi, Sechaba. "Shady Firm Wins R2.2bn SANDF Contract" *Mail and Guardian*. 27/11/98.
[15] Supra n 6. Page 1.
[16] Russell, A. Price of One Submarine Would Buy Books for All. *Sunday Independent*. 29/11/98.

Is this the same party that promised that promised that "education and healthcare were two of its greatest priorities?" [17] Terry Crawford-Brown, Convenor for the Coalition of Defense Alternatives, stated the it was "'obscene' to spend billions on arms when there were eight million people living in shacks and while teachers were being retrenched."[18]

It is also important to note that the opposition to this arms package comes not from one sector but from many. Among them is Water Affairs and Forestry Minister Kader Asmal, former chairman of the National Conventional Arms Control Committee (NCACC). Mr. Asmal reported in a television interview last October that he would "opt for butter rather than guns" even though he was "bound by Cabinet." Nobel Peace Prize winner and Truth and Reconciliation Commission chairman Desmond Tutu and Anglican Church head Njongonkulu Ndunganea are also publicly opposed to the deal.[19] Similarly dissenting is Pan Africanist Congress secretary-general Ngila Muedane who said, "I wish they would use that money to build houses. They have got their priorities wrong". He also expressed concern that "only big companies would benefit from the foreign investment."[20] Will this deal really help the South African economy if it serves to make the big companies bigger and create a greater divide of wealth in the marketplace?

In addition to the economic concerns, many people have spoken out about the moral obligation for increased spending in the social sector. Tobacco is an example of another issue which has both moral and economic dimensions. Minister Nkosazana Zuma responded to the argument that the new tobacco laws would create more unemployment by saying that "the interest of a healthy country, exceeded the cost of jobs that would be lost." Is there really no other investment alternative that is both financially and ethically sound?

In assessing the security threats to South Africa, one must question whether it is foreign military threats or unemployment and poverty that will more likely cause instability and unrest in South Africa. Will corvettes, submarines, helicopters, and fighter jets create security? Or will the alternative—investment in housing, health care, education, and job creation—nurture a cycle of increased productivity and economic growth, expanding resources for further social investment, fostering ongoing improvements in socio-economic well being, and laying the foundation for a stable and secure South Africa?

Peter Mothier of the Southern African Catholic Bishop's Conference also spoke eloquently on what he terms "human security".

"Poverty, illiteracy, unemployment, ill-health, lack of housing, and the like…are the things that pose a threat to our secure and prosperous future, both

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[17] Rosenthal, J. Supra n 12.
[18] Daily News Correspondent. Long Wait for R29BN Arms" *Daily News*. 19/11/98.
[19] Ngidi, Thami. "South Africa's R30-bn Arms Deal with Europe Comes Under Fire From Asmal" *Saturday Argus*. 17/10/98.
[20] "Some Parties Hail Defense Deal, Others Up in Arms" *Star*. 19/11/98.

domestically and regionally. Democracy cannot thrive under such conditions; unrest and instability follow in their wake, such that not all the submarines in the world can put right.

The military minded admit that there is no immediate threat of invasion, our neighbors are incapable of it. They also admit that we will never be in a position to repel a superpower, should it take it into its head to come calling. The threat they are mostly concerned with is that which may one day be posed by the medium powers. These are such countries as Brazil, India, Canada, Britain and France. If it is said that there is no sign of any aggressive intent on the part of these nations, the answer is given: You never know what will happen in the future- we must be prepared for an eventuality.

Let us hope that the unhoused, the unclothed, and the uneducated, the children dying of AIDS for lack of somewhat costly medicine, the other children dying simply for lack of food, and all their friends and relations, will now take comfort in the fact that we have sent a firm message to the Brazilians to stay on their side of the ocean."[21]

The Macroeconomic Implications

The thirty billion rand expenditure on arms imports will eventually exert an adverse effect on the government's fiscal deficit and the nation's trade balance. The extent of this negative impact is difficult to measure in the absence of more concrete details about the delivery programme and the financing schemes. However, several general conclusions can be drawn.

In the absence of the proposed arms acquisition package, there would be less pressure on the fiscal deficit. Taxes could be lowered, the budget deficit could be reduced, or more funds could be made available for social spending. It has been reported that only twenty-two billion rand of the proposed expenditure can be financed through the existing capital budget of the armed forces, and hence additional borrowing of 7.5 billion rand is required to finance the acquisition.[22] Thus, one or a combination of three things must happen: (1) spending must be diverted from other sectors of government, (2) taxes must be raised, or (3) the fiscal deficit must be increased. Given the pressing social priorities of transformation, the first option probably cannot be considered viable. The second and third options, however, are not implausible. Studies of the South African economy have documented the capacity of the tax system to mobilize between fifteen and twenty-five billion rand in additional tax revenue each year.[23] Statistical studies and cross-country comparisons also indicate that South Africa could incur additional public debt of approximately sixty billion rand without unduly burdening the economy.[24]

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[21] Pothier. Supra n 7. Page 7.

[22] Laufer, S. *Business Day*. 17/11/98.

[23] Harber, R. *South Africa's Public Finances*. USAID: Pretoria, 1995. Also, Samson, M. *Fiscal Policy for Job-Creating Growth*. NIEP: Johannesburg, 1997.

[24] Samson, A., K. Mac Quene, and I.C. van Niekerk. *South Africa's Apartheid Debt*. ESSET: Johannesburg, 1997. Also, Samson, M. *Fiscal Policy for Job-Creating Growth*. NIEP: Johannesburg, 1997.

This raises an important consideration: if macroeconomic factors do not rule out increased defense spending, how can they rule out increased spending on social priorities such as housing, health care, education, and job creation?

This defense package also has serious implications for the value of the rand. Since it involves a substantial increase in imports over the life of the deal, in the absence of compensating exports, the consequences for the trade balance will be negative. On average, imports will increase by approximately four billion rand per year, less adjustments for offsets. As the gap between imports and exports widens, pressure will be exerted on the exchange rate to depreciate. This may increase pressure on the South African Reserve Bank to stabilize the external value of the rand by raising interest rates. Higher interest rates will create increasingly hostile conditions, making it more difficult for people to invest in property and other large assets and for small businesses to create jobs.

This negative pressure on job creation will only be compounded by the restructuring policies necessary to finance the arms acquisitions. The 1998 Budget Review states: "The Defense Review proposes a reversal of this trend of increasing personnel and operating expenditures, to allow for increased capital expenditure. The Review therefore proposes that personnel levels be cut by approximately 30 000 to 70 000 by 2000/01. This would reduce personnel expenditure to 40 per cent and operating expenditure to 30 per cent of the total defense budget, allowing capital expenditure to increase to 30 per cent of the budget, a level last achieved in 1993/94"[25] [before the democratic elections].

Another consequence of a devaluation of the rand is that South Africa will wind up paying more for the arms than it had originally intended.[26] The payments are scheduled to start in about three years and continue for another seven. Depending on the extent of devaluation, this could constitute quite a large difference in expected verses actual repayments. However, because it is impossible to forecast with a good degree of accuracy that far into the future, it is also impossible to calculate how big a financial risk this actually represents. Does South Africa really want to gamble with precious resources?

Another weakness of this arms deal, which actually makes it less effective at combating unemployment relative to direct social investment, is that it is extremely capital intensive. Blumenfield explains that "South Africa's employment problem is exceptionally complex and not susceptible to simple solutions or quick fixes. However, any attempted solution that does not also address the fundamental problem of the relative prices of labour and capital is doomed to failure."[27]

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[25] Department of Finance. *The 1998 Budget Review*. RSA: Pretoria, 1998. (Page 5.24)
[26] van der Walt, Douw. "Turning Guns into Jobs" *Finance Week*. 29/1/99.
[27] Blumenfield, Jesmond. "Assessing South Africa's Growth Strategy" *The Royal Institute of International Affairs: Southern Africa Study Group: Briefing Paper. No. 49*. 7/98. Page 4.

The South African Council of Churches and the Swedish Christian Council concurred, stating that due to the "capital-intensive nature of weapons production, investment in the arms industry is likely to create fewer jobs than comparable investment in other sectors."

As Mike Pothier wryly writes: if this is such a great deal "why not spend a few (or many) billion more, and so enjoy a windfall far in excess of R110 billion?"[28] The obvious point being that perhaps this isn't such a great deal after all. As many others have noted, the reality is that South Africa is not going to be given the weapons for free and to make it appear otherwise is political hocus pocus.

On balance, the macroeconomic consequences of the arms acquisition package are adverse. It is not surprising that Finance Minister Trevor Manuel objected to the deal.[29] Two important issues merit attention. First, how will macroeconomic policy adjust to the pressures imposed by the military expenditures? Will the deficit target become more flexible, or will important social sectors face more austere budgets? Will monetary policy accommodate the balance of payments pressures? The second issue is related. If the government is willing to relax macroeconomic targets in order to facilitate the arms deal, why is this not possible in the case of important social objectives like health, housing, and education?

An assessment of the industrial participation scheme

The Department of Defense's press release projects the creation of 64 165 jobs resulting from this arms deal. Yet the details available to substantiate these projections are questionable. Based on international experience and the few facts that are publicly confirmed, skeptics have good reason to be wary. The Department of Defense's projections assume that the value of industrial participation will be 110.6 billion rand in exchange for 29.8 billion rand of purchases.[30] That is, for every rand spent on arms procurement, the Department of Defense expects to receive almost four rand back in foreign direct investment, increased exports, or local purchases. Yet, internationally, the average return on defense contract offsets is only about fifty percent—just an eighth of the Department of Defense's projections.[31] In only a few isolated cases has the return exceeded one hundred percent, and ***never*** has a reported negotiated offset exceeded even half of what the Department of Defense is projecting.[32] Given such a dismal program track record, the government seems to be gambling with, rather than thoughtfully investing, taxpayer money.

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[28] Pothier. Supra n 7. page 6.
[29] Laufer, S. *Business Day*, 11/17/98.
[30] Department of Defense. *Statement on Defense Acquisition Package*. RSA: Pretoria, 19/11/98.
[31] United States Department of Commerce, Bureau of Export Administration. *Offsets in Defense Trade, Third Annual Report to Congress*. U.S. Government Printing Office: Washington, D.C., August 1998.
[32] Martin, S. *The Economics of Offsets: Defense Procurement and Countertrade*. Harwood: Amsterdam, 1996. Page 41.

Even in a best case scenario, there are reasons to question these figures. The first problem is that the number of jobs created must be tempered by the number of jobs that the military plans on cutting to finance part of the purchase. Conservative government estimates forecast cutting 30,000 personnel over the next three years. Not only does will this at least temporarily increase unemployment, but there will also be a lot of money spent in the severance packages of these employees.[33] Simple math (64,165-30,000) tells us that the net job increase from this arms package in a *best case scenario*, then, will only be 34,165.

Many countries purchasing armaments negotiate compensating industrial and commercial schemes in exchange for their patronage. These practices "are designed to 'offset' the cost of procuring expensive weapons on the part of the buyer through the recovery of hard currency, employment creation in the buyer country, support of the buyer's industrial base and, significantly, technology transfer from buyer to seller."[34] The term "offsets" is used to refer to a broad range of industrial and commercial arrangements, including joint production, licensed production, sub-contractor production, foreign direct investment, technology transfer, and countertrade.[35] "Since most offset agreements are considered sensitive on security or proprietary grounds, there is virtually no authoritative data available about their extent."[36] Nevertheless, international experience documents numerous problems: failure of delivery, inflation of prices to compensate for offsets, cost overruns associated with industrial participation, and hidden costs of offsets.

One of the biggest risks is that South Africa has no way to protect itself from fluctuations in other economies. In other words, if one of the partner companies defaults on their offsets contract because their country is experiencing a recession, then South Africa will be forced to absorb this loss. As the Ceasefire Campaign asks: Would it not be preferable for "the control [of job creation] to remain in the hands of the people of South Africa?"[37]

Another troubling aspect of the proposed industrial developments is their long term utility, or lack thereof. To date, there have been no long-term studies published about the viability of the proposed developments after the arms productions finish. Two scenarios exist. One is that when the weapons production ceases, the factories are no longer cost effective and are shut down, resulting in a loss of capital and an increase in unemployment.

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[33] Batchelor, Peter. "Guns or Butter?" *NGO Matters*. 11/98. Pages 14 and 21.
[34] Todd, A. *Defense Industries: A Global Perspective*. Routledge: London, 1988. Page 126.
[35] Martin, S. Supra n 32. Pages 31-32.
[36] Newman, S. "Offsets in the International Arms Market" in *World Military Expenditures and Arms Transfers 1985* published by the US Arms Control and Disarmament Agency. Page 35.
[37] Thompson, Rob; Corlett, Letlojane; and Sheena Duncan. "The Ceasefire Campaign and Other NGOs Condemn the Arms Purchase Programme." *Letter*. 19/11/98.

A study of a Belgian armaments plant constructed as part of a defense offset documented a similar situation. After the weapons contracts were filled, the plant was found to be financially untenable on its own and had to be shut down.[38] Part of the problem related to the remote location of the factory, as is the plan for some of the plants to be built in South Africa. While it is politically and emotionally appealing to market the offsets of this deal as developing under-privileged areas, many economists think that if the development is not cost effective, it should not be built in the first place. Pothier argues that "If it were viable investors would be found, and it is therefore unnecessary to introduce an element of barter in to the equation. In addition, it might be argued that it is an inefficient way of promoting industrial development—why not spend the money directly on the stainless steel plant and then, assuming its viability, buy arms with the profits?"[39]

The second scenario is that South Africa can produce arms for export. Once the capital investment has been made in these facilities, it will be much more cost efficient to continue to produce arms for export than it will be to reinvest capital and transition costs, including training and temporary unemployment, into another industry. With this dubious financial incentive looming, it will also become increasingly difficult for South Africa to obey the mandate of the defense white paper and not sells arms to countries that commit human rights abuses. There was a concern that this policy was not fully adhered to in 1996 and it is not likely to become easier to monitor and manage if other countries get involved.[40] As Peter Batchelor explains"…there is no guarantee that this policy would survive in joint ventures, or where we were simply supplying components, ignorant of the end destination of the product."[41]

This problem leads directly into a greater concern. If South Africa invests heavily into armaments which are more suited for international warfare than national security, will we not fuel a regional arms race? Many experts believe that it will. It has been documented, in fact, that "Botswana and Namibia are already arming themselves and Zimbabwe and Lesotho view South Africa with deep suspicion."[42] This is referred to as the security paradox: "a cumulative process in which only the acquisition of weapons offers hope of security. The bind of this is that the buildup of destructive potential is infinite as each state acquires more and more weapons."[43] But will greater number of weapons in southern Africa really add to the relative security of South Africa? And, as mentioned earlier, does South Africa want to be in the position of needing to produce and sell weapons to these neighbors in order to maintain jobs in its defense industry?

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[38] Martin, S. Supra n 32. Pages 75-106.
[39] Supra n 7, Page 5.
[40] Hartley, Wyndham. "Defense Force Policy 'Falls Short'" *Business Day*. Tuesday, December 3, 1996.
[41] Batchelor. Supra n 33.
[42] Vale, Peter and Leon Pretorius. "Arms Purchase Will Fuel Regional Arms Race." Sunday Independent. 29/11/98.
[43] Vale. Supra n 42.

A case study of the Australian defense offsets programme documented a dramatic shortfall between offsets committed and actually achieved—selling countries (including France, Germany, Japan, the United Kingdom, and the United States) promised 1.5 billion Australian dollars (approximately 5.8 billion rand) in commitments but only delivered an amount equal to 0.7 billion Australian dollars (approximately 2.7 billion rand)—less than half the amount committed. In fact, in certain sectors, the actual achieved offset was a menial 2%. "This discrepancy was seen in the early 1980s as the major failure of the 'best endeavors' policy."[44] More successful policies have included strict penalties to ensure compliance, such as Indonesia's policy whereby "a firm failing to purchase all or part of the specified Indonesian products would be liable to pay a penalty of 50% of the contract value".[45]

However, penalties for non-compliance are not always effective. Even penalties of 50% of the contract value have not always deterred companies from defaulting. South Africa's penalty is a paltry 10%.[46] This is far less than the average rate of default in any of the above reported studies and is only an economic disincentive if the company defaults at less than 10%. It actually **encourages** companies to default by a large margin, as they will make a profit by defaulting more than ten percent. Even when default penalties are recovered, their value is diminished by the program's monitoring and enforcement costs. And who or what body will take responsibility for such an extensive bureaucracy?[47]

Many studies have documented the extent to which offsets simply inflate the cost of the defense contracts. Since offset arrangements impose costs on the arms merchant, there is a strong incentive to simply add these additional costs to the price of the military hardware. Since the costs to the seller are frequently greater than the benefits to the purchasing country, this process undermines the value of the deal. A 1984 review by the Australian government (the Inglis Review) found some evidence that premium prices were charged when offsets were involved.[48] A survey in the United Kingdom of arms exporters demonstrated that "offsets are not costless and that typically the buyers bear most of this cost." In most cases, one hundred percent of the cost premium associated with the offsets was added to the contract price.[49] Case studies in Belgium identify a subtle manner in which offset costs can be charged to the purchasing countries through cost overrun provisions. A purchase of fighter aircraft from the United States in 1984 encountered cost overruns exceeding thirty percent due to offsets.

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[44] Martin. Supra n 32. Page 60.
[45] Newman. Supra n 36. Page 36.
[46] Dunne, Professor Paul. "Workshop on the Policy of the Defense Related Industries" *Presentation*. 23/7/99.
[47] Pothier. Supra n 7.
[48] Joint Committee of Public Accounts. *Implementation of the Offsets Program*. Report 270. Parliament of the Commonwealth of Australia: Canberra, 1987.
[49] Martin. Supra n 32. Pages 353-354.

Another program completed in 1990 suffered nearly a hundred percent cost overrun due to offsets.[50]

It is also important to point out that although South Africa will start paying for the weapons in approximately three years, some of the projected jobs will not be available for even longer. Murray and Roberts chief executive for mining and industry Mike Wilde reported last August that it would be five years before the steel mill planned for the Industrial Development Zone (IDZ) of Ngqura (Coega) in the Eastern Cape is operative.[51] This is long time to wait for unemployment relief. How does the government plan to cope in the mean time? Would direct social investment not be more efficient?

Logistical problems account for economic distortions and hidden costs attributable to offsets. A study in the United Kingdom in the early 1990s identified a situation in which a series of small contracts were undertaken, each small enough to avoid the threshold for offsets considerations.[52] "Offset avoidance", while as legal as tax avoidance, similarly violates the spirit of the law, increases transaction costs, and creates economic inefficiencies. A study in the early 1980s found that Indonesia encountered procurement problems because of ambitious offset demands, while Brazil's offset agreements with Mexico and Ecuador were hastily constructed and failed to live up to expectations.[53] A study of the effects of offsets in Belgium found that "offsets were not only market distorting, but also economically inefficient...The eagerness of the Belgian authorities to protect defense firms against all economic good sense triggered the adoption of belated measures leading to obsolete structures, bad qualitative results and perverse effects."[54] A study by the United States government in 1988 found that for countries demanding offsets from American arms exporters, only about fifty percent of the offset obligations were precisely defined.[55] Ambiguous contracts lead to unnecessary compliance and enforcement costs.

These international experiences provide a context for interrogating the prospects of South Africa's industrial participation programme. First, it is critical to evaluate the likelihood of achieving projected results, given the ambitious targets and the often-disappointing performance of offsets programmes internationally. Second, one must assess the added cost South Africa is paying for weapons because of the industrial participation schemes, determining whether the additional expenditure on weapons is the best way to achieve industrial participation. Third, one must weigh the long run prospects of an industrial policy negotiated through offsets against a more autonomous job creation framework unencumbered by international contractual obligations.

[50] Martin. Supra n 32. Pages 95-99.
[51] Cull, Patrick. "Coega Arms Deal Boost." E. P. Herald. 19/11/98.
[52] Martin. Supra n 32. Page 353.
[53] Newman. Supra n 36. Page 36.
[54] Martin. Supra n 32. Page 100.
[55] Martin. Supra n 32. Page 41.

The public information regarding the industrial participation programme for South Africa's proposed arms acquisition deal is sketchy. The Department of Defense's press release on 19 November 1998 indicates that the deal would generate 64 165 jobs and 110.6 billion rand in industrial participation. The bulletin released the following week indicated that the industrial participation programme would last from 2000 to 2007. Investments would be spread across twenty-two projects, including electricity, electronics, manufacturing, textiles, chemicals, plastic, steel and other metal projects. These are expected to generated 59 billion rand in additional exports as well as 25 billion rand in local sales.[56]

On January 25, 1999 *Business Report* published incomplete details of the plans that Italian jewelry manufacturer Filk has proposed for South African investments compensating for armaments purchases from Italian helicopter company Augusta. Pietro Cremasco, the president of Filk, "declined to disclose the size of the planned investment or the number of jobs it would create, citing the South African government's ban on the release of information related to the offset agreement. But it is believed that the factory... would employ several hundred people."[57] Yet the Department of Defense's press release indicates that this portion of the arms deal will generate 4 558 jobs. Given these ambiguities, authoritative information regarding the details of the proposed industrial participation programmes is essential if civil society is to participate constructively in the policy debate.

Just as important is an evaluation of the prices the government must pay for the armaments and offsets package. Shortly after the announcement of the arms acquisition package, a press report indicated that the price of the approved helicopters were fifty percent higher than that of the major competitors—each Augusta helicopter would cost more than nine million U.S. dollars versus about six million U.S. dollars for newly developed aircraft from Bell or Eurocopter.[58] Another press report maintained that "the decision to buy German ships, although they are more expensive than others on offer, is understood to be based on the economic might Bonn threw behind the offer."[59] This raises the question of how much extra the government is paying for the industrial participation scheme, and whether the additional funds could be better utilized in a transparent job creation programme. Attracting foreign capital by purchasing contractual obligations through offsets may work in the short run, but directly investing in social assets that raise the productivity of workers may prove more persuasive in the long run.

[56] Department of Defense. *Benefits of the Defense Acquisition Package*. RSA: Pretoria, 26 November 1998.
[57] Rosenthal, J. *Business Report*, January 25, 1999.
[58] Rosenthal, J. *Business Report*, November 19, 1998.
[59] Laufer, S. *Business Day*, November 17, 1998.

International experience suggests that the Department of Defense's projections for industrial participation and job creation must be viewed with extreme caution, and in the absence of more concrete details, with judicious skepticism. No country has succeeded in obtaining even half the commitments indicated by the Department of Defense, and frequently the delivery has substantially under-performed the promise. In addition, several lessons merit special attention as one assesses the appropriateness of the proposed arms deal. First, industrial participation negotiated on a "best endeavours" basis is more likely to fail, and penalties as low as five percent do not provide substantial incentives for delivery. Second, frequently arms vendors simply mark up the price of the military equipment to cover the cost of the offsetting job creation schemes—which would with one stroke both inflate South Africa's defense budget while undermining the sovereignty of the nation's industrial policy. An indirect manner of marking up prices is to negotiate clauses that allow cost overruns associated with the offsets to be charged to the purchasing country. Third, in weighing the benefits of an industrial participation scheme driven by military spending, with all the associated constraints and compromises, one must always consider the alternative of a more transparent strategy whose fundamental focus is job creation.

Conclusions

In conclusion, three points merit particular attention. First, the debate over the arms acquisition package crystallizes the question of whether so many of South Africa's resources should be spent on weapons while social priorities are starved for funding. Investing in social assets that improve the productivity and well being of people may provide more far-reaching security. Second, while it is difficult to argue that the macroeconomic costs of the arms purchase preclude a manageable deal, the flexibility of the macroeconomic environment poses a more fundamental question: If taxes or borrowing can be increased in order to fund military expenditures, why cannot these resources be mobilized for more pressing social priorities? Third, the promised benefits of industrial participation and job creation in exchange for the arms purchases must be considered with caution, and perhaps skepticism. Even if the offsets are delivered as promised—which international experience suggests is doubtful—the result is nevertheless an industrial policy encumbered by *ad hoc* arrangements, negotiated compromises, and often short-term sustainability.