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India's Defence Offset Policy

Recently, the Minister of State for Defence Ajay Bhatt's reply to John Brittas in Rajya Sabha on the lapse in Offset Obligation signals the need for a new outlook on India's Defence Offset Policy. As per the statement, vendors have lapsed on offset obligation in 21 contracts in the last five years, which amounts to a whopping US$2.24bn as of December 31, 2021.

In this context, the objectives of India's Defence Offset Policy need to be rethought to facilitate innovation-based transformation. Perhaps, aiming to formulate a National Offset Policy (NOP), rooting toward economic development and industrial benefit, is the need of the hour. This Briefing Paper draws from the best practices of global offset policies to guide India in breaking the loop of India's offset policy experience.

Introduction

Offset is a flow-back contractual agreement, between supplier and buyer, in the form of a certain percentage of the contract value. The supplier is a foreign vendor, and the buyer is the government. In India, defence is the only sector with a defined offset policy. In this sector, offset is a condition of purchase of defence equipment where the estimated value exceeds M2,000 crore. This policy obligates the foreign supplier to invest at least 30 per cent of the contract value in India through one or more of the prescribed avenues.

It is important to note that WTO prohibits offsets in international trade as it distorts the standard practice of trade but provides exemptions on national security grounds. The national security exception clause allows nations to make defence procurement purchases with offset expectations and/or to favour their national defence industries.

Globally, more than 130 countries have offset policy. There exist numerous debates on the effectiveness of offset policy domestically and globally. The lack of publicly available data on defence procurement hinders formulating a conclusive answer on the efficacy of offset policy as a success or a failure.

Further, contestations over offset policy, often using specific case studies, are broadly three. First, most economists argue that offsets have little positive impact on economic development, and the second category argues it is a 'free lunch'. The third group claims a compound annual growth or cumulative growth does occur from offset policy.

Perhaps, one of the criteria for analysing a policy's success is drawing a comparison between its objective and its outcomes. Often there are three main aims for which any country adopts offset policy: a) economic development, b) technology transfer, and c) industrial benefit.

In the case of India, it adopted the offset policy in 2005 under Defence Acquisition Procurement Procedure (DPP). Since then, there have been multiple contestations and lapses in offset policy. The most recent is Minister of State for Defence Ajay Bhatt's reply to Member of Parliament John Brittas in Rajya Sabha, which revealed the lapse in offset obligation.

As per the statement, vendors have lapsed on offset obligation in 21 contracts in the last five years. The lapse amounts to US$2.24bn as of December 31, 2021. The Comptroller and Auditor General (CAG) has periodically submitted reports on lapses in undertaking offset obligations.

Hence, it signals the time for a new outlook on India's offset policy. The policy has evolved over the years incorporating many critical revisions, making it conducive for both buyer and seller.

This Briefing Paper distinguishes between the policy objective and implementation of India's offset policy. The focus here is on revamping the policy's objective, drawing from the offset experience of countries like Canada, Saudi Arabia, Brazil, Israel and Japan. Countries at different stages of development are focused here on making it conducive for adopting the best practices for India to facilitate offset-enabled innovation.

India's Offset Policy

Despite periodic reformulation of the offset policy, it seems to have multiple shortcomings. CAG's audit reports on the procurements indicate an under-realisation of offset benefits, including zero-value additions, invalid selection of Indian Offset Partners, inability to levy penalty from vendors; delay at different stages from contract to delivery; poor monitoring and supervision. According to Institute for Defence Studies and Analysis's (IDSA) study, one of the observations made was that the offset policy has a minimal impact, especially in the Transfer of Technology.

One of the primary aims of India's OP is to strengthen India's arms industry. Vendors can undertake offset through purchasing goods and services from the Indian defence industry, Transfer of Technology (ToT) and investment in local entities. Broadly, the offset policy over the years has evolved and articulated objectives of offset policy; broadened avenues for the discharge of the offset obligations; streamlined applicability of offset; refined mechanisms of implementation and monitoring; flexibility for vendors to plan offset activity; incorporated multipliers.

Incorporating flexibility to facilitate offset, DPP 2013 introduced offset provisions in synergic sectors like civil aerospace and internal security, only to be removed later. In a nutshell, India's offset policy experience from its introduction targeting the strengthening of India's arms industry and ToT has been minimal.



What does the latest DPP, renamed Defense Acquisition Procedure (DAP), say about offset? Exemption from offsets accorded to all single source foreign procurements and raising the limit of contracts entailing offset obligation from M300 crore to M2,000 crore in 2016 has made many experts argue that the government is gradually giving up or has realised offset is a non-mover. Here, the experience of other countries on offset will be crucial to revamping India's offset policy.

Global Offset Policy – Some Examples

The objective of offset policies varies worldwide, and it is the objective that largely shapes offset obligations. Hence India should begin by revamping the objectives of the offset policy and, in this light, looking at the case study of a few countries' experiences with offset.

Canada

The Canadian government has adopted the offset policy since the 1970s. The evolution of the offset policy of Canada started from the realisation of a shortage of capability for a large defence base**.** The initial focus of offset policy was on companies conducting economic activity for regional benefits, while today, obligations are around areas desired by the government.

Currently, Canada provides 'specialisation in sub-systems and components as tier two and three suppliers to larger original equipment manufacturers (OEMs)'. Canada has the best models, which incentivise the OEM to invest in MSME. Lockheed Martin had leveraged offsets for cutting-edge R&D technologies in Canada.

The latest offset policy, named the Industrial and Technological Benefits Policy (ITB, 2018), is connected to Canada's key industrial capabilities. It focuses on the growth of bidders and suppliers of Canada, increases the export potential of Canada-based firms, promotes skills, training and employment, and enhances innovation through R&D.

Saudi Arabia

While the core aim of Economic Offset Programmes (EOP), when introduced in Saudi Arabia (KSA) in 1983, in addition to **national security objectives**, was to make it more of a knowledge-driven economy. Thereby gradually reducing the heavy dependence on its oil-driven economy.

An example of offset aiming for a knowledge-driven economy is Boeing's sale of the Peace Shield land-based air defence system partnering with the Saudi Arabian General Investment Authority (SAGIA), and undertaking an education and training programme.

The EOP mandates an offset obligation of 35 per cent to facilitate **high-quality technical jobs** for Saudi workers and requires the usage of Saudi-origin products on priority, including subcontractors. The only exception is to procure components from outside if components are not domestically available.

Offsets aim to increase investment in sectors such as the aerospace and automotive industries. EOP envisages partnership from private players. *"The private sector has become much more involved in the EOP, largely because its expansion into civilian areas offering new opportunities for companies".*

Another instance of a successful offset-led initiative was the establishment of Synthomer Middle East in 1996. It came out of a Joint Venture initiative between Dhahran Chemical industries and the UK's Synthomer as part of the UK government and BAE System. UK's Synthomer produced polymer dispersants for West Asia's paints and adhesive markets. Now, the Synthomer Middle East specialises and exports in polymer business with an increase of three-fold export.

Israel

Israeli economy benefits from the highly skilled workforce, having a high wage rate compared to many Western countries. The Israeli government provides large subsidies, financial incentives and tax holidays for R&D investments. Within over half a decade, Israel changed from an agrarian economy to an industrialised one. It is predominantly known as the centre of high-end technology.

The primary aim of the offset policy in Israel is industrial cooperation between domestic and foreign industries under the Industrial Cooperation Authority (ICA). The mutual benefit of both parties was the critical element. One of the challenges for Israeli industries was an inability to access large global markets. Offsets were used to mitigate this challenge and generate new jobs, technology transfer, and investments. This cooperation in the long term enables the domestic Israeli firms to add value in strategic partnering.

However, the unique aspect of the Israeli offset policy is its flexibility. Offsets differ for civil and military procurements, with offset obligations of 35 per cent and 50 per cent, respectively. There are provisions for pre-offset arrangements without specific obligation and banking of offsets. Overall, the offsets in the private sector are higher than those in the government sector. There are no compulsory investment sectors, allowing flexible time frames to offset obligations.

An instance of a successful offset policy of Israel is the purchase of combat aircraft in 1994 from Mc Donnell Douglas, who agreed to a 100 per cent offset package. The Transfer of Technology that came out of this offset enabled the development of Israeli Aircraft Industries, Cyclone Aviation Products, Israeli Military Industries and TAT Aero allowing them to be competitive in export markets.

Japan

Japan's economy underwent a drastic shift post second World-War years. Japan stands as evidence of effective utilisation of strategic attention. Technology transfer and special provisions to undertake licensed production of high-tech military equipment and unique relation to the US facilitated the industrialisation of Japan. Parallelly, there were investments in human resources and education. In net effect, this resulted in high technological development both in the defence and civilian sectors.

The objective of self-sufficiency in technology and indigenisation of defence production guided the technology inflows from the defence offsets. Currently, Japan produces 90 per cent of its

defence equipment, be it in the Military, Naval or Aerospace. The most famous example of spinoff effects of defence technological production on the civilian sector is Japan's famous Bullet Train, which came from the residual effect of co-producing F-86 aircraft.

The peculiar aspects of the Japanese economy were the closely knitted development of the defence and civilian sectors. Japan's strategic industries focus on **dual-use technologies**. This is an important sector where spinoffs and reverse spinoffs benefit the defence and civilian sectors. In addition, **subcontracting** to companies that missed out on the bid facilitated mediating overdispersion and over-concentration of technology development, ensuring offsets not just benefit the primary contractor. Both the government and the private sector facilitate the **R&D.**

Spain

Spain is an instance from Europe and a developing country which successfully used a defence offset policy for industrialisation mediated through government-owned production entities**.** These industries were provided tariff protection with export-oriented production, and Spain developed niche expertise in the electronic industry. Offsets from the foreign military purchases, R&D facilitation and subsidy support to the military electronics and engineering industry remained the key to boosting the sector. All of these were mediated by a single body, the Offset Management Office (OMO).

The objectives of the Spanish offset policy were developing domestic firms in aerospace and electronics, targeted transfer of technology; access to the global export market for Spanish

firms and creating employment opportunities. Spain's offset policy is categorised into designated offsets, aerospace co-production offsets, indirect offsets and indirect commercial offsets. However, offsets were facilitated or favoured in specific sectors where Spain traditionally excelled, like chemicals, pharmaceuticals, iron and steel and electronics.

Unlike Japan, Spain could not absorb much direct defence offset, even though the limited tech transfer created capabilities in electronics, radars, automated test beds and simulators. Even though large firms reaped direct offset in Spain, indirect offsets are dispersed among many small firms. The latter added offset value to the Spanish economy. This made Spain revamp offset policy targeting smaller scale, structured, co-production and co-development agreements.

Brazil

The principle of the Brazilian offset policy was **self-sufficiency** in the defence sector through licensed production, co-production and joint ventures focused on ToT. Embraer Cooperation has been a significant player in the aerospace sector since 1969. Over the years, offset policies with different countries gradually co-developed other parts.

Currently, Brazil is embarking on a next-generation fighter replacement programme. The success in aerospace has successful effects on the civil aviation sector, and the Naval industry has a similar success story. The focus of the policy remained on technological evolution than on any objectives as seen in other countries. Hence, the offset policy has successfully facilitated Brazilian industries in co-design, developing and producing advanced aircraft in addition to benefits in technological benefits and civilian sectors.

Conclusion and Recommendations

Some questions are pertinent to be raised here. What can India learn from these different models of offset policies? What is India looking to achieve through offsets? Where can India begin to revamp its offset policy to be a successful case?

Perhaps, the Indian offset policy needs and can respond to the Indian environment. India must inevitably focus on employment opportunities with the largest working-age population and rising unemployment. The strategic location and global shift in focus to Indo-Pacific necessitates and facilitates strong defence capabilities. Economic growth and being an economic powerhouse are crucial in enabling India to be a rising power.

A comparative analysis would be helpful here. Canada adopted its offset policy, realising **of a large defence industrial base** shortage. A similar but different case exists for Japan post the World War. Japanese industrial development and indigenisation of the defence sector. India needs to develop the defence sector regarding equipment access and harp spinoff effects from such an industrial base.

All the offset models, be it Canada, Japan, Saudi Arabia, Israel, Spain and Brazil, all had similar or identical conditions when they adopted offset policy as India today. Objectives of offset policy in these respective countries were shaped in response to these conditionalities of the economy.

The objective of **national securit**y is the core of the offset policy. They were often phrased in different notations of self-sufficiency or indigenisation in the respective country's defence sector. This runs as a common theme of all countries adopting offset policy. Also, the objectives of offset policy in these respective countries were shaped in response to the **conditionalities of its economy,** that is, focusing on a factor other than the defence sector requirement.

Another commonality is the significance of **relationships with the US.** The key to the bilateral between Canada and the US was the establishment of Defence Production and Sharing Arrangements (DPSA) and Defence Development Sharing Agreement (DDSA). Canada and Japan benefited from a close relation to the US in acquiring transfer of technology through offset and emerging as a strong defence industrial base. High-income countries always benefit from technological innovation and the development of cutting-edge technology. The US is a powerhouse of innovation, especially in the defence sector.

Today, Canada and Japan are strong contenders for the US in supply to OEMs. Currently, India holds a robust bilateral relationship with the US. This cannot be any better with the coming in of the CAATSA waiver. India should be able to capture the strategic attention it is receiving in negotiating a tangible outcome.

In addition, generating **employment** is a parallel thread in offset policy, either directly or in a spinoff effect. Saudi Arabia's one of the aims of the offset policy was to generate highly skilled technical jobs. Boeing with the SAGIA undertook a training and education programme in the offset obligation. Similarly, initiatives like training and skill development can be a strong policy orientation for India's offset policy enabling the skilling of the sizeable unemployed youth. India discontinued the service sector offset post VVIP helicopter scandal, but such an approach is heedless.

Nevertheless, **spinoff effects** come with development in the defence sector had a cross-cutting impact on diverse sectors. The boost in technological development creates a ripple effect in the civilian sector. The story of the aerospace and automotive industries of Saudi Arabia, the transportation sector (Bullet train), the advancement of dual-use technologies in Japan and the electronics and aerospace industry's progress in Spain are numerous instances of spinoff effects of offset policy-led technological advancement. The spinoff effects can be a direct flow from the offset policy or an indirect spill-over to another sector.

In this regard, **diverting offsets to the country's strong sectors** like Saudi Arabia has offset policy focus on Chemical industries and Brazil's targeted focus on the aviation sector. India's IT sector is one such sector, if focused, that can reap technological innovation, and IT also falls in parallel as a dual-use technology.

Non-concentration of benefits of offset to few players. One of the mechanisms can be Japan's model of **subcontracting** procurement to companies that lost the bid or are not the primary

vendor. Spain adopted a similar policy through the indirect offset category, ensuring a horizontal growth of multiple companies deriving benefits from the same contract.

Parallelly, **Single window management** of offsets like SAGIA of Saudi Arabia, Israel's ICA, OMO of Spain, and India needs to revamp its defence procurement agency or wing or department (Defence Offset Facilitation Agency or the Defence Offset Management Wing or the Capital Acquisition Wing) with an arm's length from the Ministry of Defence (MoD). It should be moved to the Ministry of Commerce and Industry or the Department of Economic Affairs in Finance, which also conducts international economic negotiations. Thus, decisions should be taken in the larger interest of the Indian economy. A good example of arm's length in the Indian Administrative structure is the Commission of Railway Safety under the Ministry of Civil Aviation and not the Railways.

In addition, the procurement agency's key focus should be on constituting experts specialising in foreign trade, national economic priorities, and technology in procurement negotiations. Over the years, frequent personnel changes have affected the procurement agency

adversely; hence, specialisation and fairly consistent tenure in the agency must be prioritised.All case studies show that countries focusing on R&D development in offset policy can gradually turn to technology-led innovation. India's R&D sector requires major uphaul, and specifically, the defence sector needs to target the co-design and development of equipment.

India's offset policy should aim to get companies to move beyond the contract-bound manufacturing under offset and diversify to other sectors. Perhaps, this can be done by relooking at offset policy's objectives, flexing the scope of offset to more civilian sectors and, in effect, ensuring vendors from non-lapse in offset obligation aiming toward a National Offset Policy.

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